ALERT MEMORANDUM

Groundhog Day – Did the DOL's Fiduciary Rule See its Shadow?

November 10, 2023

On October 31, 2023, the Department of Labor (the "DOL") proposed a new rule[1] (the "Proposed Rule") that would redefine the universe of "investment advice" fiduciaries under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Proposed Rule is intended to "ensure that ERISA's fiduciary standards uniformly apply to all advice that retirement investors receive concerning investment of their retirement assets" and to fill "a gap in those advice relationships where advice is not currently required to be provided in the retirement investor's best interest." Many of the proposed changes are thus intended to reach rollover recommendations provided to participants and beneficiaries of 401(k) plans and individual retirement accounts ("IRAs") to ensure that these interactions fall under the umbrella of fiduciary "investment advice."[2] However, the Proposed Rule casts a wide net and is likely to have unintended consequences in a variety of different contexts. The Proposed Rule is subject to a 60-day notice and comment period, with a public hearing to be held prior to the expiration of the comment period.

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[1] Retirement Security Rule: Definition of an Investment Advice Fiduciary, 88 FR 75890 (Nov. 3, 2023), available here.

[2] *See* DOL Fact Sheet here.

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Before discussing the changes embodied in the Proposed Rule, it is important to contextualize these changes within the prior and current regulatory landscape.

The Five-Part Test

As of today, an "investment advice" fiduciary is determined by applying a "five-part" test (the "Five-Part Test"). The Five-Part Test was finalized one year after ERISA was enacted and, other than a brief hiatus in 2017 and 2018, it has been in effect since its inception. Under the Five-Part Test, a person is an "investment advice" fiduciary with respect to the assets of plans subject to ERISA and/or Section 4975 of the Code ("Plan Assets" and each such plan, a "Plan") when such person:

1. provides advice/recommendations to a Plan regarding the purchase or sale (or value of) securities or other property for a fee,
2. on a regular basis,
3. pursuant to a mutual understanding that,
4. the investment advice will serve as a primary basis for an investment decision, and
5. the advice is individualized based on the particularized needs of the Plan.

A Brief Hiatus Fraught with Difficulty

The DOL first proposed changes to the Five-Part Test in 2010.[3] In 2015, the DOL proposed a new set of changes[4] and, after four days of public hearings and a delayed effective date, the DOL's rewrite of the Five-Part Test became applicable in 2017 (the "Prior Rule"). The Prior Rule significantly expanded the definition of "investment advice" fiduciaries and included several notable exclusions,[5] including one for advice given to independent and sophisticated fiduciaries.[6] The Prior Rule was far-reaching and it impacted a wide variety of transactions involving Plan Assets – from marketing activities relating to private funds to transactions entered into with broker-dealers and beyond. The Prior Rule was met with stiff criticism and several legal challenges.[7] It is even cited as the reason why some financial institutions stopped providing certain types of services to Plans. In 2018, the Fifth Circuit Court of Appeals invalidated the Prior Rule, concluding that it was an overstep by the DOL.[8] In 2020, the DOL formally reinstated the Five-Part Test,[9] which brings us to today.

[3] *See* Definition of the Term "Fiduciary", 75 FR. 65263 (Oct. 22, 2010), available here.

[4] *See* Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice, 80 FR 21928 (Apr. 20, 2015), available here.

[5] *See* Cleary alert memo summarizing the Prior Rule located here; and *see* Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 FR 20946 (Apr. 8, 2016), available here.

[6] This exclusion provided that a person generally would not be deemed to be an "investment advice" fiduciary solely by reason of providing advice to an independent fiduciary that holds or has under management or control total assets (including non-retirement assets) of at least $50 million, or that is a bank, insurance company, registered investment adviser or registered broker-dealer, provided that (1) the recipient of the advice is sophisticated and reasonably believed by such person to be acting as an independent fiduciary of the Plan, (2) such person informs the fiduciary that it is not providing impartial or fiduciary advice and discloses the existence and nature of any financial interests in the transaction and (3) such person does not (A) receive a fee or other compensation directly from the Plan "for the provision of investment advice (as opposed to other services)" in connection with the transaction or (B) represent or acknowledge that they are acting as a fiduciary. *See supra* note 5.

[7] *See e.g., National Association for Fixed Annuities v. Perez*, F.Supp.3d 1 (D.D.C. 2016); *Market Synergy v. United States Department of Labor*, 885 F.3d 676 (10th Cir. 2018); *Thrivent Financial for Lutherans v. Acosta*, No. 16–CV–03289, 2017 WL 5135552 (D. Minn. Nov. 3, 2017).

[8] *Chamber of Commerce v. U.S. Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018).

[9] Conflict of Interest Rule-Retirement Investment Advice: Notice of Court Vacatur, 85 FR 40589 (July 7, 2020), located here.

Gone but not for Long

Revisions to the Five-Part Test have been on the DOL's regulatory agenda for the last couple of years. While the Proposed Rule has many of the hallmarks of the Prior Rule, it also has several distinguishing characteristics and is perceived as having the potential to be less expansive than the Prior Rule. Under the Proposed Rule, a person will be an "investment advice" fiduciary when such person provides investment advice or makes a recommendation to a Plan (including to its fiduciaries, participants and beneficiaries) for a direct or indirect fee or other compensation[10] *and* one of the following is true:

1. The person:

— directly or indirectly (*i.e.*, through or together with such person's affiliates) makes investment recommendations on a regular basis as part of such person's business, and

— provides a recommendation to a Plan under circumstances indicating that the recommendation

- is based on the particular needs or individual circumstances of the Plan, and
- may be relied upon by the Plan as a basis for investment decisions that are in the Plan's best interest,

<u>*or*</u>

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

Although the Proposed Rule is not a complete re-write of the Five-Part Test, it alters the current test in a number of significant ways:

— ***Regular Basis*.** The Five-Part Test focuses on fiduciary advice being given on a "regular basis" and excludes one-time recommendations (*e.g.*, certain rollover recommendations). Under the Proposed Rule, any person who directly or through affiliates makes *any* investment recommendations on a regular basis as part of its business would meet this prong of the Proposed Rule. With this change, a one-time recommendation to a Plan would be covered if the person providing such recommendation (or such person's affiliates) is in the business of regularly providing investment advice.[11] The impact of this change would reach well beyond rollover recommendations and other retail advice – nearly every financial institution and alternative asset manager will meet this prong of the Proposed Rule. In addition, this change would pick up activities engaged in by insurance companies in connection with rollovers to annuity contracts.

— ***Mutual Understanding*.** Citing the prevalence of fine-print disclaimers disavowing fiduciary status, the DOL eliminated the Five-Part Test's requirement that there be a "mutual agreement, arrangement or understanding." Instead, the Proposed Rule places an emphasis on the "objective circumstances" surrounding the advice, including the manner in which a person presents itself and describes its services. This change raises significant interpretive questions because, although the DOL posits that this change would require an objective determination to be made, whether an understanding between two parties exists is, at least in part, inherently subjective.

[10] Under the Proposed Rule, a "fee or compensation is paid 'in connection with or as a result of' such transaction or service if the fee or compensation would not have been paid but for the recommended transaction or the provision of advice, including if eligibility for the amount of the fee or compensation is based in whole or in part on the recommended transaction or the provision of advice." *See* Retirement Security Rule, *supra* note 1, at 75978.

[11] Per the preamble to the Proposed Rule, "the proposal's regular basis requirement would not defeat legitimate investor expectations by automatically excluding one-time advice from treatment as fiduciary investment advice." *See* Retirement Security Rule, *supra* note 1, at 75902.

— ***Primary Basis*****.** The Proposed Rule eliminates the Five-Part Test's "primary basis" requirement and instead looks to whether the advice is relied upon as ***a*** basis for investment decisions that are in the Plan's best interest. Under this standard, "[r]ecommendations that meet this test can be outcome-determinative for the investor and are appropriately treated as fiduciary advice when the elements of the [P]roposed [R]ule are satisfied."[12] These changes would lower the bar and result in a less straightforward analysis as to whether a Plan's reliance on advice fits within this prong of the test.

— ***Effect of Disclaimers*****.** In the first of two new twists, the Proposed Rule states that any written statements disclaiming fiduciary status "will not control to the extent that they are inconsistent with a person's oral communications, marketing materials, applicable State or Federal law or other interactions" with the investor.[13] Private fund sponsors, note issuers and a wide variety of service providers rely on disclosures to clarify that they are not intending to be fiduciaries in connection with sales/marketing activities and the provision of other services. The Proposed Rule would raise questions about whether these disclosures will need to be revised and to what extent other actions should be taken to ensure that marketing and sales activities are not inconsistent with disclosures asserting non-fiduciary status.

— ***Fiduciary Acknowledgement*****.** In the second new twist, the Proposed Rule introduces an additional basis for determining a person's status as an "investment advice" fiduciary. The Proposed Rule would pick up a person who, while making investment recommendations or providing investment advice, represents or acknowledges (whether in writing or not) its fiduciary status. The DOL intends this change to "ensure that parties making a fiduciary representation or acknowledgement cannot subsequently deny their fiduciary status if a dispute arises, but rather must honor their words."[14] Notably, the preamble to the Proposed Rule clarifies that this prong of the test is not limited to circumstances in which a person specifically represents that they are a fiduciary for purposes of ERISA. The preamble states that a person need not specifically represent "that they are a fiduciary for purposes of Title I or Title II of ERISA," or specifically reference "any particular statutory provisions. It is enough that the investment advice provider told the retirement investor that the investment advice or investment recommendations were or will be made in a fiduciary capacity."[15] This new prong raises questions about whether a fiduciary acknowledgement, without any reference to such term being defined by ERISA or any other law (*e.g.*, Delaware law or the Investment Advisers Act of 1940) could satisfy this element of the Proposed Rule. Further, this new prong may raise interpretive questions around marketing activities relating to private funds (whether subject to ERISA or not) where a fund's governing documents contain a general fiduciary acknowledgement vis-à-vis the management and operation of the fund.

Lack of Safe Harbors

In addition to the changes described above, the Proposed Rule does not include any exclusions or safe harbors. While the Prior Rule broadly swept in a wide variety of activities that could be deemed to constitute fiduciary "investment advice," it also provided exclusions, including one for independent and sophisticated fiduciaries.[16] This independent fiduciary exclusion was utilized by many private fund sponsors, Plan counterparties, service providers and financial institutions and provided a level of certainty to parties interacting with Plans as to whether they would be deemed to be providing fiduciary "investment advice." Despite the public discourse surrounding the Proposed

[12] Retirement Security Rule, *supra* note 1, at 75902.

[13] *Id.* at 75903.

[14] *Id.*

[15] *Id.*

[16] *See supra* note 5.

Rule that focuses on the protection of 401(k), IRA and retail investors, the breadth of the Proposed Rule combined with the lack of exclusions or safe harbors creates significant uncertainty regarding which activities clearly fall outside the scope of the proposal. This uncertainty would impact Plans, private fund sponsors, Plan counterparties and a wide variety of other service providers as they struggle to determine which of their actions (including regular marketing and sales activities) could be deemed to be fiduciary "investment advice."

Changes to Prohibited Transaction Exemptions

Along with the Proposed Rule, the DOL proposed amendments to Prohibited Transaction Class Exemptions ("PTCEs") 75-1, 77-4, 80-83, 83-1, 84-24, 86-128 and 2020-02. The proposed amendments to PTCE 2020-02 and PTCE 84-24 would expand the existing conditions for relief and the amendments to PTCEs 75-1, 77-4, 80-83, 83-1, and 86-128 would generally restrict or eliminate relief for "investment advice" fiduciaries under each of these PTCEs. While these proposed amendments are beyond the scope of this summary, they would have a broad impact on the availability of exemptive relief under these PTCEs in a climate where the universe of "investment advice" fiduciaries would be broader and less well defined.

What Comes Next?

The Proposed Rule is subject to a 60-day notice and comment period (*i.e.*, the beginning of January 2024) with a public hearing to be held prior to the expiration of the comment period. Initial commentators have taken issue with the brevity of the comment period, which is shorter than what was otherwise provided for in the context of the Prior Rule.[17] The DOL was careful to provide for severability of the different provisions of the Proposed Rule in order to allow a greater chance for survival of part of the rule in the event of a legal challenge. We expect many different industry groups (ranging from financial institutions, alternative investment advisers, and organizations representing Plans, Plan sponsors and insurance companies) to submit comment letters to the DOL. Topics we expect to be addressed include the lack of any safe harbor, the impact on insurance companies in the annuity context, and the impact of the amendments to the PTCEs in a climate where the world of "investment advice" fiduciaries would be expanding.

Given that this is a proposal and not a final rule, no immediate steps should be necessary at this time. However, we will continue to closely monitor developments relating to the Proposed Rule. Given the upcoming election year, the DOL may push to quickly finalize the Proposed Rule.[18]

Please contact any of the authors or your regular Cleary Gottlieb contacts for further discussion or if you have questions.

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[17] *See e.g.*, comment letter available here.

[18] Under the Congressional Review Act ("CRA"), any member of Congress can introduce a joint resolution disapproving of an agency's final rule once it is submitted. A measure of disapproval only requires a simple majority in the House and Senate (unless the disapproval is the subject of the Presidential veto and then a two-thirds majority in both chambers is required). The CRA generally gives Congress a period of 60 legislative days after the date a final rule is published in the Federal Register to challenge it. However if a rule is published within 60 days of the end of a Congressional session, a new 60-day window for disapproval restarts during the next Congressional session. A final rule that is the subject of a joint resolution of disapproval may not be reissued in the same form. *See* Congressional Review of Agency Rulemaking 5 U.S.C. §§ 801-808.