Insights: Alerts

Impact of Updated Fiduciary Investment Advice Definition on Large Plans

MAY 5, 2015

Written by William J. Vesely, Jr., Lois Wagman Colbert, R. Sterling Perkinson, Mark D. Wincek

On April 14, 2015, The Department of Labor ("DOL") re-issued proposed regulations (the "Proposed Regulations") that would expand the definition of "fiduciary" under ERISA and the Internal Revenue Code by redefining what it means to provide investment advice, which is a key concept under one of the prongs in the definition of fiduciary.

The Proposed Regulations are expected to have a transformational impact on the retirement landscape. The most fundamental effects of the Proposed Regulations will be on small plans (i.e., fewer than 100 participants) and IRAs,[1] as well as their investment advisers, consultants or other service providers. However, the Proposed Regulations will also impact the landscape for large retirement plans in various ways, including:

- *Valuation of Hard-to-Value Assets*. Any appraisal, fairness opinion or similar statement concerning the value of property that is provided in connection with a specific transaction or transactions is considered fiduciary investment advice under the Proposed Regulations. However, the DOL carved-out valuations for ESOP transactions from fiduciary investment advice because they raise unique issues that the DOL intends to address in separate guidance. Valuations in support of legally required reporting and disclosure (e.g., Form 5500 reporting) are also exempted.
- *Investment Education*.
  - Current regulations allow plan sponsors, fiduciaries, and other service providers to provide certain educational materials to participants or beneficiaries in participant-directed individual account plans, without being held to a fiduciary standard, when the materials provided are information about the plan or general financial and investment information rather than recommendations or advice. The Proposed Regulations continue to distinguish investment education from investment advice, but add a condition that investment education materials may not include advice or recommendations as to specific investment products, specific investment managers, or the value of specific securities or other property. In a departure from prior guidance, asset allocation models or interactive investment materials (e.g., investment questionnaires completed through a website) that identify specific investment alternatives as appropriate for the participant would *not* be considered "investment education", even when they are accompanied by a statement regarding the availability of other investment alternatives.
  - The Proposed Regulations also clarify the scope of the investment education concept. Investment education applies not only to information provided to participants who direct their accounts, but also to information provided to plan fiduciaries, including under plans where investments are not participant-directed. In addition, whether information is considered investment education does not turn on the identity of who is providing it. Investment education may be provided by a plan sponsor, fiduciary or service provider. For more information on investment education, see the "Investment Education" section

below.

- *Distributions and Rollovers*. Those who recommend that participants take distributions or roll over their balances to another plan or IRA may be fiduciaries, contrary to existing DOL guidance under Advisory Opinion 2005-23A. Because retail financial advisers often encourage plan participants to roll over their plan benefits into IRAs, this particular expansion of fiduciary status may result in greater protections for participants who may not understand that such encouragement is often driven by fees or commissions the adviser will receive. Some plan sponsors may find this to be a welcome development for their plan participants.
- *Representations Required for Adverse Party and Swap Transactions*. Certain plan investors may continue to engage in investment transactions, including swaps, with counterparties who incidentally provide related advice or other communication to the plan without causing the counterparty to be a fiduciary under the Proposed Regulations under certain circumstances. However, plan fiduciaries may now be required to provide written representations in order to engage in such transactions under the new regime.
- *Pension Closeouts/Annuitizations*. Consultants engaged by plan sponsors to help evaluate the suitability of group annuity contracts in connection with the termination of a defined benefit pension plan and who do not have ultimate decision-making authority are generally not considered fiduciaries under existing DOL rules because they are not consulting on a "regular" basis. However, under the Proposed Regulations, their advice could potentially be considered fiduciary in nature because the new rules dispense with the requirement that the advice be provided on a regular basis.

Background

Section 3(21) of ERISA defines a "fiduciary" to include not only those who have discretionary authority over the investment of plan assets, but also those who provide (or have authority to provide) investment advice for a fee or other compensation with respect to plan assets.

Since 1975, DOL regulations imposed a five-part test for determining fiduciary status by reason of investment advice under which an adviser is a fiduciary only if each of the following criteria are satisfied: (1) the adviser rendered advice as to the value of a security or property or recommendations for investing in or disposing of securities or property, (2) on a regular basis, (3) under a mutual agreement or understanding that (4) the advice or recommendation would be a primary basis of for investment decisions, and (5) the advice was tailored to particular needs of the plan.

This guidance was developed at a time when defined benefit plans predominated the retirement landscape, and so investment decisions tended to be made by employers or investment professionals they engaged. The DOL has long sought to update these rules in order to broaden the reach of the fiduciary definition and thereby provide greater protections for individuals who direct their investments under 401(k) plans or IRAs, which dominate the retirement landscape today. However, these changes have met with great resistance from the financial industry. Prior proposed regulations issued in 2010 (the "2010 Proposed Regulations") were withdrawn in the wake of strong opposition.

The Proposed Regulations reflect a long process in which the DOL attempted to better coordinate its rules with SEC rules for investment advisers, as well to consider public comments on its 2010 Proposed Regulations. However, they are already proving controversial in the financial service industry because they will cause fundamental changes to some business practices, especially in the small plan and IRA markets.

Summary of the Proposed Regulations

The Proposed Regulations dispense with the DOL's five-part test for determining fiduciary status. Rather, the

Proposed Regulations provide that if a person renders certain types of investment advice in exchange for a fee or other compensation, whether direct or indirect, to a plan, plan fiduciary, or plan participant or beneficiary with respect to the asset of a plan (or to an IRA or IRA owner with respect to the an asset of the IRA) result in fiduciary status in either of the following circumstances:

- *Acknowledged Fiduciary Status*. The advice is provided by a person who represents or acknowledges that it is acting as a fiduciary with respect to the advice. Investment professionals who have acknowledged their fiduciary status in connection with their provision of investment advice may not avail themselves of the carve-outs from investment advice discussed below.
- *Directed Investment Advice*. The advice is provided under an agreement, arrangement or understanding that the advice is directed to a specific recipient for the purpose of making investment decisions. Here the DOL intended to avoid bringing public pronouncements into the purview of the Proposed Regulation. Nevertheless, this provision is broader than that of the 2010 Proposed Regulations which would have required such agreement, arrangement or understanding to call for advice "individualized" to the plan, a plan fiduciary or plan participant or beneficiary. The expanded approach under the Proposed Regulations reflects the DOL's view that any investment advice that is targeted to particular recipients should be included, whether it is individualized or not.

The types of "advice" covered by the Proposed Regulations include:

- Advice or recommendations as to the advisability of investing, holding, disposing of, or purchasing securities or other property, including a recommendation to take a distribution of benefits or recommendations as to the investment of assets to be rolled over or otherwise distributed from a plan or an IRA;
- Advice or recommendations as to the management of securities or other property (e.g., voting proxies), including a recommendation as to the investment of assets to be rolled over or otherwise distributed from a plan or an IRA;
- Advice, appraisals or fairness opinions concerning the value of securities or other property if provided in connection with a specific transaction involving the acquisition disposition, or exchange of such property by a plan or an IRA (**Note**: subject to a "carve-out" of valuations of ESOP transactions, which the DOL has reserved for future guidance); or
- Recommendations of any other entity that will provide any of the types of advice described above (e.g., an investment manager).

As noted above, in order to be considered fiduciary investment advice, the advice must be provided for a fee or other compensation. The Proposed Regulations clarify that this includes not only direct compensation, like up-front fees and commissions, but also indirect sources of compensation as well, such as 12B-1 fees and revenue sharing payments.

Carve-Outs Applicable Under Directed Investment Advice

The Proposed Regulations also recognize several exceptions, or "carve-outs," that will *not* be considered to be fiduciary investment advice under the Proposed Regulations. These carve-outs are not available, however, to investment professionals who have acknowledged their fiduciary status with respect to advice provided.

Counterparties. The DOL recognizes that fiduciaries of large[2] ERISA plans are likely sophisticated investors who can

evaluate conflicted advice as to the value of securities or other property from a party who is selling investments to a plan. As a result, the Proposed Regulations carve-out incidental advice from a counterparty to a large plan in connection with an arm's length asset transaction provided that one of two sets of conditions are met:

1. The large-plan fiduciary provides a written statement that he/she is a fiduciary who exercises authority or control of the plan's assets, the plan covers at least 100 participants, and the fiduciary will not rely on the advisor to give impartial advice, act in the best interest of the plan or give advice in a fiduciary capacity. Furthermore, the counterparty providing the advice must inform the plan fiduciary of his or her financial interest in the transaction, and may not receive any fee or compensation directly from the plan or the fiduciary for the provision of the investment advice (as opposed to other services). Finally, the counterparty also must know or reasonably believe that the plan fiduciary has sufficient expertise to determine whether or not the transaction is prudent and would be in the best interest of the plan participants. For this last condition, the counterparty may rely on the written representations from the plan or plan fiduciary.

Or

2. The counterparty must know or reasonably believe that the large-plan fiduciary has responsibility for managing at least $100 million in employee benefit plan assets. As in the first set of conditions, the adverse party must inform the fiduciary that he or she is not undertaking to provide impartial investment advice or giving advice in a fiduciary capacity, and may not receive any fee or compensation directly from the plan or the fiduciary for the provision of investment advice in connection with the transaction.

The DOL extended this relief only to transactions with large plans because it believes that small plans or IRAs may be vulnerable to transactions with advisers with a conflict of interest, even when the conflict is fully disclosed.

- *Swaps and Security Based Swap Transactions.* This exception is similar to the "counterparties" carve-out described above. This carve-out applies if the person providing recommendations to and ERISA benefit plan is a swap dealer or security-based swap dealer and is not acting as an advisor to the plan. In addition, the person recommending the transaction must obtain a written statement from the plan fiduciary that the fiduciary will not rely on the recommendations made by the person.
- *Employees of the Plan Sponsor*. The DOL recognizes that plan fiduciaries often seek retirement and/or investment advice from internal employees (such as treasury department officials) and it can be beneficial for a plan to have informed employees available to provide recommendations regarding various courses of action. Thus, internal employees of a plan sponsor will not be treated as fiduciaries when they provide advice to a plan fiduciary, as long as they are acting in an employee capacity and they receive no compensation over and above their salary as an employee of the plan sponsor.
- *Platform Providers.* The DOL also recognizes that recordkeepers or third party administrators often make available a variety of investment options to defined contribution plans. Under the Proposed Regulations, marketing or making available the investment options by the plan platform providers will not be considered investment advice as long as (i) the platform is provided without regard to the particularized needs of the plan or its participants and beneficiaries, (ii) a plan fiduciary selects the options from the platform that are offered, and (iii) the person providing the information discloses in writing to the fiduciary that it is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity. This exception also applies if the

recordkeeper or other service provider merely assists the plan fiduciary by identifying investment alternatives based on objective criteria specified by the plan fiduciary. However, it is not available to IRAs, because there is no independent plan fiduciary to protect the interests of the account owners.

- *ESOP Appraisals*. The DOL recognizes the unique issues presented by transactions involving closely held employer stock in ESOPs. Thus, valuations or certain related financial reports provided to ESOPs are not subject to fiduciary treatment. The DOL anticipates addressing ESOPs in future rules.
- *Other Financial Reports or Valuations.* Likewise, providing appraisals, fairness opinions, or statements of value is also carved-out from investment advice when provided to:
    - Investment funds in which more than one unaffiliated plan has an investment, or investment funds which hold plan assets of more than one unaffiliated plan.
    - A plan, plan participants and beneficiaries, an IRA or IRA owner solely for purposes of complying with the reporting and disclosure requirements of ERISA, the Internal Revenue Code or other applicable law.
- *Investment Education*. In prior regulations, the DOL has recognized four specific categories of information regarding plan investments that is general in nature and is considered investment education rather than investment advice. These categories are (i) plan information, (ii) general financial and investment information, (iii) asset allocation models, and (iv) interactive investment materials. The Proposed Regulations generally maintain these categories, but with a several important changes.
    - The Proposed Regulations provide that the education carve-out applies not only to participants in participant-directed account plans, but also to information provided to plan fiduciaries, IRA owners, and participants in other types of plans as well. Furthermore, the Proposed Regulations clarify that the carve-out is available regardless of who provides the advice (e.g., plan sponsor, fiduciary, or service provider).
    - Investment education materials must not include recommendations as to specific investment products, specific investment managers, or the value of particular property. The 2010 Proposed Regulations specifically allowed asset allocation models and interactive investment materials to identify investment alternatives offered by the plan, so long as they were accompanied by a statement indicating that other investment options with similar characteristics were available, and included instructions on how information on such alternatives could be obtained. However, these provisions were omitted from the current Proposed Regulations. This is because the DOL felt that, even with these statements as to the availability of other investment alternatives, participants/investors may view the identification of specific funds as recommendations, which could effectively steer them to invest in the identified funds.
    - Furthermore, the Proposed Regulations specifically state that, in order to be eligible for the carve-out, general financial and investment information material may not address specific investment products, investment alternatives, specific distribution options available, or specific alternatives or services offered outside the plan or IRA. However, these materials may include information about the plan's investment alternatives with information such as historical returns and risk and return characteristics so long as the material does not comment on the appropriateness of any particular investment alternative.
    - Educational materials about the plan may include information about the plan's varying distribution options, including rollovers, annuitization and other forms of lifetime income options and the related advantages, disadvantages and risks associated with each such option.
- *Other Professional Advisors.* Several commenters on the 2010 Proposed Regulations noted that it was unclear if the regulations applied to investment advice provided by consultants who were traditionally acting in a non-fiduciary capacity, such as attorneys, actuaries and accountants. While the Proposed Regulations do not

specifically address this issue, the preamble clearly states that attorneys, actuaries, and accountants are not intended to be treated as fiduciaries simply because they provide professional advice regarding a particular investment transaction, so long as they act within their normal roles as advisors to the plan.

Impact on Health Savings Accounts

The Proposed Regulations cover health savings accounts (HSAs) and treat them in a manner similar to IRAs. However, there appears to be no action by the DOL to disturb the prior exemptions for HSAs from ERISA. DOL Field Assistance Bulletins 2004-1 and 2006-02 make it clear that HSAs can be exempt from ERISA, as long as an employer follows the steps outlined in those rulings. In general, for an HSA to not be an ERISA plan, those provisions prohibit an employer from –

- Limiting the ability of individuals to move their funds to another HSA,
- Imposing conditions on the utilization of the HSA funds,
- Making or influencing investment decisions with respect to HSA funds,
- Representing the HSA is an ERISA plan, and
- Receiving any payment or compensation in connection with an HSA.

As long as an HSA is not an ERISA plan, the impact of the Proposed Regulations would likely be felt mainly by the individual HSA owner, along with the banks and other entities that offer investments to HSA owners. Thus, at this time, the impact on employers appears to be minimal for those HSAs that are not ERISA plans.

Related Action on Prohibited Transaction Exemptions

In connection with the expansion of the fiduciary definition, the DOL also issued new prohibited transaction exemptions and amended a number of existing exemptions which are beyond the scope of this Legal Alert. The Best Interest Contract Exemption ("BICE") is the most notable of these. BICE would cover transactions involving certain individual participant-directed accounts, small plans and IRAs, which were omitted from the "Counterparties" carve-out in the Proposed Regulations due to their size.[3] BICE is generally intended to provide greater protections for these types of investors who in many cases may lack the sophistication of large plan investors.

One of BICE's most significant impacts is that it would fundamentally change the regulatory scheme for IRAs. IRAs are subject to the prohibited transaction rules under the Internal Revenue Code, but they are not subject to any of the fiduciary rules under ERISA, including the prudent person standard of care, and IRA owners do not have a statutory right to bring actions against advisors or service providers for causing prohibited transactions or other losses caused by misconduct. The DOL attempts to remedy this through BICE, which requires, among other things, that the advisor and their associated financial institution to contractually acknowledge fiduciary status, agree to act in the best interest of the IRA and to comply with applicable laws. As a result, IRA owners would have a private right of action through a contract claim against fiduciaries who provide conflicted advice or who otherwise fail to comply with the fiduciary standards.

BICE is an aggressive move by the DOL that leverages its interpretive authority over the Internal Revenue Code's prohibited transaction rules in order to extend the ERISA fiduciary liability concept beyond employer plans. As a result, BICE is one of the most controversial aspects of the DOL's initiative related to fiduciary investment advice. Some feel this move may be disruptive to the IRA market and may be contrary to legislative intent, as Congress did

not generally subject IRAs to the ERISA fiduciary rules.

Effective Date

The Obama administration has made updating the investment advice regulation one of its regulatory priorities. Accordingly, we can expect that, unlike its 2010 proposal, these Proposed Regulations will be issued as final rules. However, the DOL solicited requests for comments on a number of aspects of the rule, which makes it likely that there will be some changes before they are finalized.

The changes under the Proposed Regulations would not become effective until 60 days after final regulations are published in the Federal Register, and the requirements would not become applicable until eight months after the publication of a final rule.

For more information about these issues, please contact the authors of this Legal Alert or your existing firm contact. You can also follow us on http://www.KTSErisaCorner.com and @KTS_Benefits on Twitter.

To view a printer-friendly version of this alert, click here.

---

[1] An IRA under the Proposed Regulations includes any trust, account or annuity described in Code Section 4975(e)(1)(B) through (F). As noted in the "Impact on Health Savings Accounts" section below, HSAs may also be treated in a manner similar to IRAs.

[2] For these purposes, large plans have more than 100 participants or more than $100 million in assets.

[3] Recall that the Adverse Parties carve-out only applies to plans with either 100 or more participants or greater than $100 million in assets.

Related People



William J. Vesely, Jr.
t 404.815.6383
bvesely@ktslaw.com



Lois Wagman Colbert
t 202.508.5809
lcolbert@ktslaw.com



R. Sterling Perkinson
t 919.788.1664
sperkinson@ktslaw.com



Mark D. Wincek
t 202.508.5801
mwincek@ktslaw.com