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Executive Summary

Definition of the Term ‘Fiduciary’ U.S. Department of Labor ‘Conflict of Interest Rule’¹

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I. Introduction.

Background. The U.S. Department of Labor (the “Department” or “DOL”) on April 14, 2015, released for public comment a proposed rule (the “Proposal”) that envisions a sweeping, principles-based approach to defining investment fiduciaries under the Employee Retirement Income Security Act of 1974 (“ERISA”). The Proposal also would cover the provision of investment advice to individual retirement accounts (“IRAs”) under section 4975 of the Internal Revenue Code of 1986 (the “Code”) and IRA “rollover advice.” The Proposal contains limited exemptions and amendments to existing exemptions from prohibited transaction rules applicable to fiduciaries under ERISA and the Code.

The original proposal was introduced in 2010 and withdrawn the following year in response to strong industry opposition and bipartisan concerns expressed in Congress.

Purpose. The purpose of the rule, according to the DOL, is to update a five-part test that applied to fiduciary investment advice prior to the advent of 401(k)-type self-directed participant plans and IRA rollovers. Today, many financial intermediaries that play a critical role in guiding plan and IRA investments have no obligation or requirement under current regulation to serve as ERISA fiduciaries. As such, the Department believes that some may provide conflicted and tainted advice that results in failing to act solely in the plans’ interest as required if those same persons were fiduciaries.

Status. The Department is accepting comments for 75 days following publication in the Federal Register, or July 6, 2015. A public hearing will be scheduled sometime in July or early August with additional comments

¹ This executive summary is a regulatory update and should not be relied upon as a legal authority or advice for compliance purposes.

accepted thereafter. Most of the requirements would be effective eight months after adoption of the final rule.

II. Definition.

Current. The original five-part test for determining functional fiduciary status under ERISA is defined as a person who does not have discretionary authority over plan assets and who, for compensation

1. Renders advice as to the value of securities or other property;
2. On a regular basis;
3. Pursuant to a mutual agreement;
4. The advice serves as the primary basis for investment decisions; and
5. The advice is individualized.

All five prongs of the test must be met to be deemed an investment fiduciary.

Proposed. The proposed changes would remove the “regular” and “primary basis” prongs (nos. 2 and 4) from the definition. The new “agreement” prong removes “mutual” and simply includes advice rendered “pursuant to a written or verbal agreement, arrangement, or understanding.” In addition, persons who represent themselves as ERISA fiduciaries and who provide investment advice for compensation would be held to the fiduciary standard under ERISA.

The categories of investment activities covered under the revised definition include investment advice and investment management recommendations, non-ESOP investment appraisals, and recommendations of investment professionals. Recommendations would include rollover advice and other distributions from a plan or IRA.

“Mere execution” of a securities transaction at the direction of a plan or IRA owner would not be deemed a fiduciary activity. Nor would it apply to order taking where no advice is provided.

III. Exemptions from the Fiduciary Definition.

Given the more expansive definition, the Proposal includes several new carve-outs and modifications of exemptions from the 2010 proposal. Subject to additional conditions not described below in detail, the carve-outs would



cover seven activities of persons who do not represent themselves as ERISA fiduciaries.

1. **Seller's Carve-out.** Two alternatives are available to a broker.
 - a. The first applies to providing advice to plans with more than 100 participants in which the broker reasonably believes that the fiduciary exercising control over plan assets has sufficient expertise to evaluate the transaction and obtains written representation from the fiduciary that the fiduciary will not rely on the seller to act in the plan's best interests or provide impartial advice. In addition, the broker discloses any financial interests in the transaction and is not paid directly by the plan.
 - b. The second applies to plans with at least \$100 million in plan assets and that otherwise generally meets the same conditions except that the broker need not obtain written representations other than to "fairly inform" the fiduciary of his or her adverse interests.
2. **Swaps.** Recommendation to a plan fiduciary to enter into a swap or securities-based swap regulated by the U.S. Securities and Exchange Commission or Commodity Futures Trading Commission.
3. **Plan Sponsor Employees.** Internal staff of the company sponsoring the plan that provides advice and receives no compensation beyond the employee's "normal compensation" for work performed.
4. **Investment Platform Providers.** The person markets investment options to the plan without regard to the individualized needs of the plan through a platform from which the plan fiduciary may select investment options. The platform provider must disclose in writing that she is not undertaking to provide impartial investment advice or act as a fiduciary.
5. **Objective Criteria or Financial Data.** The person limits advice to identifying investment alternatives meeting objective criteria of the plan fiduciary (such as expense ratios, size of fund, type of asset, etc.), or providing data and comparisons with independent benchmarks.
6. **ESOP Appraisals.** Applies primarily to persons providing an appraisal to an employee stock ownership plan.
7. **Investment Education.** A person who provides information on investment options in a plan or IRA without making

recommendations regarding specific investment products or IRA alternatives. Educational materials may include information on investment concepts such as risk and return, diversification and dollar-cost averaging, as well as objective questionnaires, worksheets and interactive software.

Prohibited Transaction Exemptions.

a. Best Interest Contract 'PTE.'

The centerpiece of the Department's exemptions from ERISA's prohibited transaction rules is the so-called "Best Interest Contract Exemption," one of several prohibited transaction exemptions ("PTE"). The proposal is designed to respond to critics expressing concerns that the 2010 proposal would have banned or *de facto* eliminated brokerage commissions and other indirect forms of compensation. At the same time the DOL has attempted to preserve a "best interest" standard protecting advice recipients.

Brokerage firms would still be able to set their own compensation practices with respect to plan or IRA advice as long as the compensation was 'reasonable.' In addition, a firm must commit in writing in the contract that it

- Acknowledges fiduciary status
- Adheres to basic standards of impartial conduct
- Warrants compliance with federal and state laws governing advice
- Disclose basic conflicts of interest
- The cost of their advice; and
- Has adopted policies and procedures reasonably designed to mitigate conflicts of interest.

According to the DOL, this approach is rooted in longstanding trust-law duties of prudence and loyalty as reflected in sec. 404 of ERISA and would not expand or contract the existing standard of care for plan advice. Instead, the exemption would expand the same standard to IRA advice.

As such, IRA accountholders would have a private right of action to assert contract violations in a legal forum.

b. 'Low-Fee' PTE.

The DOL also has requested comments on a conceptual "streamlined" PTE that would apply to variable compensation received by brokers for recommending certain "high-quality, low-fee investments" in a given product class. None has been proposed. The Department believes a properly drafted PTE could minimize compliance burdens for advisers when they offer products with little potential for material conflicts of interest.

c. Principal Transaction Exemption.

Similar in concept to the SEC's principal transaction relief for dually registered broker-dealers and investment advisers selling higher-quality fixed-income securities out of inventory, advisers would be able to recommend similar products to plan participants and IRA accounts under a special PTE. The Principal Transaction PTE would be subject to the same contractual requirements as the Best Interest Contract PTE.

In addition, the broker-adviser would have to obtain two price quotes from unaffiliated counterparties for the same or a similar security, with the transaction price as favorable to the plan or IRA as the two quotes.