

Department of Labor – Fiduciary Advice Definition and Conflict of Interest Rule

May 11, 2015

On April 14, 2015, the U.S. Department of Labor (“**DOL**”) released its long-awaited re-proposed regulation redefining who is a “fiduciary” under Section 3(21) of the Employee Retirement Income Security Act of 1974, as amended (“**ERISA**”), by reason of providing “investment advice” to ERISA plans and IRAs (“**Reproposal**”). The Reproposal expands the types of individuals and entities that would be viewed as “investment advice” fiduciaries, and provides carve-outs for certain activities that could give rise to fiduciary status. In addition, the Reproposal includes amendments to six existing DOL “prohibited transaction” class exemptions (“**PTEs**”) and introduces two new exemptions, including a “Best Interest Contract Exemption,” which allows some retirement account advisers to continue to receive payments that create a conflict of interest if the adviser commits to impartiality and meets other contractual, recordkeeping and reporting requirements. If enacted, the Reproposal will have a significant impact on the delivery of services to ERISA plans and IRAs and related compensation practices for the financial services industry.

Below is an overview of the Reproposal and some of our initial thoughts on its key implications. We have also included summaries of the [terms and conditions of the new PTEs](#) and [amendments to existing PTEs](#).

I. The Reproposed Rule

Under the current ERISA regulations (the “**Current Rule**”), a person is deemed to be a fiduciary by reason of providing “investment advice” if that person: (1) renders advice as to the purchase, sale or value of securities or other property, (2) on a regular basis, (3) pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a plan fiduciary, that the advice will (4) serve as a primary basis for investment decisions with respect to plan assets, and (5) the advice will be individualized to the particular needs of the plan (the “**Five-Part Test**”).

In 2010, the DOL proposed to expand the definition of “investment advice” for purposes of fiduciary determinations by eliminating this Five-Part Test (“**2010 Proposal**”), but withdrew the proposal in 2011 in the face of strong opposition from members of both parties of Congress and the financial services industry.

The Reproposal like the 2010 Proposal dispenses with this Five-Part Test and states that a person will be deemed to provide investment advice if that person provides advice in any one of the following four categories:

- (i) *investment recommendations*: a recommendation as to the advisability of acquiring, holding, disposing of or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
- (ii) *investment management recommendations*: a recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
- (iii) *appraisals of investments*: 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 or transactions involving the acquisition, disposition or exchange of such securities or other property by the plan or IRA; or

(iv) *recommendations of persons to provide investment advice for a fee.*

Persons who provide such investment advice will generally fall within the fiduciary definition if they either directly or indirectly (*e.g.*, through or together with an affiliate) (i) represent or acknowledge fiduciary status, or (ii) provide the advice under an agreement, arrangement or understanding that the advice is individualized to, or specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property.

Similar to the 2010 Proposal, the Reproposal eliminates the “regular basis,” “mutual understanding” and “primary basis” elements of the Five-Part Test, significantly lowering the bar for the finding of an investment advisory relationship. When coupled with the additions of “investment recommendations” and “investment manager recommendations”, the Reproposal converts a broad range of informal communications between plans and their service providers, such as brokers and bankers, into *per se* investment advice. Like the 2010 Proposal, it appears that the agreement or understanding may be one-sided and the advice could constitute a discrete comment where the service provider has no expectation that the comment may be considered by the recipient. The Reproposal also clarifies the DOL’s position that recommendations of investment managers, not just securities or other property, constitute investment advice.

Implications for Financial Institutions. The Reproposal as drafted will have a significant impact on the practices of bankers or brokers who provide low-cost banking or brokerage services. For example, the practice of relationship bankers or brokers to provide lists of more than three potential asset managers in an effort to avoid the conclusion that the plan was relying on the advice as a “primary basis” for its investment decision may no longer be a workable approach. Bankers or brokers who provide ancillary services to plans and IRAs, such as lists and reviews of third-party mutual funds or investment products, could be characterized as investment advice fiduciaries if the plan or IRA invests in one of the listed funds or products. The breadth of the Reproposal and its limited exceptions discussed below call into question situations the market has not considered to be fiduciary in nature.

If the Reproposal is finalized without any substantive revisions, retail brokerage firms will need to consider modifying their business practices when dealing with plans and IRAs including (i) halting the provision of any written and oral information to plans and IRAs, (ii) complying with the onerous terms and conditions of the Best Interest Contract Exemption (described below), (iii) changing their advisory arrangements to fit within another DOL exemption or sanctioned investment advice program (*e.g.*, providing advice through an “eligible investment advice arrangement” such as a level fee or computer model program, the terms and conditions of which are set forth in Section 408(b)(14) of ERISA or through a SunAmerica type program described in Advisory Opinion 2001-09A) or (iv) moving their retirement plan and IRA clients into managed account programs.

The treatment of plan or IRA rollover advice as “investment advice” is a departure from the DOL’s position in Advisory Opinion 2005-03A, where it stated that it is not fiduciary advice to make a recommendation as to plan distribution options even if that advice is accompanied by a recommendation as to where the distribution would be invested. In the Reproposal, the DOL attempts to distinguish between a recommendation to take distributions or to entrust plan or IRA assets to particular managers or investments (which would be considered investment advice) and the provision of information about plan or IRA distribution options, including the consequences associated with the available types of distributions, which would not be covered by the rule.

Implications for Hedge and Private Equity Funds. Asset managers, through their sales and investor relations personnel, provide investment-related information to potential plan investors such as pension-related strategies and solutions, trend reports, market forecasts and analysis relating to particular managers or market sectors. Unless the provision of such information falls into the counterparty or

investment education exceptions described below, these practices could be construed as investment advice under the Reproposal. In order to reduce the risk of potential fiduciary claims where a fund investment performs subpar, the practices and protocols of sales and investor relations personnel and placement agents should be reviewed and reassessed. Fund placement agents would likely want to make very clear to investing plans that they are acting in their own interest and as agents of the fund.

If access to a hedge or private equity fund is being considered for a defined contribution plan (e.g., a 401(k) plan) investment platform, interaction between the fund sponsor or its agents and the plan investment committee could raise the question whether investment advice has been provided to the committee. The proposed counterparty exception should be helpful in many circumstances; however, for plans and plan representatives that do not meet the requirements, responding to even informal requests for information could be construed as investment advice.

Exceptions to Fiduciary Investment Advice Status

Similar to the 2010 Proposal, there are exceptions to investment advice status. Some of these exceptions were included with the 2010 Proposal and some of which were not. These exceptions include the following:

1. Counterparty Exception

Providing incidental advice or recommendations in connection with an arm's length sale, purchase, loan or bilateral contract between an expert plan investor and a counterparty would not give rise to fiduciary status provided that several conditions are met.

(a) Counterparty transaction with plan fiduciary with financial expertise

For the Counterparty Exception to apply to a transaction, either of the following must be true:

- (i) The plan must be represented by a fiduciary with responsibility for managing at least \$100 million in employee benefit plan assets (the counterparty must confirm the value of the fiduciary's assets under management either by relying upon the plan's most recently filed Form 5500 or by obtaining a written representation from the fiduciary regarding its assets under management); or
- (ii) The independent plan fiduciary must make the following representations:
 - (A) it exercises authority or control with respect to the management or disposition of the plan's assets,
 - (B) the plan has 100 or more participants covered under the plan, and
 - (C) the independent fiduciary will not rely on the provider to act in the best interest of the plan, to provide impartial investment advice or to give advice in a fiduciary capacity.

In both cases, the service provider needs to disclose to the plan fiduciary the existence and nature of its financial interests in the transaction and inform the plan that it is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity. Further, it 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.

Implications. This carve-out resembles the "seller's rule" in the 2010 Proposal but is much narrower in scope. While the DOL is seeking comments as to whether the requirements that the independent plan fiduciary manage at least \$100 million in plan assets or the employee benefit plan have at least 100 participants are the appropriate thresholds, the DOL does not intend to extend the carve-out to include recommendations to retail investors, including small plans, IRA owners and plan participants and beneficiaries. In that regard, the DOL is of the view that investment recommendations to retail investors do not fit the "arms-length" requirement of this carve-out. Many financial institutions rely on provisions in

their customer agreements and “big boy” letters from “Qualified Professional Asset Managers” (“**QPAMs**”) or “In-House Asset Managers” (“**INHAMs**”); if the DOL does not conform its “independent plan fiduciary” definition to the QPAM or INHAM definitions in the final regulation, counterparties to plans will need to review and revise their forms of contracts, agreements and subscription forms to include the representations and disclosure statements set forth above.

(b) Swap and security-based swap transactions

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 of 1934, as amended, with employee benefit plans of any size (not IRAs) would not constitute investment advice if (i) the plan is represented by a fiduciary independent of the counterparty; (ii) the counterparty is a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant; (iii) the counterparty is not acting as an adviser to the plan in connection with the transaction; and (iv) in advance of providing any recommendations with respect to the transaction, the person obtains a written representation from the independent plan fiduciary that the fiduciary will not rely on recommendations provided by the person.

Implications. Perhaps to avoid criticism that the swap exception is inconsistent with other regulatory regimes, the conditions to this exception are largely consistent with representations that apply to ERISA plans set forth in Schedules 5 and 6 of the ISDA 2012 August DF Supplement, which adopts the best conduct rules issued by the Commodity Futures Trading Commission pursuant to the Dodd-Frank Act.

2. Employees of the Plan Sponsor

Employees of a sponsor of an ERISA plan would not be treated as investment advice fiduciaries with respect to advice they provide to the fiduciaries of the sponsor’s plan as long as they receive no compensation for the advice beyond their normal compensation as employees of the plan sponsor.

Implications. This exception is in response to the DOL’s recognition that internal employees routinely provide reports and recommendations for investment committees and other named fiduciaries of the sponsor’s plan that are incidental to their employment duties for the sponsor, without acting as paid fiduciary advisers.

3. Platform Providers/Selection and Monitoring Assistance

Service providers such as record-keepers and third party administrators who market or offer a platform or selection of investment vehicles to participant-directed individual account plans under ERISA, or assist plan fiduciaries in monitoring such investment vehicles, would not be considered investment advice fiduciaries so long as they disclose in writing that they are not undertaking to provide impartial investment advice or give advice in a fiduciary capacity.

Implications. The Reproposal clarifies a corresponding provision in the 2010 Proposal that offering investment alternatives meeting objective criteria specified by the plan fiduciary or providing objective financial data (e.g., expense ratios, fund size or asset type) regarding available alternatives to the plan would not cause a platform provider to be an investment advice fiduciary. Notably, the carve-out does not extend to IRAs.

4. Financial Reports and Valuations

Persons who provide appraisals, fairness opinions or statements of value to:

- (i) employee stock ownership plans (“**ESOPs**”);

- (ii) collective investment funds or pooled separate accounts in which more than one unaffiliated plan has an investment or which holds “plan assets” within the meaning of 29 C.F.R. Section 2510.3-101 (“**Plan Asset Regulations**”) of more than one unaffiliated plan; or
- (iii) a plan, plan fiduciary, plan participant or beneficiary, an IRA or IRA owner solely for purposes of compliance with the reporting and disclosure provisions under ERISA, the Internal Revenue Code of 1986, as amended (the “**Code**”), or any other applicable law would not be considered investment advice fiduciaries.

Implications for Appraisers. The Reproposal provides that only valuations provided in connection with a particular transaction would be considered fiduciary acts. While the Reproposal has carved out appraisers of ESOPs as fiduciaries, the DOL cautions that valuations provided to ESOPs will be subject to separate regulatory guidance.

The Reproposal offers relief to IRA custodians if they provide valuations for purposes of compliance with reporting obligations, including Forms 5498 and 1099.

Implications for Hedge and Private Equity Funds. One of the open questions of the 2010 Proposal was whether the provision of pricing and valuation services by prime brokers, administrators or managers of private equity or hedge funds would cause those service providers to be investment advice fiduciaries. While the DOL’s clarification that valuations of a fund portfolio and fund shares by the general partner of a fund and its service providers does not make the general partner or service providers fiduciaries is helpful, a question remains as to whether provision of the foregoing information to single investor funds composed of one ERISA plan or group of affiliated plans could make a third party administrator or prime broker, for example, a fiduciary for valuation purposes.

5. Investment Education

If adopted, this provision would supersede the DOL’s Interpretative Bulletin 96-1 (“**IB 96-1**”). IB 96-1 has been relied upon as guidance for distinguishing between the furnishing of information and investment advice. Consistent with IB 96-1, the Reproposal lists several categories of investment-related information and materials that would be considered investment education and not investment advice if provided to a plan, plan fiduciary, participant or beneficiary, IRA or IRA owner: (i) general plan information and materials; (ii) general financial, investment and retirement information; and (iii) asset allocation models and interactive investment materials where the models and materials are based on generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time and that disclose the assumptions on which such models are based.

Implications. Unlike IB 96-1, the Reproposal includes a condition that none of the information and materials may include recommendations with respect to specific investment products or investment managers or the value of a particular security or other property. Specific alternatives or distribution options available under a plan or IRA may not be provided unless such alternative or option is specified by the plan participant, beneficiary or IRA owner. One point for clarification is whether the provision of such investment alternatives and options can be initiated by the service provider. As mentioned above, the narrowing of IB 96-1 will limit the types of information brokers, bankers, consultants, sales and investor relations personnel can provide to retail plans and IRAs without incurring fiduciary status.

6. Brokerage Services

The Reproposal preserves the carve-out under current law for a broker acting as an agent in a securities transaction, so long as the client specifies the security, price range, time span for the transaction (not to exceed 5 business days) and the minimum or maximum quantity of the security which may be purchased or sold within such price range.

Implications. The DOL over time has clarified that certain services provided to plans are not fiduciary acts (see, e.g., Advisory Opinion 2013-01A (the liquidation by a clearing member of the swap contracts in an

ERISA plan's account or sale of margin posted by the ERISA plan are not fiduciary acts); Advisory Opinion 82-049A (similarly, the liquidation by a futures commission merchant of contracts or margin in the futures account of an ERISA plan that was in default is not a fiduciary act)). It would be helpful if the Reproposal in its final form consolidates the DOL's past advice and expands this carve-out to include other non-fiduciary relationships to plans.

II. Overview of New Class Exemptions

The 2010 Proposal was heavily criticized for not addressing the prohibited transaction relief that would have been necessary to deal with the conflicts that result from reclassifying traditionally non-fiduciary activity as fiduciary in nature. In response to the criticism and in recognition of the significant impact of the Reproposal, particularly on retail brokerage practices, the DOL has proposed a "Best Interest Contract Exemption" from the prohibited transaction provisions of Section 406 of ERISA and Section 4975 of the Code. The exemption permits non-discretionary investment advice fiduciaries and the financial institutions that employ them to continue to receive and retain compensation that could otherwise be deemed to be a conflict of interest in connection with the purchase, sale or holding of "Assets" of individual ERISA plan participants, IRAs or the plan sponsor of a non-participant-directed plan with under 100 participants ("**Retirement Investors**"). "Assets" is defined to include only highly liquid securities. It is unclear why the exemption does not extend relief to plan sponsors of small participant-directed plans with less than 100 participants.

The DOL states that "the exemption is designed both to impose broad fiduciary standards of conduct on advisers and financial institutions, and to give them sufficient flexibility to accommodate a wide range of business practices and compensation structures that currently exist or that may develop in the future." In a marked departure from existing PTEs which are prescriptive in nature and limited to much narrower categories of investments and transactions, the proposed exemption is principles-based and requires advice provided to retail Retirement Investors be in their best interest.

Under the proposed Best Interest Contract Exemption, the adviser and firm must include representations and warranties in all advisory contracts including: (i) an acknowledgement of fiduciary status; (ii) a commitment to adhere to basic standards of impartial conduct; (iii) a representation that they will comply with applicable federal and state laws governing advice and that they have adopted policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest; and (iv) disclosure of basic information on their conflicts of interest and the cost of their advice. The contract can require the parties to arbitrate claims but as under existing FINRA rules, the contract cannot 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.

The inclusion of these representations and warranties permit plans and IRAs to bring state law claims for breach of contract and are particularly important for IRAs. IRAs are subject to the prohibited transaction rules of the Code but not ERISA. Unlike ERISA plan participants, IRA owners do not have a statutory right to bring suit against fiduciaries for violations of the prohibited transaction rules and fiduciaries are not personally liable to IRA owners by statute for violating such requirements of the Code. Since the DOL also does not have authority to enforce prohibited transaction rules against IRA fiduciaries, these new contractual requirements would provide an avenue for IRA owners to bring a cause of action against advisers and their firms.

The exemption requires advisers to satisfy what are referred to as "**Impartial Conduct Standards**" (*i.e.*, the fiduciary acts in the best interest of the plan or IRA, its compensation must be reasonable and any statements about recommended investments, fees, material conflicts of interests and any other matters must not be misleading). The terms of the Impartial Conduct Standard are general and perhaps purposefully vague. If a fiduciary advises a client to invest in an investment product from which it will derive a higher amount of compensation, it must be able to defend this advice as being in the best

interest of the client. The exemption also imposes significant disclosure and recordkeeping conditions on both the adviser and the financial institution, including the maintenance by the institution of a webpage easily accessible by the public that would disclose the adviser's personal compensation information. The DOL has also proposed a Pre-Existing Transaction Exemption which would exempt compensation received by the adviser and financial institution in connection with the purchase, sale or holding of an "Asset" that was effected before the "applicability date" of the Reproposal. But like the Best Interest Contract Exemption, this exemption would not exempt any compensation received in connection with a transaction involving any security, derivatives or other investment product that is not included in the "Asset" definition. Query whether the Best Interest Contract Exemption will be functional or whether best interest is always unclear especially with 20/20 hindsight.

The DOL is also proposing a separate PTE that would permit principal transactions in certain debt securities between a plan or IRA owner and an investment advice fiduciary (the "**Principal Transactions Exemption**"). The Principal Transactions Exemption includes all of the contract requirements of the Best Interest Contract Exemption plus specific conditions related to the price of the debt security involved in the transaction. The adviser is required to 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. The adviser would also need to disclose the mark-up it expects to receive on the transaction.

The DOL is seeking comments on a proposal to craft an additional streamlined PTE that would apply to compensation received in connection with investments by plans, participants, beneficiaries and IRA owners in certain high-quality, low-fee investments, subject to fewer conditions than the Best Interest Contract Exemption.

III. Overview of Amendments to Class Exemptions

The DOL has proposed amendments to six existing class exemptions, PTE 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128, which are regularly relied upon by financial service providers. Principal among the proposed changes are the following:

- Imposing the "Impartial Conduct Standard", which is described above, upon fiduciaries as a condition to each of the exemptions;
- Excluding investment advice fiduciaries to IRAs from exemptive relief under PTE 86-128 for the receipt of compensation in connection with the execution of agency transactions or PTE 84-24 for commissions earned in connection with the purchase and sale of annuity contracts that constitute securities and transactions involving the purchase of mutual fund shares; accordingly, they would have to rely upon the Best Interest Contract Exemption for these transactions;
- Narrowing the definition of "commissions" under both PTE 86-128 and PTE 84-24 to exclude revenue sharing, administrative or marketing fees;
- Revoking PTE 75-1, Part I(b) and (c), which provides exemptions for the provision of certain non-fiduciary services to plans and IRAs. The DOL noted that the statutory exemption under ERISA Section 408(b)(2) is more appropriate to cover the provision of non-fiduciary services; and
- Revoking PTE 75-1, Part II(2), which provides exemptive relief for fiduciaries receiving commissions for the sale of third-party mutual fund shares out of their own inventory to plans and IRAs. The DOL has proposed providing relief for PTE 75-1, Part II(2) transactions under PTE 86-128 but has significantly narrowed the definition of "commission" to only permit the receipt of front-end sales loads by a dealer acting as principal. 12b-1 fees, revenue sharing payments and marketing, administrative, sub-TA or sub-accounting fees would not be permitted. While investment advice fiduciaries would be able to recommend third party mutual funds and receive

12b-1 and other fees, there is no comparable relief for discretionary managers offering non-proprietary funds through managed account programs.

The amendments to each of the proposed exemptions are outlined in more detail in the attached charts.

* * * * *

The initial deadline for comments on the Reproposal is currently scheduled for July 6, 2015. According to the DOL, a public hearing will be scheduled shortly after the close of the initial public comment period and the public record will be reopened for additional comments after the public hearing. Any final rule would be effective 60 days after publication in the Federal Register and the requirements of the final rule would generally become applicable eight months after publication of a final rule, subject to certain exceptions. We would be happy to discuss the implications of the Reproposal on your firm's business and compliance programs at your convenience.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Cynthia Akard	650 752 2045	cynthia.akard@davispolk.com
Erin K. Cho	202 962 7077	erin.cho@davispolk.com
Jeffrey P. Crandall	212 450 4880	jeffrey.crandall@davispolk.com
Edmond T. FitzGerald	212 450 4644	edmond.fitzgerald@davispolk.com
Kyoko Takahashi Lin	212 450 4706	kyoko.lin@davispolk.com
Jean M. McLoughlin	212 450 4416	jean.mcloughlin@davispolk.com
Chaoyuan Charles Shi	212 450 4702	chaoyuan.shi@davispolk.com

© 2015 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. Please refer to the firm's [privacy policy](#) for further details.