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MEMORANDUM RE: PROPOSED LABOR DEPARTMENT REGULATION DEFINING "FIDUCIARY"

Late last year, the Department of Labor proposed an important regulation defining when a person or entity offering investment advice becomes a "fiduciary" under the Employee Retirement Income Security Act (ERISA). The proposed regulation would replace an earlier regulation that artificially limited the meaning of fiduciary and has exposed participants to serious conflicts of interest. This memorandum discusses the proposed regulation.

One of the principal congressional goals in enacting ERISA was to ensure that those individuals who provide investment advice with respect to retirement plan assets would be fiduciaries, subject to ERISA's prohibitions against fiduciaries entering into certain conflict-tainted transactions. ERISA was clear and unequivocal on this issue: the term fiduciary is defined to include any person "who renders investment advice for a fee or other compensation, direct of indirect, with respect to any moneys or other property" of a plan."

Despite the clarity of the statute, the Department of Labor issued a regulation in 1975 that narrowed this definition, providing that investment advisers would not be considered fiduciaries unless their advice was provided "on a regular basis" and "pursuant to an agreement, arrangement or understanding that such services will serve as a primary basis for investment decisions with respect to plan assets." There is nothing in the legislative history that supported these extra-statutory limitations on the definition of fiduciary. Moreover, the terms "regular basis," "mutual agreement, arrangement or understanding," and "a primary basis" are subjective and ambiguous and have created confusion.

In the context of the times, however, the regulation's inconsistency with the statute did not create serious problems. The retirement world was then dominated by defined benefit pension plans and the regulations permitting today's 401(k) plan was almost six years away. Investment professionals were primarily advising sophisticated fiduciaries who were more capable of synthesizing market information and better able to identify and evaluate potential conflicts of interest than today's typical participant in a self-directed 401(k) plan.

Today, the world is different: most retirement plan participants are in 401(k) plans and have to make their own investment decisions, despite their lack of investment experience or knowledge. Thus, they are highly dependent on the advice offered to them by the investment industry, but unfortunately the advice they receive is sometimes subject to serious conflicts of interest. Indeed, some investment advisers receive undisclosed payments from the vendors of the products they recommend. This would be prohibited under ERISA if the investment advisers are ERISA fiduciaries, but a significant part of the advice industry claims that the 1975 regulation shields them from fiduciary status and allows them to accept these third-party payments. As the Governmental Accountability Office has shown, these conflicts can have significant costs to participants in 401(k) plans. They are also unfair to those investment advisers who regard themselves as fiduciaries and comply with ERISA and its prohibited transaction rules.

The Department of Labor's proposed regulation would revise the 1975 regulation to bring it into closer conformity to the statute's legislative language. The new regulation would apply the statutory judgment that a person providing investment advice for a fee is a fiduciary and, unlike the 1975 regulations, would not provide escape hatches to avoid fiduciary status, but would continue to allow investment advisers with conflicting interests to offer advice under applicable prohibited transaction exemptions. The proposed regulation would thus prohibit investment professionals from offering investment advice only when they face serious conflicts of interest, which over time will result in better investment advice, lower fees, and substantial additional retirement savings for working men and women.

Certain segments of the investment advice industry have mounted an intensive lobbying effort against the proposed regulations, asking that the Department of Labor re-propose or withdraw them. These lobbying efforts have been replete with distortion, misinformation, half-truths, and fanciful speculation. Examine the following lobbying claims through the lens of reality:

The Claim: The Dodd-Frank Act requires that the Securities and Exchange Commission adopt a uniform fiduciary standard for broker-dealers and registered investment advisors and that the proposed regulation thus violates that Act.

The Truth: Dodd-Frank required that the SEC study the feasibility of adopting a uniform fiduciary standard for registered investment advisers and broker dealers under the securities law, which provides a level of protection for all investors. Dodd-Frank did not suggest, let alone mandate, that the securities law standards should supplant the fiduciary standards under ERISA, which was intended to be especially protective of retirement plan participants given their general lack of investment sophistication and the special significance of retirement savings underwritten by tax subsidization. The Department of Labor has had extensive discussions with the SEC during the development and review of the proposed regulation. Moreover, the SEC issued a report that did not recommend that the securities law standards should replace the ERISA fiduciary rules. Rather, the two sets of standards work in complementary fashion in the context of tax-subsidized retirement savings.

The Claim: The proposed regulations would prohibit broker-dealers from giving investment advice.

The Truth: The proposed regulation would not prohibit broker-dealers from giving investment advice. Indeed, many broker-dealers today give investment advice by complying with statutory and regulatory exemptions to the prohibited transaction rules. The argument that broker-dealers would be excluded from giving investment advice apparently is based on the notion that the only permissible form of compensation paid to an investment adviser would be on a fee basis. This is not correct: the Department of Labor has a prohibited transaction exemption that permits fiduciaries to receive commission-based compensation for the sale of mutual funds, insurance, and annuity contracts, and the Department has signaled its willingness and intent to issue additional exemptions. In addition, the statute itself includes a prohibited transaction exemption for investment advice, if fees are leveled or if the investment advice is determined through objective computer programs. And broker-dealers are also free to provide investment education rather than investment advice.

The Claim: The proposed regulations would expose fiduciaries, and particularly those who provide services to IRA holders, to increased risks of participant litigation.

The Truth: First, the proposed regulation would not expose IRA fiduciaries to litigation under ERISA. Indeed, ERISA does not permit a participant or anyone else to sue an IRA fiduciary. The only consequence of the proposed regulation for IRA fiduciaries is that they would not be allowed to enter a prohibited transaction with respect to IRA assets. And, as already noted, the Department has a prohibited transaction exemption that is easily adapted to broker-dealer transactions with IRAs and has also indicated that it would issue additional exemptions. The notion that investment advisers to 401(k) participants would incur ruinous litigation liability is far-fetched. Indeed, it is difficult to find ERISA litigation over the last 30 years in which investment advisers have been sued for anything except gross incompetence or palpable wrongdoing.

The Claim: The Department of Labor has rushed these regulations and failed to provide the investment advice industry a fair opportunity to comment.

The Truth: The Department of Labor has gone to extraordinary lengths to seek the input of the financial industry, consumer groups, trade associations, plan sponsors, individuals, and others. It has held two days of hearings and twice extended the time for comment, including an additional comment period after publishing complete transcripts of the hearings. It has met individually with groups interested in the regulation, some on multiple occasions. And it has signaled numerous times that it will make changes to the proposed regulation and issue additional guidance in response to this unprecedented effort to solicit public input.

Despite the self-serving protests of parts of the investment advice industry, the proposed regulation is thoughtful and balanced and will help create a more transparent and efficient market for investment advice. Unlike the 1975 regulation, the proposed regulation is consistent with the statute’s language and intent. It will provide basic and modest protections guarding participants against just the sort of conflicts of interest that Congress sought to end, and regulatory guidance will permit a wide variety of business models.

In the present retirement plan world, where 401(k)s predominate, the proposed regulation is essential if we expect employees to be able to prepare financially for retirement.