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Private fund sponsors should take note of DOL's new investment advice rule proposal

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Key takeaways

- The U.S. Department of Labor ("DOL") has received more than 20,000 comments on its proposed new investment advice rule (the "Proposal").[1] Comments were due Jan. 2.
- If finalized, the Proposal, which the DOL issued October 31, 2023, would materially increase the likelihood that a fund sponsor could inadvertently become a fiduciary to ERISA plans, individual retirement accounts ("IRAs"), within the meaning of Section 4975 of the Code, and similar plans, by reason of being deemed to have rendered investment advice in the context of fundraising and investor engagement.[2]
- The Proposal broadly applies to any written or oral communication made to ERISA-governed plans, IRAs, and their fiduciaries that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the plan engage in, or refrain from taking, a particular course of action. Some sales and marketing communications, therefore, may be deemed "recommendations" under the Proposal, thereby potentially creating a fiduciary relationship between the fund sponsor and an ERISA plan or IRA for purposes of that communication. In almost all cases, this would result in the fund sponsor needing to satisfy a complicated exemption to avoid a self-dealing prohibited transaction under ERISA and the Code.
- The Proposal will not take effect until the DOL issues a final rulemaking, which will most likely be in 2024. There is a reasonable likelihood the DOL will ultimately move forward with a final rule, though the DOL may revise the compliance requirements and considerations in the interim. For this reason, fund sponsors and all others potentially impacted by the Proposal will face difficult choices in how much time and resources to spend over the coming months on mitigating their risk under the Proposal.
- Fund sponsors should consider adding in, or clarifying existing, language in the fund materials to the effect that the parties agree the communications are made on an arm's length basis and not in a fiduciary capacity. Though this language would not be dispositive under the Proposal, we continue to believe it remains a sensible approach and defense.[3]
- Fund sponsors may wish to review marketing materials and establish policies over sales communications with plan and IRA investors, given this Proposal.

Note that investment management services are unaffected by the Proposal.

Background and context

Section 3(21)(A)(ii) of ERISA provides that one is a fiduciary if such person "renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so."[4]

An inadvertent one-time recommendation — on its own — could be considered fiduciary investment advice, even if the recipient of that communication is a large, sophisticated registered investment adviser or plan committee.

The longstanding regulatory test (the "Five-Part Test") for when one is deemed to provide investment advice to an ERISA plan, IRA or other "benefit plan investor" requires that "individualized" advice or recommendations be provided to the plan regarding purchasing or selling, or the value of, securities or other property "for a fee" on a "regular basis" and pursuant to a "mutual agreement, arrangement or understanding" that the advice will "serve as a primary basis for investment decisions with respect to plan assets."

A meeting of the minds is essentially required for a firm to be an investment advice fiduciary to a plan under the Five-Part Test. This is important because it protects firms from inadvertently becoming an investment advice fiduciary to a plan or IRA, even if a one-off recommendation slips through.

Thus, it is common for limited partners and fund sponsors to agree in writing that communications by the fund sponsor made in connection with the purchase or sale of interests in the fund are not intended to constitute fiduciary investment advice for purposes of ERISA and the Code.

Since 2010, the DOL, in fits and starts, has sought to develop a new test for when one becomes an investment advice fiduciary under ERISA and Section 4975 of the Code. The Obama Administration finalized a rule in 2016,[5] including a package of new and amended prohibited transaction exemptions, only for the U.S. Court of Appeals for the Fifth Circuit to vacate them in 2018.[6]

In 2020, the Trump Administration reinstated the Five-Part Test (with updated interpretative guidance) and finalized a new class exemption that provided broad prohibited transaction relief for investment advice transactions ("PTE 2020-02").[7]

Now, the Biden Administration is proposing a new test for when one becomes an investment advice fiduciary, and, as briefly discussed below, proposes amendments to PTE 2020-02 and several other prohibited transaction exemptions.

New investment advice proposal

The Proposal provides that one becomes an investment advice fiduciary if the person:

(1) makes a "recommendation" of any securities or other investment transaction or any investment strategy involving securities or other investment property to an ERISA-covered plan, plan fiduciary, plan participant or beneficiary, IRA, IRA owner or beneficiary, or IRA fiduciary ("Retirement Investor");

(2) satisfies one of the enumerated status conditions ("Status Conditions"); *and*,

(3) the person (or any affiliate) receives any *explicit* fee or compensation from any source for the advice, or the person (or any affiliate) receives any other fee or other compensation from any source *in connection with, or as a result of*, the recommended purchase, sale or holding of a security of other investment property or the provision of investment advice.

Meaning of 'recommendation'

In pertinent part, the Proposal encompasses recommendations related to:

- the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property;
- investment strategy (no particular securities need be mentioned);
- investment policies, strategies or portfolio composition;
- the selection of other persons to provide investment advice or investment management services; and
- proxy voting.[8]

In a major departure from the Five-Part Test, which required recommendations to be provided on a "regular basis," a *one-time* recommendation to a Retirement Investor could render the firm an investment advice fiduciary with respect to that recommendation under the Proposal.

Unlike the 2016 rulemaking, the Proposal offers no safe harbor for recommendations provided to sophisticated parties.[9] Thus, an inadvertent one-time recommendation — on its own — could be considered fiduciary investment advice, even if the recipient of that communication is a large, sophisticated registered investment adviser or plan committee.

This could be of significant consequence to fund sponsors, given the vast majority of prospective and current limited partners are (or are represented by those who are) highly sophisticated and experienced.

The Proposal further deviates from the current Five-Part Test by providing that written statements disclaiming fiduciary status or aspects of the Proposal will not control to the extent they are inconsistent with the person's "oral communications, marketing materials, applicable State or Federal Law, or other interactions with the retirement investor."

Thus, disclaimer language in subscription agreements and other fund documents may not be sufficient, shifting the risk to the fund sponsor that marketing materials, oral communications and other nebulous "interactions" — individually or in the aggregate — may override the expressly negotiated terms and preferences of the parties that the fund sponsor does not provide recommendations to limited partners with respect to the purchase and sale of interests in its funds.

The Proposal, as with the 2016 rule, views a recommendation by whether the communication is reasonably viewed by the Retirement Investor as a suggestion to engage (or refrain from engaging) in a particular course of action, after taking into account the communication's content, context and presentation. In this respect, the DOL noted that it makes no difference that a communication is made to a group — rather than an individual — in determining whether a recommendation was provided.

Lastly, the Proposal resurrects the "hire me" exception from the prior rules, which allows firms to tout their *own* services and otherwise market themselves, without being deemed to be providing investment advice.[10]

As before, a marketing communication that "effectively includes a recommendation on how to invest or manage plan or IRA assets," would transmute into a "recommendation" under the Proposal. Accordingly, there will be practical challenges of teasing out when a marketing communication effectively encompasses a recommendation on how the assets should be managed.

Status conditions

The linchpin of becoming an investment advice fiduciary under the Proposal is that the firm triggers *one* of the following Status Conditions:

- The person either directly or indirectly (*e.g.*, through affiliates) has discretionary authority or control, whether or not pursuant to an agreement, arrangement or understanding, with respect

to purchasing or selling securities or other investment property for the Retirement Investor ("Discretionary Status");

- The issue here is whether the firm *separately* provides discretionary services to *any* assets (*i.e.*, need *not* be assets held in an IRA or plan) of the Retirement Investor. In our view, the DOL should clarify in a final rulemaking that discretionary management over a fund *that does not hold "plan assets"* (*e.g.*, satisfies the VCOC/REOC or 25% tests), and in which a Retirement Investor holds an interest, is *not* sufficient to confer Discretionary Status on the fund sponsor.
- The person either directly or indirectly (*e.g.*, though affiliates) makes investment recommendations to investors on a regular basis as part of their 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 ("Business Model Status"); *or*,
- The issue here is whether the firm (or its affiliates) is in the business of providing investment recommendations to *any* class of investors (*i.e.*, the investors need not be Retirement Investors) or otherwise holds itself out as providing investment advice. The DOL intends for Business Model Status to be objectively determined based on the totality of the circumstances.
- The person making the recommendation represents or acknowledges that they are acting as a fiduciary *when making investment recommendations* ("Fiduciary Acknowledgment Status").
- The issue here is whether the firm specifically represents that they are a fiduciary when making investment recommendations under any law or rule (*i.e.*, the firm need *not* acknowledge it is a "fiduciary" for purposes of ERISA or Section 4975 of the Code). A final rule should clarify that a fund sponsor meets the Fiduciary Acknowledgement Status Condition only if the fund sponsor has specifically acknowledged fiduciary status *with respect to a recommendation it made to* its limited partners — and not merely because of, for example, a fund sponsor's general status as a fiduciary under Delaware or other local law.

Proposed amendments to prohibited transaction exemptions

The DOL also proposes revisions to several prohibited transaction exemptions ("PTEs") that are used by fiduciaries when providing investment advice to ERISA plans and IRAs.

The proposed amendments, therefore, have little to no effect on fund sponsors who, regardless of whether their funds hold "plan assets," are usually not intending to provide investment advice to ERISA plans, IRAs or "plan asset" vehicles.[11] That is, they would only be relevant if the fund sponsor were acting in an investment advice fiduciary capacity with respect to a Retirement Investor.[12]

Notes

[1] *Retirement Security Rule: Definition of an Investment Advice Fiduciary*, 88 Fed. Reg. 75890 (Nov. 3, 2023), available here: https://bit.ly/41YrScw.

[2] For purposes of this memorandum, "ERISA" refers to the U.S. Employee Retirement Income Security Act of 1974, as amended, and the "Code" refers to the U.S. Internal Revenue Code of 1986, as amended.

[3] Consider, for example, that the preamble to the Proposal stated that "[i]n the retirement context, the Department has stressed the importance of clarity regarding the nature of an advice relationship and has encouraged retirement investors to ask advice providers about their status as an ERISA fiduciary with respect to retirement accounts and seek a written statement of the advice provider's fiduciary status."

[4] The imposition of fiduciary status under ERISA or Section 4975 of the Code would force the fund sponsor to navigate the intricate prohibited transaction rules thereunder, a violation of which may result in both civil liability and excise tax exposure.

[5] *Definition of the Term "Fiduciary"; Conflict of Interest Rule-Retirement Investment Advice*, 81 Fed. Reg. 20946 (Apr. 8, 2016), available here: https://bit.ly/4aZg6T7.

[6] *Chamber of Commerce v. United States Department of Labor*, 885 F.3d 360 (5th Cir. 2018).

[7] *Conflict of Interest Rule-Retirement Investment Advice: Notice of Court Vacatur*, 85 Fed. Reg. 40589 (July 7, 2020), available here: https://bit.ly/47BCTlc; *Prohibited Transaction Exemption 2020-02, Improving Investment Advice for Workers & Retirees*, 85 Fed. Reg. 82798 (Dec. 18, 2020), available here: https://bit.ly/3tUtFma.

[8] Notably, the Proposal does not cover recommendations regarding valuations and appraisals, which the DOL reserves for a future rulemaking.

[9] The 2016 rule provided a safe harbor for "transactions with independent fiduciaries with financial expertise," pursuant to which a person would not be deemed to be providing a recommendation if the communication is to made to an independent fiduciary of the plan (who satisfied certain requirements) in connection with an arm's length purchase and sale of securities and other investment property.

[10] A recommendation of *another* firm to provide investment advisory or management services to a Retirement Investor is not a "hire me" communication and, therefore, would be a "recommendation" for purposes of the Proposal.

[11] A fund sponsor may agree to act as a discretionary fiduciary under ERISA, such as managing a fund that is deemed to hold "plan assets" or a separate account for an ERISA plan. Here, the firm would continue to be an ERISA fiduciary regardless of whether a "recommendation" is made because discretion over "plan assets" separately confers fiduciary status. Firms providing discretionary services to ERISA plans, IRAs and other retirement investors should ensure they comply with applicable rules, including reliance on an applicable prohibited transaction exemption.

[12] (A) PTE 2020-02: the DOL proposes, inter alia, additional disclosures to the exemption and additional guidance for complying with the exemption's "Impartial Conduct Standards"; (B) PTEs 75-1, 77-4, 80-83, 83-1, and 86-128: the DOL proposes to amend these exemptions by limiting them to discretionary arrangements (the DOL intends that investment advice prohibited transactions be funneled through PTE 2020-02); and (C) PTE 84-24: the DOL proposes certain amendments to address insurers' compliance with PTE 2020-02 when distributing annuities through independent agents.

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