



## Employee Benefits & Investment Management Update

May 2015

### Department of Labor Revises “Investment Advice” Definition

On April 14, 2015, the Department of Labor (Department) released a long-awaited proposed regulation (Regulation) that revises the definition of “investment advice” for purposes of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code (Code). At the same time, the Department withdrew its much-maligned 2010 proposed regulation on the same subject and proposed new and modified prohibited transaction exemptions related to changes proposed by the Regulation.

As proposed, the Regulation significantly expands the recommendations and advice that are considered investment advice and, as a result, will impose fiduciary status on many service providers not currently considered fiduciaries. Due to the breadth and substance of the changes made by the Regulation, service providers to ERISA plans, plan fiduciaries, participants and beneficiaries, IRAs and IRA holders – including recordkeepers, trustees, broker-dealers, investment advisers and consultants – are well advised to carefully review and consider the Regulation’s potential impact on their current business practices, and the additional compliance obligations associated with the revised standards.

#### Current Investment Advice Standard

Under ERISA, an individual who serves in a fiduciary capacity with respect to a covered plan is subject to heightened duties and responsibilities including, among others, to discharge its obligations to the plan:

- Solely in the interest of participants and beneficiaries.
- For the exclusive purposes of providing benefits to participants and beneficiaries, and defraying reasonable expenses of administering the plan.

- With the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.

In addition to these general obligations, fiduciaries also must avoid engaging in prohibited transactions. Fiduciaries who engage in non-exempt prohibited transactions may be personally liable to make good to the plan any losses resulting from the transaction, and to restore to the plan any profits made through use of plan assets. ERISA fiduciaries who engage in prohibited transactions also are liable for excise taxes arising under the Code.

Certain individuals are fiduciaries by virtue of their position with respect to a plan; trustees, plan administrators and other named fiduciaries fall within this category. According to ERISA Section 3(21)(A), others are fiduciaries to the extent of their actions:

[A] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

Current guidance clarifies that an individual will be deemed to be rendering investment advice under Section 3(21)(A)(ii) only if he renders advice as to the value of securities or other property, or makes recommendations as to the

advisability of investing in, purchasing or selling securities or other property:

- On a regular basis,
- Pursuant to a mutual agreement or understanding, with the plan or a plan fiduciary that:
  - The advice will serve as a primary basis for investment decisions with respect to plan assets, and
  - The advice will be individualized based on the needs of the plan or IRA.

### Rationale for Change

The Department has become increasingly concerned that the definition of investment advice as currently formulated is outdated and fails to provide adequate protection due to:

- A shift from professionally managed defined benefit and defined contribution plans to individual account plans in which the participant or beneficiary bears investment responsibility.
- Increased complexity of investment alternatives available to plan participants and beneficiaries, and account holders.
- Increased complexity in the methods by which investment professionals and other providers are compensated for their services.
- Rapid expansion and prevalence of IRA rollovers (the Department estimates that rollovers over the next five years will total more than \$2 trillion).
- The absence of an independent plan fiduciary in the IRA setting to protect the interests of the IRA holder.
- The narrow current definition of investment advice that fails to capture communications and recommendations that recipients would reasonably view to be investment advice.
- The high costs of conflicted advice (the Department estimates that conflicted advice costs participants and beneficiaries approximately \$17 billion per year).
- Future demographic shifts that will further aggravate the preceding issues.

### Proposed Guidance

The proposed guidance consists of several components:

- The Regulation.
- Proposed amendments to existing prohibited transaction exemptions.
- A proposed class exemption for principal transactions in certain debt securities.
- A proposed best interest contract exemption.

The remainder of this bulletin primarily summarizes the Regulation. Future bulletins will detail the proposed new and revised prohibited transaction exemptions.

### The Regulation

Under the Regulation, a person renders investment advice and is a fiduciary with respect to moneys or property of a plan or IRA if:

- The person provides to a plan, plan fiduciary, plan participant or beneficiary, IRA or IRA holder certain advice or recommendations (Advice) in exchange for a fee or other compensation (whether direct or indirect), and
- Such person either directly or indirectly:
  - Represents or acknowledges that he is acting as a fiduciary with respect to the Advice, or
  - Renders Advice pursuant to a written or verbal agreement, arrangement or understanding that the Advice is individualized to, or that such Advice is specifically 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.

Under the Regulation, Advice includes:

- Recommendations as to:
  - The advisability of acquiring, holding, disposing 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.
  - 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.
  - A person who is also going to receive a fee or other compensation for providing Advice (such as a recommendation of an investment manager to a plan).
- 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.

**“Recommendation” defined.** *The Regulation defines a “recommendation” as “a communication that, based on its content, context, and presentation,*

would reasonably be viewed as suggesting that the advice recipient engage in or refrain from taking a particular course of action.”

Noting that FINRA has developed guidelines to assist advisers and broker-dealers in determining whether a communication rises to the level of a recommendation, the Department solicited comments on whether it should adopt some or all of FINRA’s standards for this purpose.

Several provisions of the Regulation mark significant departures from the current guidance. Of particular note:

- The “regular basis” requirement of the current guidance has been eliminated. This means, among other things, that one-time Advice could trigger fiduciary status.
- The “mutual agreement or understanding” and “primary basis” requirements have been eliminated. This means that the parties need not have a meeting of the minds on the extent to which the Advice recipient will rely on the Advice, but rather must simply understand that the Advice is individualized or specifically directed to the recipient.
- Recommendations regarding the investment of securities to be rolled over or otherwise distributed from a plan or IRA constitute Advice. This marks a reversal of the Department’s current position described in Advisory Opinion 2005-23A.
- Execution of a securities transaction, without more, does not constitute Advice.

### Carve-Outs

Acknowledging that the Regulation’s broad language would reach certain conduct and behavior that the Department would generally not, without more, consider to be fiduciary in nature, the Regulation “carves out” certain conduct described below.

**Caution!** *The carve-outs provided under the Regulation do **not** apply in situations in which the person has acknowledged or represented his fiduciary status with respect to the Advice.*

### ERISA Plan & Plan Fiduciary Carve-Outs

The following carve-outs are only available in connection with ERISA plans and plan fiduciaries:

*Arm’s length transactions with sophisticated plan fiduciaries.* This carve-out is intended to exclude certain transactions between sophisticated parties if certain protections are present. Specifically, the carve-out applies to incidental advice provided in connection with an arm’s length sale, purchase, loan or bilateral contract between certain plan fiduciaries and the adviser if:

- 1) The person provides advice to an independent plan fiduciary who exercises authority or control over the management or disposition of the plan’s assets, with respect to an arm’s length transaction (or proposed transaction) between the plan and the person, and
- 2) Prior to the transaction, such person satisfies the requirements of either (a) or (b):
  - a. For plans with 100 or more participants, such person:
    - i. Obtains a written representation from the plan fiduciary that he is a fiduciary who exercises authority or control with respect to management or disposition of the employee benefit plan’s assets, that the employee benefit plan has 100 or more participants covered under the plan, and that the fiduciary will not rely on the person to act in the best interests of the plan, to provide impartial investment advice or to give advice in a fiduciary capacity.
    - ii. Fairly informs the plan fiduciary of the existence and nature of the person’s financial interests in the transaction.
    - iii. Does not receive a fee or other compensation directly from the plan or plan fiduciary for providing investment advice in connection with the transaction (though the person can receive compensation for other services).
    - iv. Knows or reasonably believes that the independent plan fiduciary has sufficient expertise to evaluate the transaction and to determine whether the transaction is prudent and in the best interest of the plan participants (written representations from the independent plan fiduciary would suffice).
  - b. Such person knows or reasonably believes that the independent plan fiduciary has responsibility for managing at least \$100 million in employee benefit plan assets (by reference to the most recent Form 5500 for the plan or written representations from an independent plan fiduciary of the value of benefit plan assets under management) and has

sufficient expertise to evaluate the transaction, the person fairly informs the independent plan fiduciary that the adviser is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity, and the person does not receive a fee or other compensation directly from the plan or plan fiduciary for providing investment advice in connection with the transaction.

*Swap transactions.* This carve-out is predicated on the presence of other applicable regulatory regimes that provide protection against conflicted advice. Specifically, the carve-out applies to advice and other communications provided by counterparties in connection with swap or security-based swap transactions under the Commodity Exchange Act or the Securities Exchange Act if:

- The plan is represented by an independent fiduciary.
- The person is a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant.
- The person (if a swap dealer or security-based swap dealer) is not acting as an adviser to the plan (as defined under the relevant statutes) in connection with the transaction.
- In advance of providing any recommendations with respect to the transaction, the person obtains a written representation from the independent fiduciary that the fiduciary will not rely on recommendations provided by the person.

*The plan sponsor's employees.* A plan sponsor's employees who provide Advice to a plan fiduciary and do not receive any fee or compensation beyond their normal compensation will not be considered fiduciaries under the Regulation.

*Platform providers.* Many ERISA plans access investments through service providers that market investments to employee benefit plans through a platform or similar mechanism without regard to the individualized needs of the plan, its participants or beneficiaries (e.g., many of the recordkeeping companies that work within the industry). These "platform providers" will not be considered investment advice fiduciaries if they disclose in writing to the plan fiduciary that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

Additionally, a platform provider will not be considered an investment fiduciary with respect to a plan solely because it:

- Identifies investment alternatives that meet objective criteria specified by the plan fiduciary (such as stated parameters concerning expense ratios, size of fund, type of asset, credit quality, etc.), or
- Provides objective financial data and comparisons with independent benchmarks to the plan fiduciary.

#### Other Carve-Outs

The preceding carve-outs are only available in connection with transactions or conduct involving ERISA plans and plan fiduciaries. In contrast, the following carve-outs may apply to an ERISA plan, plan fiduciary, participant or beneficiary, IRA or IRA holder.

*Financial reports and valuations.* The Regulation also carves out certain appraisals, fairness opinions and statements of value to:

- An ESOP regarding employer securities.
- An investment fund in which more than one unaffiliated plan has an investment, or that holds plan assets of more than one unaffiliated plan under 29 CFR 2510.3-101.
- A plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner solely for purposes of compliance with the reporting and disclosure provisions under ERISA, the Code, and the regulations, forms and schedules issued thereunder, or any applicable reporting or disclosure requirement under a federal or state law, rule or regulation or self-regulatory organization rule or regulation.

*Investment education.* Consistent with current guidance, providing certain investment-related information and materials is considered investment education rather than investment advice and, accordingly, providing such information and materials will not make a person an investment fiduciary. Specifically, providing the following investment-related information and materials to a plan, plan fiduciary, participant or beneficiary, IRA or IRA owner to the extent the information and materials do not include recommendations with respect to specific investment products or specific plan or IRA alternatives, or recommendations on investment, management or value of a particular security or securities, or other property will not result in fiduciary status:

- Plan information.
- General financial, investment and retirement information.
- Asset allocation models.
- Interactive investment materials.
- Other educational information and materials.

**Caution!** *Although the carve-out for investment education follows much of the current guidance found in the Department’s Interpretive Bulletin 96-1, the Regulation departs from the existing guidance in several material respects:*

- *Information and materials cannot include advice or recommendations as to specific investment products, investment managers or the value of particular securities or other property.*
- *General information that assists an individual to assess and understand retirement income needs past retirement and associated risks or explains general methods to manage those risks would not result in fiduciary status.*

### Related Prohibited Transaction Exemptions

Contemporaneous with the Regulation’s publication, the Department issued amendments to numerous existing prohibited transaction exemptions and proposed two new exemptions. As a general matter, the new and revised exemptions are designed to provide greater flexibility in meeting the requirements of the exemption, but at the same time impose additional contractual obligations on providers that rely upon them for relief.

For instance, in recognition of the Regulation’s expanded breadth of coverage (which will likely expand fiduciary status to providers not currently considered fiduciaries), the Department has proposed the “Best Interest Contract Exemption,” which would allow providers to continue many of their current compensation practices if, among other things, the providers:

- Commit to provide advice in the client’s best interests (and contractually acknowledge such).
- Warrant that the firm has adopted policies and procedures designed to mitigate conflicts of interest.
- Clearly and prominently disclose any conflicts of interest.

The Best Interest Contract Exemption and the other proposed exemptions will be examined in future bulletins.

### Comment Period & Effective Date

The Department originally announced that it would accept comments on the Regulation and other guidance through July 6, 2015 (the 75-day period beginning April 20, 2015, the Regulation’s date of publication), and plans to hold an administrative hearing within 30 days of the close of the comment period. On May 15, 2015, the Department announced that it would extend the comment period by 15 days – through July 21, 2015.

The Regulation, once finalized, will become effective 60 days after its publication in the *Federal Register*, and the requirements will apply eight months after publication in the *Federal Register*.

### Next Steps

**Remember,** the proposed guidance is just that: **proposed**.

As with the Department’s first attempt to revise the definition of investment advice, we expect the Regulation to be the subject of many comments and much debate. As such, it is simply too early to implement wholesale changes to current practices, and providers should monitor future developments as they analyze and consider the Regulation. However, given the breadth and significance of the proposed changes and the Department’s dogged determination in this area, service providers should consider, among other things:

- Existing business models to determine whether current practices would result in fiduciary status under the Regulation.
- For would-be fiduciaries, whether the manner in which they are compensated would constitute a prohibited transaction under ERISA or the Code.
- Whether the terms of existing or proposed prohibited transaction exemptions could potentially provide relief from otherwise prohibited transactions, keeping in mind the proposed modifications to several commonly used exemptions.
- Whether changes to the types of information considered investment education will cause current practices to be considered fiduciary in nature, and whether changes to current materials and practices are viable.
- Whether the proposed changes may require modification to current service contracts or agreements, particularly if the provider will rely upon the Best Interests Contract Exemption.

**FOR MORE INFORMATION**

For more information, please contact any member of our [Employee Benefits & Executive Compensation](#) group or our [Investment Management](#) group.

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