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Milliman

CLIENT ACTION Bulletin
Employee Benefits

Labor Department Proposes New “Conflict of Interest” Fiduciary Rule

SUMMARY

The Department of Labor has proposed a definition of “fiduciary” that covers individuals who provide investment advice or recommendations for a fee to ERISA-covered and non-ERISA plans and participants (and individual retirement account (IRA) owners). The proposed rule aims to reduce conflicts of interest that may arise when investment advisers make recommendations that favor their own financial well-being over a client’s best interest. The proposal is the DoL’s second attempt at addressing this concern, having withdrawn a 2010 proposed rule that came under heavy criticism.

This *Client Action Bulletin* provides an overview of the DoL’s proposed rule and related proposed prohibited transaction exemptions (PTEs) as they apply to plan sponsors and participants (and does not cover the requirements relating to advice given to IRA owners). Although the proposed rule focuses on the defined contribution retirement plan arena, it also has implications for defined benefit plan sponsors and their advisers. In addition, the proposed rule affects a broad range of individual account plans (e.g., 403(b) arrangements), including, potentially, nonretirement programs such as health savings accounts.

DISCUSSION

The Proposed Rule in General

The proposed rule primarily targets advisers (including broker-dealers, registered investment advisers, and insurance agents) who receive compensation for individualized advice given to plan sponsors or participants. It requires advisers, as fiduciaries, to act in their clients’ “best interest and provide impartial advice,” rather than under the current “suitability” standard that generally permits recommendations of products that takes into account tolerance for risk. The DoL proposes to modify the current five-part test (which was developed in 1975) that is used to determine whether an adviser who does not have discretionary authority is a fiduciary under ERISA. The agency reasoned that by requiring advisers to satisfy all of the test’s conditions, the test permits many to escape or evade fiduciary status, to the detriment of plan sponsors and participants.

The revised definition of fiduciary investment advice covers: investment recommendations; investment management recommendations; appraisals of investments; or recommendations of persons to provide investment advice for a fee or to manage plan assets. In general, individuals providing such advice are fiduciaries if they:

- represent that they are acting as a fiduciary under ERISA or the tax code; or
- provide advice pursuant to an agreement, arrangement, or understanding that the advice is individualized or specifically for the recipient to make investment or invesment management decisions about plan assets.

Both the “investment” and the “investment management” recommendations cover distributions of benefits or rollovers of assets from a plan to an IRA.

Carve-outs for Common Retirement Plan Activities

The proposed rule carves out several practices commonly found in retirement plans in the workplace. Without the carve-outs, the proposed rule could sweep in these activities (enumerated below) and make fiduciaries of individuals providing those services if they do not represent that they are acting as ERISA fiduciaries. The carve-outs include:

- information and materials that constitute investment or retirement “education”;

- statements or recommendations provided to an ERISA plan by an employee of the plan sponsor if he/she receives no fee beyond his/her normal compensation;
- marketing or making available a platform of investment alternatives to be selected by an ERISA plan fiduciary for a participant-directed individual account plan;
- identification of investment alternatives that meet objective criteria specified by, or the provision of objective financial data to, an ERISA plan fiduciary; and
- statements or recommendations made to a “large plan investor with financial expertise” by a counterparty acting in an arm’s-length transaction or in swap and security-based transactions.

The proposed rule also provides a carve out for appraisals, fairness opinions, or valuations to: an employee stock ownership plan (ESOP) regarding employer securities; a collective investment vehicle holding plan assets; or a plan for meeting reporting and disclosure requirements. The proposed rule’s preamble indicates that a separate regulatory initiative will further address ESOP-related fiduciary issues.

The proposed rule retains the current regulation’s position that broker-dealers, reporting dealers, and banks executing a client’s order to buy or sell securities or other investments are not acting as fiduciaries to the client.

The Proposed PTEs in General

The proposed (and proposed modifications to) PTEs cover: securities transactions; transactions involving plans and certain broker-dealers, reporting dealers, and banks; transactions involving plans in IRAs; and transactions with insurance agents and brokers, pension consultants, insurance companies, and investment company principal underwriters.

One of the new proposed PTEs would create a “best interest contract exemption” to permit investment firms and individual advisers to continue setting their own revenue-sharing, commissions, or other compensation structures if they “commit to putting their clients’ best interests first” and disclose conflicts that may prevent them from doing so. The exemption would require a contract between the parties acknowledging the investment firm/adviser’s fiduciary status, warranting that the firm has adopted policies and procedures designed to mitigate conflicts of interest, and clearly and prominently disclosing conflicts of interest.

ACTION

All sponsors of ERISA-covered, non-ERISA-covered, retirement, and individual account plans should review the proposed rule and related proposed PTEs for their potential effects. Special attention should be paid to the revised definitions and conditions for carve-outs. Sponsors should consider whether their practices, operations, and procedures can comply relatively easily with the proposed rule or whether significant and costly changes will be required if the proposed rule becomes final in its current form. A review of investment education materials to ensure that they do not provide advice also should be undertaken by plan sponsors.

Plan sponsors also should file formal comments with the DoL by July 6, 2015, to seek modifications or clarifications.

For additional information about the DoL’s proposed rule and PTEs, or for assistance with assessing the effects of the proposals on your employee benefits programs, please contact your Milliman consultant.