SULLIVAN & CROMWELL LLP

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November 17, 2023

Fiduciary Rule

DOL Proposes Fiduciary Investment Advice Regulations

SUMMARY

On November 3, 2023, the Department of Labor proposed regulations that would, if adopted, significantly expand the circumstances in which a person will be treated as a fiduciary under the Employee Retirement Income Security Act of 1974 by reason of providing investment advice for a fee to a retirement investor (e.g., an employee benefit plan or an individual retirement account). The proposal also would curtail the scope of exemptions from prohibited transactions that can arise for such fiduciaries.

The DOL has framed the changes as bringing the rules for retirement investors into line with the SEC's Regulation Best Interest and aligning the rules with investor expectations about impartiality and best interest advice. However, the Proposed Regulations are the DOL's fourth attempt since 2010 to expand fiduciary status. While there are significant differences between the Proposed Regulations and prior DOL efforts, the general thrust of the changes is very similar and an important question going forward will be whether the differences are sufficient to allow the proposal to survive legal challenge.

The DOL will hold a public hearing regarding the Proposed Regulations on December 12, 2023, and the comment period ends on January 2, 2024.

I. BACKGROUND

ERISA imposes stringent duties on persons treated as fiduciaries of an employee benefit plan, including a duty of undivided loyalty, a duty to act for the exclusive purpose of providing plan benefits (and defraying costs) and a stringent duty of care. In addition, ERISA prohibits a fiduciary from causing a plan to engage in certain "prohibited transactions," such as transactions involving a conflict of interest between the fiduciary and the plan and certain other transactions with parties in interest to the plan including, for example, sales of property, making loans, and providing banking or accounting services.

Unless otherwise covered by a DOL exemption, a breach of ERISA's fiduciary duties or prohibited transaction rules can result in liability to make the plan whole for any losses, to disgorge profits, to pay civil penalties to the DOL and/or to pay penalty taxes under the comparable provisions of the Internal Revenue Code ranging from 15% to 100% of the face amount of the relevant transaction. Further, the availability of common prohibited transaction exemptions, such as the statutory service provider exemption under Section 408(b)(17) of ERISA, may depend, in part, on whether the counterparty to the employee benefit plan is treated as a fiduciary.

Under current law, as set forth in a DOL regulation issued in 1975, a person who does not have discretionary authority or control with respect to the assets of a plan will not be treated as a fiduciary by reason of providing investment advice unless such person satisfies a five-part test: (1) such person renders advice with respect to the value of securities or other property or makes recommendations as to the advisability of investing in particular securities or property (2) on a regular basis, (3) the advice is provided pursuant to a mutual agreement, arrangement or understanding with the plan that (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and (5) the advice is individualized to the plan based on the needs of the plan.

In 2016, the DOL promulgated final regulations that significantly broadened the definition of "investment advice" for purposes of these rules.[1] The 2016 regulations also provided for limited new prohibited transaction exemptions that required advisors to act in the best interest of clients satisfy certain disclosure requirements, and in some circumstances provided the client with a private right of action against fiduciaries that do not comply with the terms of the exemption. In 2018, the Court of Appeals for the Fifth Circuit vacated the 2016 regulations in their entirety, holding that—among other shortcomings—the rules were inconsistent with the statutory and common law definition of an "investment advice fiduciary" and that the Best Interest Contract Exemption exceeded the DOL's authority by creating a private right of action for Individual Retirement Accounts.[2]

II. PROPOSED REGULATIONS

The Proposed Regulations would replace the current regulatory framework with new rules that once again expand the definition of investment advice. Once effective, the Proposed Regulations would also apply for purposes of the analogous provisions under Section 4975 of the Code. Under the Proposed Regulations, an investment advice fiduciary would include a person that makes a recommendation of a securities or investment transaction or strategy to a retirement investor if:

- that person either directly or indirectly (*e.g.*, through or together with any affiliate) makes investment recommendations to investors on a regular basis as part of their business;
- the recommendation is provided under circumstances indicating that the recommendation is based on the particular needs or individual circumstances of the retirement investor; and

- the recommendation may be relied upon by the retirement investor as a basis for investment decisions that are in the retirement investor's best interest.[3]

The Proposed Regulations explicitly state that a recommendation to roll over, otherwise transfer, or distribute assets from a plan or IRA, including whether to engage in such a transaction, are recommendations for this purpose. The rules also specify that written statements disclaiming fiduciary status or the conditions described above will not control to the extent inconsistent with oral communications, marketing materials, applicable laws, or other interactions with the retirement investor.

The DOL explains in the preamble to the Proposed Regulations that it expects "wholesaling" activity—communications between product developers or other financial service providers to financial intermediaries who then directly advise retirement investors—would typically fall outside the scope of the new rules. Outside of that specific case, the DOL generally expects the new rules to apply broadly to recommendations to retirement advisors. Moreover, the DOL explicitly rejects the distinction between a mere sales recommendation and advice in the context of retail investment products.

III. PTE REVISIONS

In addition to expanding the scope of investment advice arrangements that give rise to fiduciary relationships, the DOL would simultaneously narrow the scope of exemptions to prohibited transactions that could result from such a relationship.

First, the DOL is proposing to amend PTE 2020-02, an exemption that allows investment advice fiduciaries to receive compensation that would otherwise give rise to a prohibited transaction. The current requirements of PTE 2020-02 include a written acknowledgment of fiduciary status, disclosure of conflicts, the adoption by the fiduciary of policies intended to ensure compliance with impartial conduct standards, certain documentation obligations, and an annual compliance review. The proposed amendments would expand the disclosure requirements under the PTE and require financial institutions to report any non-exempt prohibited transactions and pay any resulting excise taxes. Notably, the amendments would rely on the existing remedy framework for prohibited transactions, rather than creating a private right of action such as was included with the 2016 regulations and was identified by the Fifth Circuit as an inappropriate exercise of DOL authority.

In addition to the amendments to PTE 2020-02, the DOL is proposing amendments to five prohibited transaction exemptions that currently offer relief for investment advice fiduciaries who receive compensation when plans and IRAs enter transactions recommended by the fiduciaries or purchase certain securities from the fiduciary or a party related to the fiduciary. The proposed amendments would remove investment advice fiduciaries from the category of persons covered by these exemptions. The DOL intends for this change to require investment advice fiduciaries to rely instead on PTE 2020-02, thereby aligning the standards applicable to various types of advice under the rules of PTE 2020-02.

Finally, the DOL is proposing to amend PTE 84-24, which generally provides relief for compensation of insurance agents or brokers, pension consultants, and principal underwriters in connection with purchases of insurance or annuity contracts or investment company securities by retirement investors. The amendments add a new section specifically addressing investment advice fiduciaries, while excluding such fiduciaries from relief under the existing provisions.[4] The new provisions are intended to align the requirements with those of PTE 2020-02, would require independent insurance agents to sell annuities of two or more unrelated insurers, and would provide relief only for fully disclosed commissions or fees in connection with the sale of annuities or other insurance products not regulated by the SEC. Agents that sell or recommend products other than annuities would have to rely on PTE 2020-02.

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ENDNOTES

[1] For additional information on the 2016 proposed regulations, see our Client Memorandum, DOL Releases Final “Investment Advice” Regulation, dated April 20, 2016, *available at* https://www.sullcrom.com/SullivanCromwell/_Assets/PDFs/Memos/SC_Publication_DOL_Releases_Final_Investment_Advice_Regulation.pdf.

[2] For additional information on the Fifth Circuit’s decision, see our Client Memorandum, ERISA Fiduciary Rule, dated March 19, 2018, *available at* https://www.sullcrom.com/SullivanCromwell/_Assets/PDFs/Memos/SC_Publication_ERISA_Fiduciary_Rule_3_19_18.pdf.

[3] Also, consistent with the existing regulations, a person would be treated as providing investment advice if that person has discretionary authority or control with respect to property of the retirement investor or acknowledges that they are acting as a fiduciary when making investment recommendations.

[4] The revised PTE would no longer require an insurance company to provide a fiduciary acknowledgment or be treated as a fiduciary with respect to independent insurance agents (as opposed to captive agents) merely because the insurer exercises oversight responsibilities over the independent insurance agent; instead, it is proposed that the independent agent would be required to make the fiduciary acknowledgment.

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