Overview of the DOL Conflict of Interest Rule Proposal

In mid-April, the Department of Labor (DOL) released for public comment its revised proposal to update the definition of "fiduciary investment advice" under the Employee Retirement Income Security Act (ERISA). Determining what types of activities subject a financial adviser to fiduciary obligations is critically important to retirement savers. When a retirement saver is protected by a fiduciary duty, it means her financial adviser must serve her interests ahead of his own. Conversely, when a retirement saver is not protected by a fiduciary duty, it means her financial adviser is legally allowed to put his own interests ahead of hers and can therefore profit at her expense.

- **The DOL proposal closes loopholes in the definition of "fiduciary investment advice" under current ERISA rules.**

The current definition of investment advice under ERISA rules includes a five-part test that must be met before investment recommendations are considered to be advice subject to a fiduciary standard. For example, advice must be given on a "regular basis" before the fiduciary standard applies, and there must be a mutual agreement or understanding between the customer and the adviser that the advice will serve as a "primary basis" for the investment decision. Moreover, under the DOL's current interpretation of the existing rule, advising a customer to take money out of an employer-sponsored plan, such as a 401(k) plan, and invest it elsewhere is not covered by the fiduciary duty. This regulatory definition is far narrower than the statutory definition in ERISA itself.

The rule proposal replaces this five-part test with a functional definition of investment advice that more accurately reflects the statutory language. Under the revised definition, a person renders "fiduciary investment advice" when he or she receives compensation for providing a recommendation that is individualized or specifically directed to: an employee retirement plan, such as a traditional pension or 401(k); a plan participant, such as an employee who is saving for retirement in her company's 401(k); an Individual Retirement Account (IRA); or an IRA owner. The proposal also supersedes the DOL's previous interpretation relating to rollovers and other distributions, ensuring that these all-important investment decisions are subject to fiduciary protections.

The proposed definition is virtually identical to the definition of investment advice under the securities laws. As with the securities law definition, the advice would not have to be provided on a "regular basis," nor would there have to be a mutual agreement that the recommendation serve as the "primary basis" for the investment decision, for the advice to be considered fiduciary investment advice under ERISA. Unlike the securities laws, however, the proposal adopts a functional approach to the question of who is considered a fiduciary based on the types of services being rendered, not based on the title of the person rendering the services. This means that broker-dealers, registered investment advisers, insurance agents, and other advisers and their firms will be held to the same standard when they perform the same advisory function.

- **The rule proposal clarifies that certain services do not constitute fiduciary advice.**

The DOL recognizes that, in many circumstances, employee retirement plans, plan participants, and IRA owners may receive recommendations that, despite meeting the general definition of "investment advice," should not be treated as fiduciary investment advice under the rule. The rule proposal includes two main carve-outs from the definition of fiduciary investment advice.

The Seller's Carve-out

The rule proposal allows a financial adviser to make sales recommendations to a fiduciary of a large employer-sponsored plan (with 100 or more participants, or $100 million or more in assets) without being subject to a fiduciary duty. The purpose of this carve-out is to avoid triggering fiduciary obligations on sales pitches that are part of arm's length transactions where neither side assumes that the financial adviser is acting in the plan's best interests.

The carve-out is premised on the assumption that large plan fiduciaries have sufficient expertise and sophistication to understand sales-related conflicts of interest, and are able to effectively assess the quality of the recommendations they receive. Because retail investors and smaller plan fiduciaries do not have that same level of expertise and by and large are unable to effectively assess the quality of recommendations they receive, the carve-out is not available for sales pitches to retail investors and smaller plan fiduciaries. Instead, they can receive sales recommendations subject to the conditions of the Best Interest Contract Exemption (see below).

The Education Carve-out

As is the case under current rules, the rule proposal allows firms and financial advisers to provide significant amounts of educational information and materials to investors without being subject to a fiduciary duty, as long as that information does not contain any specific investment recommendations that the retirement saver can reasonably be expected to act upon. This carve-out applies regardless of who provides the educational information and materials or the form in which the information and materials are provided.

Educational information and materials can include:

- Information about a retirement plan or IRA, such as information about the costs and benefits of rollovers and annuitization as well as risk and return characteristics and historical return information of investment alternatives under the plan.
- Information about a wide range of financial, investment, and retirement concepts, such as diversification, dollar cost averaging, compound interest, tax deferral, historic differences in performance among asset classes, effects of inflation, risk tolerance, and investment time horizon.
- Asset allocation models that portray portfolios of hypothetical individuals with different time horizons and risk profiles.
- Interactive investment materials that estimate future retirement income needs and assess the impact of different asset allocations on retirement income.

In clarifying the line between education and advice, the rule proposal distinguishes between informing investors of their various options and providing specific options that reasonably can be expected to be acted upon. In keeping with this principle, the rule proposal changes its treatment of certain website tools that direct savers toward specific investments. Often, financial firms offer website tools that ask retirement savers to provide specific information about themselves and their investment goals, including time horizon and risk tolerance. The saver is then provided "hypothetical" illustrations that are specific and tailored to their goals with the option of hitting an "Act Now" button to implement the plan. Under current rules, these tools are treated as education. Because such illustrations can reasonably be expected to be acted upon, the revised rule would treat them as fiduciary advice.

Non-advisory Services

The DOL proposal makes clear that traditional brokerage activities, including "order-taking" and other purely administrative activities, do not meet the definition of "investment advice" and therefore do not trigger a fiduciary duty under the rule. This means, for example, that if an investor instructs her broker

to buy or sell a specific investment, the broker is not considered a fiduciary under the DOL rule with regard to that transaction.

- **The rule proposal provides exemptions to accommodate a wide range of business models.**

Under ERISA, fiduciaries are prohibited from receiving compensation that creates conflicts of interest unless they qualify for an exemption to the general rule. To ensure that financial professionals of all stripes can comply with their fiduciary obligations, the revised rule proposal includes broad new principles-based prohibited transaction exemptions (PTEs) that will accommodate a range of existing and evolving business and compensation models.

The Best Interest Contract Exemption

The most significant of the new exemptions would enable firms and their financial advisers to receive conflicted compensation, including a wide range of commissions and other sales fees, and still comply with the ERISA fiduciary standard.

- Fiduciary Duty

In order to rely on the exemption, broker-dealers, insurance agents, and others who receive conflicted compensation would be required to enter into a contract with their customers in which they acknowledge their fiduciary status and commit to giving advice that is in the customer's best interest. As such, they would be required to provide advice with the care, skill, prudence, and diligence of a prudent and impartial expert. Assessment of whether a recommendation is in the best interest of the investor would be based not on the outcome of the investment, but on conditions at the time the recommendation was made. As fiduciaries, they would also be required to pledge to comply with all applicable federal and state laws, avoid misleading statements and receive no more than reasonable compensation in light of the services offered.

- Limits on Conflicts

The firm would also be required to adopt policies and procedures that are reasonably designed to minimize the harmful impact of conflicts of interest and warrant in the customer contract that it has done so. This requires firms to take meaningful steps to eliminate practices that could encourage the firm's advisers to make recommendations that do not serve the best interests of the customer. For example, while firms would remain free to recommend proprietary or "in-house" products, they could no longer set quotas for the sale of such products and base advisers' bonuses on their success in meeting those quotas. Similarly, while firms would be free to pay their advisers more to sell certain investments, those differential payments would have to be based on neutral and objective factors, such as the amount of time necessary to research and implement the investment strategy, and not just on a desire to promote sales of particular investments.

- Prohibited Contract Provisions

Consistent with existing FINRA policy, advisers would be prohibited from including provisions in the contract that would free the adviser or firm from liability for breaching the contract or that would restrict investors' ability to participate in class action lawsuits. However, advisers would be free to include pre-dispute binding arbitration clauses in customer contracts.

- Enhanced Disclosure Requirements

Advisers would be required to provide retirement savers with point-of-sale and on-going annual disclosures regarding the costs and conflicts associated with their advice.

- Permissible Investment Recommendations

Advisers who rely on the exemption would be free to recommend a broad range of investment assets that are considered relatively transparent and liquid. The list of permissible assets is extensive and ensures that the investor can build a diversified portfolio. It includes, for example: bank deposits, certificates of deposit (CDs), exchange-listed stocks, mutual funds, exchange-traded funds (ETFs), exchange-traded Real Estate Investment Trusts (REITs), registered corporate bonds, Treasuries, and annuities.

Less transparent, less liquid, and more risky investment options, such as private placements, non-traded REITs, private equity, and hedge funds, are not within the scope of permissible assets. Such assets are traditionally reserved for more sophisticated and wealthier investors who can stand to lose significant amounts of money if their investments fail. Advisers would be free to recommend such assets outside a retirement account or within a retirement account if they do not receive conflicted compensation. Similarly, if a retirement saver wants to invest in those assets, she is free to instruct her financial adviser to execute an order on her behalf. As discussed above, so long the adviser does not provide a recommendation, no fiduciary obligation arises and compliance with the Best Interest Contract Exemption is unnecessary.

- Sale from a Limited Menu of Investment Options

Where a firm's product menu consists of a limited number of investment options, including a menu made up exclusively of in-house products, the firm and the adviser would be required to take additional precautions to protect against the particularly acute conflicts of interest associated with this business model.

- The firm would have to make a written finding that the limitations do not prevent the adviser from providing advice that is in the best interest of the retirement investors.
- Payments received for the services could not exceed the fair market value of the services provided, a more specific determination than is required under the Best Interest Contract Exemption's reasonable fees requirement.
- Before making recommendations, the firm would have to provide clear notice of any limitations placed by the firm on the investments offered by the adviser.
- The adviser would have to notify the customer if their product menu did not include options that meet that individual's needs.

Principal Trading Exemption

The rule proposal also includes an exemption to permit advisers to sell certain fixed income (debt) securities to retirement plans and IRAs out of their inventory. Because advisers who sell out of inventory may be able to dictate unilaterally the price that investors pay and charge them more than is appropriate, the DOL proposal includes protections that would apply to such transactions.

- The adviser would have to meet all of the contract requirements in the Best Interest Contract Exemption.
- To attain a price reference that ensures the investor is not paying more than fair market value, the adviser would have to obtain two price quotes from unaffiliated firms for the same or a similar security, and the transaction would have to occur at a price at least as favorable as the two price quotes.
- The adviser would have to disclose the amount of compensation and profit that he expects to receive on the transaction.