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## LEGAL UPDATE

# The Great Divide: The Different Effect of the DOL's Fiduciary Proposal on Large and Small Plans

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**T**he Department of Labor's (DOL's) new conflicts proposal significantly broadens the definition of investment advice, the rendering of which will result in fiduciary status if it is specifically directed to a plan client and the recommendation results in the receipt of compensation by its maker. Recommendations relating to securities or other property, rollovers, investment managers, and financial valuations would all be covered by the new definition, as would recommendations to hire an adviser to provide guidance on these matters. Even one-time advice not provided on a regular basis could be treated as fiduciary advice.

Some communications will not result in fiduciary status if they qualify for one of a half dozen exceptions, otherwise referred to as carve-outs. And, even if fiduciary status applies, an exemption may allow the fiduciary to receive variable compensation that would otherwise be prohibited under ERISA's prohibited transaction rules. As will be discussed, however, the carve-outs and exemptions are aimed at different groups of advisers and some advisers are not covered by any carve-out or exemption.

### Large Plan Carve-Out

For large plans with 100 or more participants, advice by a person acting as a counterparty in an arm's length purchase, sale, or loan transaction with a plan may provide this advice without being treated as a fiduciary by limiting his or her communications to the specific transaction between the counterparty and the plan and meeting certain other conditions. First, the plan sponsor or another independent plan fiduciary would need to provide a written representation

that the plan has at least 100 participants, that the sponsor or independent fiduciary has sufficient expertise to evaluate the transaction, and that it will not rely on the counterparty to act as a fiduciary. Under the counterparty carve-out, this written representation is not required if the plan fiduciary has at least \$100 million of assets under management (taking into account all plan client assets under the fiduciary's management). The counterparty also must inform the plan fiduciary of the nature of the counterparty's role in the transaction and may not receive a direct fee from the plan or plan fiduciary in connection with the transaction.

Thus, if a broker-dealer were to sell a financial product from its inventory to such a large plan, the broker would be a counterparty to the plan client, and it would be permitted to provide incidental advice without being deemed a fiduciary if the foregoing conditions are met. Because of the sponsor's size or the independent fiduciary's expertise, it is assumed that there will be no reliance on the broker's acting in the plan's best interest. Basing this assumption on a plan having 100 participants seems questionable, and the definition of a large plan could be reset when the proposal is finalized.

### BICE Exemption

*Plans Covered.* The Best Interest Contract Exemption (BICE) is designed to provide relief to fiduciary advisers who earn variable commissions from retail retirement clients. In contrast to the large plan carve-out, covered retirement clients include sponsors of nonparticipant-directed plans with fewer than 100 participants, such as small defined benefit plans, as well as plan participants and IRA owners. However, sponsors

of small 401(k) plans and other plans with participant-directed investments are conspicuously omitted from this list, even though the BICE is supposed to cover retail retirement clients. The DOL has requested comments from the public on whether advice to small 401(k) plans on the composition of a plan investment menu should be covered by the BICE. If the list is not expanded when the rules are finalized, brokers and insurance agents may be unable to earn variable compensation, such as commissions, when selling investments to small 401(k) plan sponsors. Even if this change is made, the DOL does not contemplate providing similar relief for brokers and insurance agents serving large plans as fiduciaries so that variable compensation from plans with 100 or more participants would be prohibited for most investments.

**Covered Assets.** BICE relief is specifically limited to certain listed investment products. They include bank deposits, CDs, mutual funds, exchange-traded funds, bank collective investment funds, insurance company separate accounts, exchange-traded REITs, corporate bonds registered under securities law, publicly traded equity securities, Treasury and government agency debt securities, and insurance and annuity contracts, as well as GICs. This list is intended to represent investments that are commonly purchased by retail plan clients (*i.e.*, small plans, participants and IRAs). However, privately placed debt securities, nontraded REITs, derivatives (*e.g.*, puts, calls, straddles, and futures contracts) and alternative investments (hedge funds, private equity) are omitted. This means that fiduciary advisers would no longer be able to earn commissions by selling these types of investments to their IRA and plan clients, no matter what their size.

**Written Agreement.** To qualify for the BICE, an adviser and the financial institution employing or retaining the adviser must sign a written agreement making certain promises to the retirement client. The agreement must acknowledge that the adviser is a fiduciary for purposes of ERISA or the Code, as applicable, with respect to the advice being provided. In addition, the agreement must provide that the advice will be rendered in accordance with the “best interest” fiduciary standard, which is similar to the “prudent man standard of care” under ERISA, except that it must be based on the specific needs of the retirement investor and without regard to the adviser’s financial interests. The agreement also must provide that the adviser only will earn reasonable compensation and that no misleading statements will be made.

For its part, the financial institution must warrant that it has adopted written policies and procedures designed to mitigate conflicts of interest, and that it has eliminated any incentives that would encourage the adviser to make recommendations that are inconsistent with the “best interest” fiduciary standard. Thus, even though the BICE is intended to permit variable compensation, a compensation scheme that creates an incentive for the financial institution’s representative

to recommend certain products, thereby resulting in a material conflict, could potentially be subject to a plan or participant lawsuit for breach of contract. The BICE agreement may not limit the adviser’s liability for contract violations.

## Prohibited Transaction Exemption 84-24

Prohibited Transaction Exemption (PTE) 84-24 has traditionally permitted advisers to receive commissions in connection with the purchase and sale of insurance products and mutual fund shares by plans and IRAs. Going forward, the DOL proposes to revise PTE 84-24 to require that an adviser act in the best interest of a plan, participant, or IRA, just as would be required under the BICE, except that it would not be necessary for the plan and adviser to enter a written agreement or adopt formal policies and procedures to mitigate conflicts of interest. Just as under the BICE, however, compensation must be reasonable and an adviser will need to disclose material conflicts of interest that could affect the exercise of its best judgment as a fiduciary in rendering advice. It should be noted that historical practice with respect to commission levels are not a guarantee that compensation will be seen as reasonable under the new standards.

While the BICE and PTE 84-24 share the same impartial conduct standard, they differ as to the plans and products that they cover. In contrast to the BICE, PTE 84-24 is not limited to transactions with plans of less than 100 participants. This means that advisers potentially can receive commissions on insurance, certain annuity products, and mutual funds sold to large plans with more than 100 participants.

In addition, PTE 84-24 will be modified so that it no longer covers transactions in which IRAs purchase or sell mutual funds or variable annuities treated as securities. Advisers will need to seek exemption for these transactions under the BICE, which means that IRA owners will have a contractual right to enforce fiduciary standards with respect to an adviser’s recommendations. Transactions not involving IRAs will continue to be covered by PTE 84-24, as revised by the DOL proposal, as will IRA transactions involving insurance and traditional fixed annuities.

## Recommendation

The DOL conflicts proposal includes a complex array of exceptions and exemptions, the requirements of which vary depending on the size and/or nature of the retirement vehicle, as well as the type of product being sold. Some of these requirements will change in the process of finalizing the proposal. It is incumbent on plan sponsors, as well as their advisers, to avoid engaging in prohibited transactions, but to do this will require close monitoring of how the new rules work together.

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