Proskauer

Game of Tomes: A Guide to the DOL's Retirement Security Rule Proposal

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The new "retirement security rule" package, issued by the U.S. Department of Labor (the "DOL") on October 31, 2023, is the latest chapter in an almost 15-year effort by the DOL to amend the five-part test in its 1975 regulation for determining whether a person is a "fiduciary" by reason of providing "investment advice" for a fee (the "Five-Part Test"). (For more on the history, see here, here, and here.) The package includes a proposed new fiduciary "investment advice" rule (the "Proposed Rule") and proposed amendments to certain prohibited transaction exemptions.

Very generally speaking, the Proposed Rule would significantly expand the circumstances under which a person could be treated as providing "investment advice" that is subject to ERISA's fiduciary standards (including the self-dealing prohibited transaction rules). In particular, the Proposed Rule would replace the Five-Part Test's requirements that advice be provided (1) on a "***regular basis***" pursuant to (2) a "***mutual agreement, arrangement or understanding***" that (3) it would serve as "***a primary basis for investment decisions***" with a much broader test that is based on the retirement investor's reasonable expectations and context. The Proposed Rule would specifically cover a recommendation to roll over an account from an employer-sponsored plan (*e.g.*, a 401(k) plan) into an individual retirement account (an "IRA").

Comments on the proposal are due on January 2, 2024, and the DOL has scheduled a virtual public hearing on December 12 through December 13, 2023 (continuing, if necessary, on December 14, 2023). In an unusual move, the DOL will be holding the hearing before the deadline for written submissions, and the DOL rejected industry group requests to extend the comment period. Certain members of Congress are continuing to push for the comment period to be extended.

Background

Under Section 3(21) of ERISA and Section 4975(e) of the Code, a person is considered a "fiduciary" with respect to an ERISA plan or an IRA if ***the person renders investment advice for a fee or other compensation, direct or indirect, or has any authority or responsibility to do so***. Separately, a person would be a fiduciary if it has discretionary authority or responsibility over the management, administration, or investment of the assets of an ERISA plan or IRA; the Proposed Rule has no bearing on becoming a fiduciary by reason of having such discretionary authority or responsibility.

Under the Five-Part Test, a person is considered to be providing "investment advice" for these purposes only if the person: (1) renders advice to the ERISA plan or IRA as to the value of securities or other property, or makes recommendations as to investing in, purchasing or selling securities or other property, (2) on a ***regular basis***, (3) pursuant to a ***mutual agreement, arrangement, or understanding*** with the ERISA plan, the ERISA plan fiduciary or the IRA owner that, (4) the advice will serve as a ***primary basis*** for investment decisions with respect to the ERISA plan's or IRA's assets, and (5) the advice will be individualized based on the particular needs of the ERISA plan or IRA. A person who meets all five prongs of the test and receives direct or indirect compensation will be considered an "investment advice" fiduciary with respect to the applicable ERISA plan or IRA.

Proposed New Test

The Proposed Rule would replace the Five-Part Test with a rule that says a person provides "investment advice" if it provides a "recommendation" of "any securities transaction or other investment transaction or any investment strategy involving securities or other investment property" to a "retirement investor" (*i.e.*, an ERISA plan, plan fiduciary, plan participant or beneficiary, or an IRA, IRA fiduciary, or IRA owner or beneficiary) and satisfies ***any*** of the following three requirements:

- The person either directly or indirectly (through or together with an affiliate) has discretionary authority or control with respect to purchasing or selling securities or other investment property for the retirement investor;
- The person either directly or indirectly (through or together with an affiliate) makes investment recommendations to investors on a regular basis as part of its business, and the recommendation is provided under circumstances indicating that the recommendation is based on the particular needs or individual circumstances of the retirement investor and may be relied upon by the retirement investor as a basis

for investment decisions that are in the retirement investor’s best interest; ***or***

- The person making the recommendation represents or acknowledges that it is acting as a fiduciary when making investment recommendations.

Key Takeaways and Implications of Proposed New Test

- **Elimination of requirement that investment advice be provided to advice recipient on a “regular basis”**. Under the Five-Part Test, an isolated one-time interaction generally would not be treated as fiduciary investment advice. The Proposed Rule would expand the fiduciary net by allowing the “regular basis” requirement to be satisfied for anyone who makes investment recommendations to any investors on a regular basis ***as part of its business or is affiliated with an advisor that makes investment recommendations on a regular basis***. This means that one-time advice can be subject to the fiduciary standard.
    - ***Practice pointer***: The Proposed Rule picks up an individualized recommendation to a retirement investor by an adviser that regularly provides investment recommendations to ***any*** investors and, therefore, many common “one-time” advice scenarios that historically were not covered by the fiduciary standard, such as a recommendation for a single financially-significant real estate transaction, a recommendation related to purchasing an annuity contract for a defined benefit pension plan, and a recommendation to roll over assets from an employer-sponsored plan to an IRA could be considered fiduciary investment advice.
    - ***Comments requested by DOL***:The extent to which the Proposed Rule should take into account an investor’s understanding as to whether making investment recommendations is a regular part of the adviser’s (or an affiliate’s) business, as well as examples of financial professionals who may be “reasonably viewed” by investors as giving investment advice but would not in fact meet the new test’s requirements.

- **IRA rollover advice specifically covered***.* The DOL emphasizes that it intends for the Proposed Rule to pick up advice on whether to take a distribution or roll over assets from a retirement plan to an IRA, even if there is no recommendation as to *how to invest* the assets after the rollover.

- **Elimination of “mutual agreement, arrangement or understanding” and “primary basis” requirements**. Under the Five-Part Test, an adviser could avoid fiduciary status by making clear (including via contract disclaimers) that there is no “mutual agreement, arrangement or understanding” that anything the adviser says will serve as a "primary basis" for an investment decision. The Proposed Rule would look insteadto whether the objective circumstances surrounding the recommendation make it reasonable for the retirement investor to believe that it could rely upon the advice as ***a*** basis for an investment decision that is in the retirement investor's best interest.

- ***Comments requested by DOL***: Whether particular titles for advisers are commonly perceived to convey that individualized advice is being provided that may be relied upon as a basis for investment decisions in the investor's best interest, and whether other types of conduct, communications, representations and terms of engagement of advisers should merit similar treatment.

- **No safe harbor for sales or sophisticated retirement investors**.The DOL rejected the difference between a "sales" recommendation and "investment advice" in the retail market. In the DOL's view, when retirement investors talk to investment providers about the investments they should make, they commonly pay for and receive covered "investment advice." Also, the Proposed Rule does not include an exception for recommendations to "sophisticated" advice recipients.
  - ***Practice pointer***: The omission of a "sales" or "sophisticated investor" safe harbor may leave a lack of clarity for many common marketing activities. Although the DOL says it is trying to protect smaller retail investors, the regulatory wording also sweeps in common interactions with institutional and other sophisticated investors—even those who have the means to engage advisers and counsel.

- **Valuation of securities and other investment property not covered**. Valuation and appraisal services, as well as fairness opinions, are excluded from recommendations covered by the Proposed Rule. Such services alone would not be considered fiduciary investment advice.

- **Recommendations outside the scope of a manager's engagement**. As noted above, the Proposed Rule picks up any "recommendation" by a party that directly or indirectly (through or together with an affiliate) has discretionary investment authority or control over a retirement investor's assets—even if the discretion relates to other assets that are not plan assets. For example, if an adviser manages an individual's non-retirement assets, the Proposed Rule would pick up a recommendation by that adviser that the client consider rolling over retirement assets or making a particular investment within the client's IRA.
  - ***Practice pointer***: It is often the case that a discretionary investment manager is engaged to manage only a portion of the assets of a plan or a retirement investor's non-retirement assets. Under the Proposed Rule, a

covered “recommendation” provided by such a manager (or its affiliate) would constitute “investment advice” ***even if the recommendation is made with respect to assets that are not managed by the manager***. This change would make it even more difficult for a manager to offer an unrelated investment product to an existing retirement investor client.

- **Exception for investment education would remain in effect**. The Proposed Rule does not change the distinction between investment “advice” and investment “education.” The policies outlined in DOL Interpretive Bulletin 96-1 (“IB 96-1”) regarding investment education would remain in effect and IB 96-1’s analysis (which by its terms applies only to participants and beneficiaries in participant-directed individual account plans) would apply for all retirement investors.
  - ***Comments requested by DOL***: Whether the examples of investment education information and materials identified in IB 96-1 constitute a “recommendation” under the Proposed Rule, and whether IB 96-1 should be amended or incorporated into the final regulation.

- **“Hire me” recommendations**. The DOL confirmed in the preamble that an adviser’s normal activity of marketing itself would not be treated as investment advice, ***so long as they do not make any investment recommendations along with*** the “hire me” pitch. However, there is no safe harbor: the complete facts and circumstances surrounding each recommendation would need to be considered. Also, as noted above, the Proposed Rule’s finding of an advisory relationship based on discretion over an investor’s ***other*** assets could make it impossible to pitch for expanding an existing relationship without it being subject to the fiduciary standard.
  - ***Practice pointer***: It remains to be seen whether there is a practical way to make a “hire me” pitch without discussing what the adviser would recommend if engaged. Pitches could be particularly problematic for providers that already have some relationship with the retirement investor (for example, pitching an existing client to expand the relationship).

- **“Day 1” impact on fiduciary monitoring**. If the Proposed Rule is finalized, service providers who do not currently hold themselves to fiduciary standards, have not contractually agreed to comply with ERISA, and possibly have compensation arrangements that would violate ERISA, could be deemed to be providing covered investment advice when the new rule becomes effective. Plan fiduciaries and service providers should review their existing arrangements to assess the potential impact of the Proposed Rule.

- **No disclaimers**. The Proposed Rule states that disclaimers regarding fiduciary status will not control to the extent they are inconsistent with the adviser's verbal communications, marketing materials, state or federal law or other interactions with the retirement investor.
  - ***Practice pointer***: Although disclaimers cannot override contrary communications and materials, they can still be helpful to establish that there is no intent to provide advice. In practice, the challenge will be to avoid comments, materials, and conduct that are inconsistent with the intent not to provide advice that can be relied on.

- **Recommendation required***.* A threshold element for fiduciary status is making a "recommendation." Although the Proposed Rule does not include a formal definition of "recommendation," the DOL notes in the preamble that it views a "recommendation" as a communication (written or oral) that, based on its ***content, context, and presentation*** (including the extent to which the communication is more individually tailored to a specific retirement investor or group of investors) would reasonably be viewed as a suggestion that the retirement investor engage in or refrain from taking a particular course of action. The DOL also noted that a series of actions or communications taken together may constitute a recommendation even if they would not have met the threshold individually. The DOL states that the determination of whether a recommendation has been made would be based on an objective, rather than subjective, analysis of the facts and circumstances; but the DOL references the standard for a "recommendation" under the SEC's Regulation Best Interest, which standard considers whether the communication reasonably could be viewed as a "call to action" that reasonably would influence an investor to trade a particular security of group of securities—a question that is inherently subjective.
  - ***Comments requested by DOL***: If this approach (*i.e.*, no formal definition of "recommendation") is sufficiently clear or if an express definition of "recommendation" would be preferable to include in the Proposed Rule.

- **Fee or other compensation, direct or indirect**. As noted above, investment advice is subject to the fiduciary standard only if it is provided for "a fee or other compensation, direct or indirect." Although the preamble offers comfort to human resources professionals who are not compensated for investment advice, the "fee or other compensation" requirement can be satisfied by indirect compensation that isn't explicitly provided for advice—such as commissions, loads, finder's fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, mark ups or mark downs, underwriting compensation, expense reimbursements, gifts and gratuities, or other non-cash compensation. A fee or compensation will be treated as paid for a recommendation if the fee or compensation would not have been paid ***but for*** the recommended transaction or the provision of advice, including if eligibility for or the amount of the fee or compensation is affected by the recommended transaction or the provision of advice.

Proposed Prohibited Transaction Exemption Amendments

Section 406(b) of ERISA and Section 4975(c) of the Code prohibit (among other things) investment advice fiduciaries from receiving compensation that varies based on their investment advice and compensation that is paid from third parties, unless the conditions of an available exemption are satisfied. The DOL has previously issued prohibited transaction class exemptions ("PTEs") covering certain common transactions that would provide relief to investment advice fiduciaries for certain otherwise prohibited compensation arrangements. In connection with the issuance of the Proposed Rule, the DOL also proposed amendments to PTEs 2020-02, 84-24, 75-1, 77-4, 80-83, 83-1 and 86-128, which essentially would require all investment advice fiduciaries to comply with "impartial conduct standards." The "impartial conduct standards" incorporate ERISA's principles of prudence and loyalty, and are intended to be aligned with the standards of conduct for investment advice professionals established and considered by other U.S. federal and state regulators—in particular, the SEC and its Regulation Best Interest.

Proskauer's Perspective

The DOL's latest proposal would significantly expand what constitutes fiduciary "investment advice," and would affect ERISA plans, IRAs and many service providers that currently take the position that their communications and interactions with ERISA plan and IRA clients are not subject to the fiduciary duty or prohibited transaction rules under ERISA or Section 4975 of the Code. Although the Proposed Rule and related proposed PTE amendments are simply that at this point—proposed—given the potential expansion and impact, ERISA plan and IRA fiduciaries and service providers should carefully review the proposal to determine whether and how the proposal might apply to them.

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