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A Guide to the DOL's New Investment Advice Fiduciary Rule Proposal – What Investment Advisers and Managers Need to Know

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The new "retirement security rule" package, issued by the U.S. Department of Labor (the "DOL") on October 31, 2023, is the latest chapter in an almost 15-year effort by the DOL to amend the five-part test in its 1975 regulation for determining whether a person is an ERISA "fiduciary" by reason of providing "investment advice" for a fee (the "Five-Part Test"). (For more on the history, see here, here and here.) The package includes a proposed new fiduciary "investment advice" rule (the "Proposed Rule") and proposed amendments to certain prohibited transaction exemptions.

Very generally speaking, the Proposed Rule would significantly expand the circumstances under which a person could be treated as providing "investment advice" that is subject to ERISA's fiduciary standards (including the self-dealing prohibited transaction rules). In particular, the Proposed Rule would replace the Five-Part Test's requirements that advice be provided (1) on a "***regular basis***" pursuant to (2) a "***mutual agreement, arrangement or understanding***" that (3) it would serve as "***a primary basis for investment decisions***" with a much broader test that is based on the retirement investor's reasonable expectations and context. The Proposed Rule is broad enough to potentially cover certain marketing and other related activities considered common to the investment management industry (including the private investment fund industry).

Comments on the proposal are due on January 2, 2024, and the DOL has scheduled a virtual public hearing on December 12 through December 13, 2023 (continuing, if necessary, on December 14, 2023). In an unusual move, the DOL will be holding the hearing before the deadline for written submissions, and the DOL rejected industry group requests to extend the comment period.

Background

Under Section 3(21) of ERISA and Section 4975(e) of the Code, a person is considered a "fiduciary" with respect to an ERISA plan or an individual retirement account (an "IRA") if ***the person renders investment advice for a fee or other compensation, direct or indirect, or has any authority or responsibility to do so***. Separately, a person would be a fiduciary if it has discretionary authority or responsibility over the management or investment of the assets of an ERISA plan or IRA (or a vehicle considered to be holding "plan assets" under ERISA or Section 4975 of the Code — for example, a private investment fund that is over the "ERISA 25% limit" but not operated as a "VCOC" or "REOC"). However, the Proposed Rule has no bearing on becoming a fiduciary by reason of having such discretionary authority or responsibility over "plan assets," nor does it change the rules for determining whether or not a private investment fund is holding "plan assets" under ERISA.

Under the Five-Part Test, a person is considered to be providing "investment advice" for these purposes only if the person: (1) renders advice to the ERISA plan or IRA as to the value of securities or other property, or makes recommendations as to investing in, purchasing or selling securities or other property, (2) on a ***regular basis***, (3) pursuant to a ***mutual agreement, arrangement or understanding*** with the ERISA plan, the ERISA plan fiduciary or the IRA owner that, (4) the advice will serve as a ***primary basis*** for investment decisions with respect to the ERISA plan's or IRA's assets and (5) the advice will be individualized based on the particular needs of the ERISA plan or IRA. A person who meets all five prongs of the test and receives direct or indirect compensation will be considered an "investment advice" fiduciary with respect to the applicable ERISA plan or IRA.

As you may recall, in 2016, the DOL replaced the Five-Part Test with a new fiduciary regulation (the "2016 Rule") that (temporarily) significantly expanded the scope of "investment advice." However, the 2016 Rule was vacated by the U.S. Court of Appeals for the Fifth Circuit in 2018 and, following that decision, the DOL reinstated the Five-Part Test.

Proposed New Test

The Proposed Rule would replace the Five-Part Test with a rule that says a person provides "investment advice" if it provides a "recommendation" of "any securities transaction or other investment transaction or any investment strategy involving securities or other investment property" to a "retirement investor" (*i.e.*, an ERISA plan, plan fiduciary, plan participant or beneficiary, or an IRA, IRA fiduciary or IRA owner or beneficiary) and satisfies ***any*** of the following three requirements:

- The person either directly or indirectly (through or together with an affiliate) has discretionary authority or control with respect to purchasing or selling securities or other investment property for the retirement investor;
- The person either directly or indirectly (through or together with an affiliate) makes investment recommendations to investors on a regular basis as part of its business, and the recommendation is provided under circumstances indicating that the recommendation is based on the particular needs or individual circumstances of the retirement investor and may be relied upon by the retirement investor as a basis for investment decisions that are in the retirement investor's best interest; ***or***
- The person making the recommendation represents or acknowledges that it is acting as a fiduciary when making investment recommendations.

Key Takeaways and Implications of Proposed New Test

- **Elimination of requirement that investment advice be provided to advice recipient on a "regular basis."** Under the Five-Part Test, an isolated one-time interaction generally would not be treated as fiduciary investment advice because the advice was required to be provided on a "regular basis" ***to the advice recipient***. The Proposed Rule would expand the fiduciary net by allowing the "regular basis" requirement to be satisfied for anyone who makes (or has an affiliate that makes) investment recommendations to ***any investors*** on a "regular basis" ***as part of its business***. This means that one-time advice can be subject to the fiduciary standard.
    - ***Practice pointer:*** The Proposed Rule picks up an individualized recommendation to a retirement investor by an adviser that regularly provides investment recommendations to ***any*** investors. As a result, many common "one-time" advice scenarios that historically were not covered by the fiduciary standard, such as recommendations related to a single financially-significant real estate transaction, purchasing an annuity contract for a defined benefit pension plan or rolling over assets from an employer-

sponsored plan to an IRA, could all be considered fiduciary investment advice under the Proposed Rule.

- **Elimination of "mutual agreement, arrangement or understanding" and "primary basis" requirements.** Under the Five-Part Test, an adviser could avoid fiduciary status by making clear (including via contract disclaimers) that there is no "***mutual agreement, arrangement or understanding***" that anything the adviser says will serve as "***a primary basis***" for an investment decision. The Proposed Rule would look instead to whether the objective circumstances surrounding the recommendation make it reasonable for the retirement investor to believe that it could rely upon the advice as "***a basis***" for an investment decision that is in the retirement investor's best interest.
- **Recommendation required.** A threshold element for fiduciary status is making a "recommendation." Although the Proposed Rule does not include a formal definition of "recommendation," the DOL notes in the preamble that it views a "recommendation" as a communication (written or oral) that, based on its ***content, context and presentation*** (including the extent to which the communication is more individually tailored to a specific retirement investor or group of investors) would reasonably be viewed as a suggestion that the retirement investor engage in or refrain from taking a particular course of action. The DOL also noted that a series of actions or communications taken together may constitute a recommendation even if they would not have met the threshold individually. The DOL states that the determination of whether a recommendation has been made would be based on an objective, rather than subjective, analysis of the facts and circumstances. However, at the same time, the DOL describes the standard for a "recommendation" under the SEC's Regulation Best Interest as meeting the standard for a recommendation under the Proposed Rule — and that standard turns on the inherently subjective inquiry as to whether the communication reasonably could be viewed as a "call to action" that reasonably would influence an investor to trade a particular security or group of securities.
    - ***Practice pointer:*** The simple act of a private investment fund manager sending its fund's offering memorandum and other governing documents to a retirement investor (in and of itself) generally should not constitute a "recommendation" to invest in the fund under the Proposed Rule. However, if such document delivery is combined with individualized discussions and other related interactions between the fund manager and the prospective investor that address the particular needs or individual circumstances of the retirement investor such that the retirement investor reasonably could believe it could rely on the interactions as a basis for determining that an investment in the fund is in its best interest — those interactions could be a

recommendation that would be considered fiduciary investment advice under the Proposed Rule.

- **No safe harbor for sales or sophisticated retirement investors.** The DOL rejected the difference between a "sales" recommendation and "investment advice" in the retail market. In the DOL's view, when retirement investors talk to investment providers about the investments they should make, they commonly pay for and receive covered "investment advice." Although the vacated 2016 Rule included an exclusion for transactions with independent plan fiduciaries with financial expertise which provided relief for many common sales and marketing practices involving institutional investors, the Proposed Rule does not include a similar exception for recommendations to "sophisticated" advice recipients.
    - ***Practice pointer:*** The omission of a "sales" or "sophisticated investor" safe harbor may leave a lack of clarity for many common marketing activities. Although the DOL says it is trying to protect smaller retail investors, the regulatory wording also sweeps in common interactions with institutional and other sophisticated investors — even those who have the means to engage advisers and counsel. As was the case under the 2016 Rule, fund managers would need to be careful regarding communications made to prospective and existing IRA investors if the Proposed Rule is finalized in its current form.

- **Informal advice outside the scope of a manager's engagement.** As noted above, the Proposed Rule picks up any "recommendation" by a party that directly or indirectly (through or together with an affiliate) has discretionary investment authority or control over a retirement investor's assets — even if the discretion relates to other assets that are not plan assets. Accordingly, if, for example, an adviser (or its affiliate) manages an individual's non-retirement assets, the Proposed Rule would pick up a recommendation by that adviser (or its affiliate) for the client to consider investing its IRA in the adviser's private investment fund. Another common example is if an adviser (or its affiliate) manages a company's non-retirement assets, any recommendation by that adviser (or its affiliate) to that company (in its capacity as sponsor of the company's ERISA-covered retirement plan and, therefore, a "retirement investor") regarding the investment of the ERISA plan's assets would likely be treated as covered "investment advice" under the Proposed Rule. Similarly, if an adviser (or its affiliate) manages an ERISA plan's assets within a "plan asset fund" or a separate account arrangement, any "recommendations" by that adviser (or its affiliate) to any of the ERISA plan's fiduciaries, participants or beneficiaries, even if made in a completely unrelated context that is not within the adviser's contractual mandate, could also be treated as a fiduciary investment advice.

    - ***Practice pointer:*** It is often the case that a discretionary investment manager is engaged to manage only a portion of the assets of a plan or a retirement investor's non-retirement assets. Under the Proposed Rule, a covered "recommendation" provided by such a manager (or its affiliate) would constitute "investment advice" ***even if the recommendation is made with respect to assets that are not managed by the manager***. This change would make it even more difficult for a manager to offer an unrelated investment product to an existing retirement investor client.

- **Acknowledgement of fiduciary status.** Under the Proposed Rule, an adviser that represents or acknowledges that it is acting as a fiduciary when making investment recommendations should be prepared to comply with ERISA's fiduciary duty and prohibited transaction rules when making such investment recommendations to a retirement investor. There is no requirement that such an adviser provide investment recommendations on a regular basis as part of its business or on a regular basis to the retirement investor — if the adviser says it will be acting as an ERISA fiduciary when providing advice, it will be held to that standard with respect to the provision of such advice (but not necessarily with respect to any other aspect of the relationship or a future relationship).
- **"Hire me" recommendations.** The DOL confirmed in the preamble that an adviser's normal activity of marketing itself would not be treated as investment advice, ***so long as the adviser does not make any investment recommendations along with*** the "hire me" pitch. However, there is no safe harbor, as the Proposed Rule requires consideration of the complete facts and circumstances surrounding each recommendation. Also, as noted above, the Proposed Rule's finding of an advisory relationship based on discretion over an investor's ***other*** assets could make it impossible to pitch for expanding an existing relationship without the pitch being subject to the fiduciary standard.
    - ***Practice pointer:*** It remains to be seen whether there is a practical way to make a "hire me" pitch without discussing what the adviser would recommend if engaged. For example, when an investment manager pitches a potential retirement investor with the intention of managing the retirement plan investor's assets within the manager's private investment fund, that "hire me" pitch could be viewed as including a "recommendation" to invest in the fund. Accordingly, the "hire me" exception in the Proposed Rule will be very difficult to utilize for the purposes of marketing specific funds or preset investment strategies. Pitches could be particularly problematic for providers that already have some relationship with the retirement investor (for example, pitching an existing client to expand the relationship).

- **“Day 1” impact on fiduciary status / ERISA compliance.** If the Proposed Rule is finalized in its current form, service providers to ERISA plans or IRAs (or vehicles holding “plan assets”) who do not currently hold themselves to fiduciary standards or have not contractually agreed to comply with ERISA, could be deemed to be providing covered investment advice pursuant to an arrangement that does not comply with ERISA when the new rule becomes effective. In particular, non-compliant compensation structures might especially pose a problem. Accordingly, service providers to ERISA plans or IRAs (or vehicles holding “plan assets”) should review their existing arrangements to assess the potential impact of the Proposed Rule.
- **No disclaimers.** The Proposed Rule states that disclaimers regarding fiduciary status will not control to the extent they are inconsistent with the adviser’s verbal communications, marketing materials, state or federal law or other interactions with the retirement investor. Accordingly, common provisions set forth in private investment fund documentation (such as subscription agreements, offering materials and other governing documents) purporting to make clear that the manager is not providing investment advice to invest in the fund would not be dispositive if inconsistent with the manager’s fundraising and marketing activities related to retirement investors.
    - ***Practice pointer:*** Although disclaimers cannot override contrary communications and materials, they can still be helpful to establish that there is no intent to provide advice. Accordingly, fiduciary investment advice disclaimers will likely continue to be common practice in the private investment fund industry. In practice, the challenge will be to avoid comments, materials and conduct that are inconsistent with the intent not to provide advice that can be relied on by a retirement investor.
- **Valuation of securities and other investment property not covered.** Valuation and appraisal services, as well as fairness opinions, are excluded from recommendations covered by the Proposed Rule. Such services alone would not be considered fiduciary investment advice.
- **IRA rollover advice specifically covered.** The DOL emphasizes that it intends for the Proposed Rule to pick up advice on whether to take a distribution or roll over assets from a retirement plan to an IRA, even if there is no recommendation as to ***how to invest*** the assets after the rollover.
- **Fee or other compensation, direct or indirect.** As noted above, investment advice is subject to the fiduciary standard only if it is provided for “a fee or other compensation, direct or indirect.” This requirement can be satisfied by indirect compensation that isn’t explicitly provided for advice. If the adviser (or an affiliate) receives any fee or compensation, from any source, specifically for the advice or in

connection with or as a result of the applicable recommendation, then the requirement will be satisfied. Examples include commissions, loads, finder's fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, mark ups or mark downs, underwriting compensation, expense reimbursements, gifts and gratuities or other non-cash compensation. A fee or compensation will be treated as paid for a recommendation if the fee or compensation would not have been paid ***but for*** the recommended transaction or the provision of advice, including if eligibility for or the amount of the fee or compensation is affected by the recommended transaction or the provision of advice.

- ***Practice pointer:*** Certain common private investment fund industry marketing activities could be considered fiduciary investment advice even though, in the case of a prospective investor or client, a fee will not be charged until after the investor invests in the fund or the separately managed account is established. For example, if an adviser is considered to provide "investment advice" to a prospective retirement investor with respect to investing in the adviser's private investment fund, a typical management fee, carried interest or incentive fee paid by the fund would likely be considered to satisfy the "fee or other compensation, direct or indirect" requirement.

Proposed Prohibited Transaction Exemption Amendments

Section 406(b) of ERISA and Section 4975(c) of the Code prohibit (among other things) investment advice fiduciaries from receiving compensation that varies based on their investment advice and compensation that is paid from third parties, unless the conditions of an available exemption are satisfied. The DOL has previously issued prohibited transaction class exemptions ("PTEs") covering certain common transactions that would provide relief to investment advice fiduciaries for certain otherwise prohibited compensation arrangements. In connection with the issuance of the Proposed Rule, the DOL also proposed amendments to PTEs 2020-02, 84-24, 75-1, 77-4, 80-83, 83-1 and 86-128, which essentially would require all investment advice fiduciaries to comply with "impartial conduct standards." The "impartial conduct standards" incorporate ERISA's principles of prudence and loyalty and are intended to be aligned with the standards of conduct for investment advice professionals established and considered by other U.S. federal and state regulators — in particular, the SEC and its Regulation Best Interest.

Proskauer's Perspective

The DOL's latest proposal would significantly expand what constitutes fiduciary "investment advice" and would affect many advice providers that currently take the position that their communications and interactions with ERISA plan and IRA clients are not subject to the fiduciary duty or prohibited transaction rules under ERISA or Section 4975 of the Code.

Importantly, certain common marketing, pitch practices, offering activities and periodic communications for private investment funds and separately managed accounts involving retirement investors could be considered investment advice if viewed as a "recommendation" to invest in a fund, to remain invested in a fund or to continue a separately managed account arrangement. And if such communications or activities constitute fiduciary "investment advice" to a retirement investor to purchase or continue to hold an interest in the manager's own funds and/or establish or continue a separately managed account arrangement with the fund manager (and to pay any related management or other fees), this advice could be treated as "conflicted," resulting in a violation of fiduciary duty and/or a prohibited transaction absent compliance with an exemption.

Although the Proposed Rule and related proposed PTE amendments are simply that at this point — proposed — given the potential expansion and impact, investment advisers and managers should carefully review the proposal to determine whether and how the proposal might apply to them.

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