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## Defining “Fiduciary”: Aligning Obligations with Expectations

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# Defining “Fiduciary”

## ALIGNING OBLIGATIONS WITH EXPECTATIONS

### INTRODUCTION

Half of Americans saving for retirement report feeling “not confident” or only “slightly confident” that they will make good investment decisions in managing their 401(k) plans, individual retirement accounts (IRAs), and other savings accounts.<sup>1</sup> And the stakes are high: poor investment decisions rob many Americans of the worry-free retirement for which they had desperately planned. Even the 40% of retirement savers who receive investment advice from a professional<sup>2</sup> may make poor investment decisions. Contrary to what one may think, professional investment advice is not always trustworthy. Some retirement investment advisers receive commission for recommending certain investments, which encourages them to recommend products that generate more income for themselves rather than products that would most benefit the investors.<sup>3</sup> The White House Council of Economic Advisers estimated that IRA investors place \$1.7 trillion into commission-generating products each year.<sup>4</sup> This practice was legal under the former language of the Employee Retirement Income Security Act of 1974 (ERISA), which governs who is considered a “fiduciary” of an employee benefit plan.<sup>5</sup> For an investment adviser to be the investor’s fiduciary, the adviser must (1) give advice (2) on a regular basis (3) under a mutual understanding (4) that the advice is individualized and (5) will be the primary basis for investment

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<sup>1</sup> BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT ON THE ECONOMIC WELL-BEING OF U.S. HOUSEHOLDS IN 2015, at 63 (2016).

<sup>2</sup> *Id.*

<sup>3</sup> Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21,928, 21,930 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509–10) [hereinafter *Fiduciary Definition 2015 Proposal*].

<sup>4</sup> EXEC. OFFICE OF THE PRESIDENT, THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS 2 (2015) [hereinafter *EFFECTS OF CONFLICTED INVESTMENT ADVICE*], [https://permanent.access.gpo.gov/gpo55500/cea\\_coi\\_report\\_final.pdf](https://permanent.access.gpo.gov/gpo55500/cea_coi_report_final.pdf) [<https://perma.cc/YC8V-4Y6Z>].

<sup>5</sup> Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 3(21)(A), 88 Stat. 829, 836 (codified at 29 U.S.C. § 1002(21) (2012)).

decisions.<sup>6</sup> An adviser must meet all five requirements in order to be considered an investor's fiduciary.<sup>7</sup> Under this rigorous test, many advisers, whose clients think they are fiduciaries and who *should* be considered fiduciaries, do not have legal fiduciary obligations. This narrow definition creates a problem because it leaves retirement investors vulnerable to manipulation and exploitation by their advisers. The definition of fiduciary is important because individuals who qualify as fiduciaries must provide only advice that is in the investor's best interest.<sup>8</sup> Advisers who fall outside of this definition, on the other hand, may provide suitable advice and recommendations outside of the investor's best interest.<sup>9</sup>

According to a report by the President's Council of Economic Advisers, receiving conflicted advice, or advice given by an adviser whose profit depends on the investor's decisions,<sup>10</sup> causes retirees to run out of savings five years earlier than if they had not received such advice.<sup>11</sup> To combat these "direct and substantial conflicts of interest,"<sup>12</sup> the United States Department of Labor (DOL) promulgated a new regulation interpreting who is a "fiduciary" of an employee benefit plan under ERISA.<sup>13</sup> "A fiduciary is an agent who is required to treat his principal with utmost loyalty and care . . . , as if the principal were himself."<sup>14</sup> When an adviser is considered a fiduciary, he must abide by the "[p]rudent man standard of care," meaning he must provide advice to plan participants and beneficiaries solely in their best interest, without taking into consideration the adviser's own financial gains.<sup>15</sup> The new rule "treat[s] persons who provide investment advice or recommendations to an employee benefit plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner as fiduciaries under ERISA and the [Internal Revenue] Code in a wider array of advice relationships than the [previous] regulations."<sup>16</sup> This broadens which advisers must provide

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<sup>6</sup> Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946, 20,954 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509–10, 2550) [hereinafter *Fiduciary Definition Final Rule*]; *see* 29 C.F.R. § 2510.3-21(c) (2014); *see also* Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 3(21)(A)(ii), 88 Stat. 829, 836 (codified at 29 U.S.C. § 1002(21) (2012)) (supplying the language the five-part test interprets).

<sup>7</sup> *See* *Fiduciary Definition Final Rule*, *supra* note 6, at 20,954.

<sup>8</sup> *Fiduciary Duties*, 29 U.S.C. § 1104(a)(1) (2012).

<sup>9</sup> *See id.*

<sup>10</sup> EFFECTS OF CONFLICTED INVESTMENT ADVICE, *supra* note 4, at 6.

<sup>11</sup> *Id.* at 3.

<sup>12</sup> *Fiduciary Definition 2015 Proposal*, *supra* note 3, at 21,930.

<sup>13</sup> *See* *Fiduciary Definition Final Rule*, *supra* note 6, at 20,946.

<sup>14</sup> *Pohl v. Nat'l Benefits Consultants, Inc.*, 956 F.2d 126, 128–29 (7th Cir. 1992).

<sup>15</sup> *Fiduciary Duties*, 29 U.S.C. § 1104(a)(1) (2012).

<sup>16</sup> *Fiduciary Definition 2015 Proposal*, *supra* note 3, at 21,928.

recommendations solely in their clients' best interest. The new rule is necessary to protect investors from receiving conflicted advice in connection with retirement investment decisions. These broad protections make the new rule more congruous with the broad protections the legislature intended ERISA to afford. Imposing a fiduciary standard on all commission-based retirement advice and forcing advisers to act in the investors' best interest<sup>17</sup> delivers the best possible protection for that uniquely vulnerable class of retirement investors.

Part I of this note provides a background on retirement savings products, how they are regulated, and the different standards of care governing retirement investment advisers. Part II explains the previous regulation defining "fiduciary" under ERISA and explores problems with the former regulatory scheme. Part III tracks the DOL's attempts to solve those problems with the 2010 proposal, the 2015 proposal, and the final rule. Part IV contemplates the benefits of the new rule in protecting retirement investors. The new rule imposes the best interest standard on all providers of retirement investment advice, protecting them from the harms of conflicted advice.

## I. WHAT IS A FIDUCIARY?

In order to understand the complex changes the proposal will effect upon the investment industry, one must first understand the reasons retirement investors require a separate standard, the purposes and legal implications of imposing a standard of care, and the various bodies of law governing such issues. Two standards of care govern advisers to a retirement investor: the suitability standard and the fiduciary standard.<sup>18</sup> The fiduciary standard provides a heightened level of protection to investors. Retirement investors utilize various retirement savings options, many of which are regulated by different bodies of governing law.<sup>19</sup> Which standard of care governs an adviser depends on which type of retirement savings option the investor uses. The distinction between which advisers are and are not considered fiduciaries is important because it governs which standard of care applies. Different standards of care apply to a given individual and during a given transaction.

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<sup>17</sup> See Fiduciary Duties, 29 U.S.C. § 1104(a)(1).

<sup>18</sup> See *infra* notes 35–40 and accompanying text.

<sup>19</sup> See *infra* Section I.B.

### A. *Standards of Care Governing Retirement Investment Advisers*

Congress enacted ERISA, which has been codified in Title 29 of the United States Code and governs employee benefit plans,<sup>20</sup> to “protect the interests of plan participants and beneficiaries, the integrity of employee benefit plans, and the security of retirement, health, and other critical benefits.”<sup>21</sup> The DOL manages and enforces ERISA,<sup>22</sup> and has the authority to interpret its provisions.<sup>23</sup> According to the DOL, ERISA sets the minimum requirements for the management of retirement plans, including mandating disclosures to participants, establishing participation and eligibility standards, providing legal rights to participants, and “requir[ing] accountability of plan fiduciaries.”<sup>24</sup> These investor-protective requirements illustrate the extent to which the legislature intended ERISA to protect retirement investors. ERISA imposes various obligations on individuals who manage or advise covered plan participants to prevent advisers from taking advantage of investors. Some of the obligations imposed on certain advisers and experts—those considered to be “fiduciaries”—include a heightened standard of care, which they must follow in making recommendations.<sup>25</sup> According to ERISA,

a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he 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, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.<sup>26</sup>

This rule defines a plan fiduciary as a person whose activities and authority place him in any of the categories identified in

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<sup>20</sup> 29 U.S.C. § 1003(a).

<sup>21</sup> Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,932.

<sup>22</sup> See *Summary of the Major Laws of the Department of Labor*, U.S. DEP'T LAB., <https://www.dol.gov/general/aboutdol/majorlaws> [<https://perma.cc/ZYX3-FPNB>].

<sup>23</sup> See Chamber of Commerce of the United States of Am. v. Hugler, No. 3:16-CV-1476-M, 2017 WL 514424, at \*9–15 (N.D. Tex. Feb. 8, 2017).

<sup>24</sup> See *Retirement Plans and ERISA FAQs*, U.S. DEP'T LAB., <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/faqs/retirement-plans-and-erisa-consumer> [<https://perma.cc/8TLK-27CG>].

<sup>25</sup> See *infra* notes 34–37 and accompanying text; see also Fiduciary Duties, 29 U.S.C. § 1104(a)(1).

<sup>26</sup> Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 3(21)(A), 88 Stat. 829, 836 (codified at 29 U.S.C. § 1002(21)(A)).

Sections 3(21)(A)(i), (ii), or (iii).<sup>27</sup> Most relevant, for purposes of this note, is Section 3(21)(A)(ii), which classifies a person as a plan’s fiduciary if he advises an investor “for a fee or other compensation.”<sup>28</sup> In 1975, the DOL promulgated a regulation interpreting when a person is a fiduciary under Section 3(21)(A)(ii).<sup>29</sup> The 1975 interpretation significantly narrowed who qualifies as a Section 3(21)(A)(ii) fiduciary, by requiring that the adviser (1) give advice (2) on a regular basis (3) under a mutual understanding (4) that the advice is individualized and (5) will be the primary basis for investment decisions.<sup>30</sup> After the 1975 interpretation, determining whether an adviser constitutes a fiduciary required some analysis into whether the advice satisfied the five conditions.

In contrast to ERISA-regulated 401(k) plan investors, IRA holders did not benefit from regulations as committed to protecting investors as ERISA. Instead, IRAs were governed by the Internal Revenue Code (the Code), which creates an even more confusing scheme to determine which plan advisers constitute fiduciaries.<sup>31</sup> The Code classifies an adviser as a fiduciary based on his actions with respect to the particular plan at hand, i.e., whether he is acting as an adviser or just a broker.<sup>32</sup> Under that scheme, a person is a plan’s fiduciary when acting as an adviser, but is not a fiduciary when acting as a broker.<sup>33</sup>

The distinction between who constitutes a fiduciary under ERISA is important because benefit-plan fiduciaries have more duties and liabilities than nonfiduciary advisers.<sup>34</sup> A fiduciary must abide by the “prudent man standard of care,” meaning he must “discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries.”<sup>35</sup> ERISA and subsequent case law provide parameters defining required,

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<sup>27</sup> See *id.*

<sup>28</sup> See *id.* § 3(21)(A)(ii).

<sup>29</sup> See Fiduciary Definition Final Rule, *supra* note 6, at 20,954.

<sup>30</sup> *Id.*; see 29 C.F.R. § 2510.3-21(c) (2014); Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 3(21)(A)(ii), 88 Stat. 829, 836 (codified at 29 U.S.C. § 1002(21)).

<sup>31</sup> See Stephen Saxon, *DOL Fiduciary Proposal Subjects Rollover Advice to ERISA Fiduciary Standard of Care*, PRINCIPAL FIN. GRP. (Aug. 27, 2015), <https://blog.principal.com/2015/08/27/dol-fiduciary-proposal-subjects-rollover-advice-to-erisa-fiduciary-standard-of-care> [<https://perma.cc/ZQ8E-CXSP>].

<sup>32</sup> See Rick Rodgers, *Fiduciary vs. Suitability Standard*, RODGERS-ASSOCS. (May 7, 2015), <https://rodgers-associates.com/newsletters/fiduciary-vs-suitability-standard> [<https://perma.cc/932Y-37LJ>].

<sup>33</sup> See *infra* notes 34–40 and accompanying text.

<sup>34</sup> See, e.g., *Tibble v. Edison Int'l*, 135 S. Ct. 1823 (2015) (holding that ERISA fiduciaries’ “duty of prudence involves a continuing duty to monitor investments and remove imprudent ones”).

<sup>35</sup> Fiduciary Duties, 29 U.S.C. § 1104(a)(1).

permitted, and prohibited fiduciary actions. The prudent man standard, as defined in ERISA § 404(a)(1) and U.S.C. § 1104(a)(1), requires that fiduciaries act:

(A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan; (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and (D) in accordance with the documents and instruments governing the plan.<sup>36</sup>

Under the prudent man standard of care, if a fiduciary has a conflict of interest, she must disclose such conflict to the investor. The standard also requires an adviser to perform adequate research prior to advising a client and to provide advice in the client's best interest.<sup>37</sup>

In contrast, nonfiduciary advisers are governed by the "suitability standard" of care, which requires only that advisers "reasonably believe that any recommendations made to clients are suitable in terms of the client's financial needs, objectives, and unique circumstances."<sup>38</sup> Requiring advisers to provide suitable recommendations is less protective to investors than the prudent man standard's requirement that fiduciaries provide recommendations in the investor's best interest. A broker violates the suitability standard if he imposes excessive transaction costs upon an investor, such as through "excessive trading or churning the account simply to generate more commissions."<sup>39</sup> However, in various situations, a broker could fail to disclose potential conflicts of interest without violating the suitability standard.<sup>40</sup>

Additionally, fiduciaries under ERISA are not allowed to receive commission-based compensation in exchange for providing advice to a client. Investment advisers provide advice for compensation, which is calculated using two major payment calculation methods: a transaction-based model and a fee-based model.<sup>41</sup> In a transaction-based model,<sup>42</sup> the investor pays a

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<sup>36</sup> *Id.*

<sup>37</sup> *See* Rodgers, *supra* note 32.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *See* *Fiduciary*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/fiduciary.asp> [<https://perma.cc/WPR4-PF6G>].

<sup>41</sup> *See* U.S. Chamber of Commerce v. Hugler, No. 3:16-cv-1476-M, 2017 WL 514424, at \*3 (N.D. Tex. Feb. 8, 2017); David Kaufman, *The Trouble with Investing*

one-time commission<sup>43</sup> on each transaction the adviser performs for that investment plan.<sup>44</sup> In a fee-based model,<sup>45</sup> the investor pays the adviser an hourly or annual fee, or a portion of his assets (typically 1%–1.5%) that are under the management of the adviser per year, in exchange for the adviser's maintenance services.<sup>46</sup> The different compensation structures for advisers who all provide retirement advice serve only to confuse (and often exploit) retirement savers.

It is important for fiduciaries to be aware of all of their duties under the law due to the heightened liability standards that apply. If fiduciaries violate their duties (by failing to abide by the prudent man standard of care), they "may be personally liable to restore any losses to the plan, or to restore any profits made through improper use of the plan's assets resulting from their actions."<sup>47</sup> This means that if a benefits-plan holder experiences a loss, the fiduciary could face legal ramifications implicating his personal assets rather than solely those of his employer. Because of the important implications of being classified as a fiduciary under the law, it is vital that advisers know exactly when they constitute plan fiduciaries. Moreover, it is important for retirement savers to know exactly which standard of care governs their advisers. Nonfiduciary advisers must give clients suitable recommendations, while fiduciary advisers must provide recommendations in their clients' best interest.<sup>48</sup> Despite the importance, keeping the standards straight is quite complex and changes based on which retirement savings option the investor uses.

### B. Retirement Savings Options

Adding to investors' confusion over when their advisers have fiduciary obligations, the distinction sometimes turns on which retirement savings option the investor uses. Members of

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*Fees: Are Commission- or Fee-Based Accounts Better?*, FIN. POST (Nov. 14, 2014), <http://business.financialpost.com/investing/the-trouble-with-investing-fees-are-commission-or-fee-based-accounts-better-for-investors> [<https://perma.cc/244E-HGL7>].

<sup>42</sup> Also referred to as a commission-based model. See Kaufman, *supra* note 41.

<sup>43</sup> Also referred to as a "sales load" or "mark-up." See Hugler, 2017 WL 514424, at \*3.

<sup>44</sup> See *id.*

<sup>45</sup> Also referred to as an assets-under-management model. See Kaufman, *supra* note 41.

<sup>46</sup> See *id.*; Hugler, 2017 WL 514424, at \*3.

<sup>47</sup> U.S. DEPT OF LABOR, FREQUENTLY ASKED QUESTIONS ABOUT FIDUCIARY RESPONSIBILITIES UNDER AN APPRENTICESHIP AND TRAINING PLAN, <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/faq-ATP.pdf> [<https://perma.cc/HK89-VAQL>].

<sup>48</sup> See *supra* notes 34–40 and accompanying text.

the working class plan for a comfortable retirement through various employment retirement savings plans, such as “Social Security, traditional pensions, employer-based retirement savings plans such as 401(k)s, and Individual Retirement Accounts (IRAs).”<sup>49</sup> Social security is a federal security plan in which all working Americans (and their employers) pay 6.2% of their annual income as social security taxes in exchange for the benefit of receiving social security payments upon retirement.<sup>50</sup> Almost all current retirees—91%—report using social security as a source of income during retirement.<sup>51</sup> In July 2015, the average retired worker received \$1336 per month in social security benefits.<sup>52</sup> The government did not intend for social security to be the sole source of retirement savings, but rather for it to bolster other retirement plans.<sup>53</sup> Only 10% of preretirement, working Americans are “very confident” that the Social Security system will pay out consistent benefits by the time they retire, but 84% still report anticipating social security to be a major or minor source of their retirement income.<sup>54</sup>

Older generations typically saved for retirement through defined benefit plans, such as traditional pension plans, in which the employer agrees to provide an employee with a defined amount of benefits (i.e., money) for a certain period of time in consideration of the employee’s continued employment.<sup>55</sup> The employer is generally the plan’s sole contributor and manager, with no maintenance required by the employee.<sup>56</sup> This means that defined benefit plan holders do not require assistance from advisers because their employers manage and control the account funds for them. The plan is a defined *benefit* plan because the value to the employee upon retirement is pre-established by the employer and not contingent upon asset

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<sup>49</sup> EFFECTS OF CONFLICTED INVESTMENT ADVICE, *supra* note 4, at 2.

<sup>50</sup> *What Is Social Security?*, NAT’L ACAD. SOC. INS., <https://www.nasi.org/learn/socialsecurity/overview> [<https://perma.cc/X8Z5-QQLU>].

<sup>51</sup> RUTH HELMAN ET AL., EMP. BENEFIT RESEARCH INST., THE 2016 RETIREMENT CONFIDENCE SURVEY: WORKER CONFIDENCE STABLE, RETIREE CONFIDENCE CONTINUES TO INCREASE 30 (2016), [https://www.ebri.org/pdf/briefspdf/ebri\\_ib\\_422.mar16.res.pdf](https://www.ebri.org/pdf/briefspdf/ebri_ib_422.mar16.res.pdf) [<https://perma.cc/YP85-7WHV>].

<sup>52</sup> *What Is Social Security?*, *supra* note 50.

<sup>53</sup> Amelia Josephson, *Average Retirement Savings: Are You Normal?*, SMART ASSET (Mar. 29, 2017), <https://smartasset.com/retirement/average-retirement-savings-are-you-normal> [<https://perma.cc/S54Y-KTKJ>].

<sup>54</sup> HELMAN ET AL., *supra* note 51, at 30–31.

<sup>55</sup> *See 4 Types of Retirement Plans and Employer-Sponsored Plans*, INVESTOR GUIDE, <http://www.investorguide.com/article/11703/4-types-of-retirement-plans-and-employer-sponsored-plans-igu> [<https://perma.cc/2CXA-FCYK>].

<sup>56</sup> *See Choosing a Retirement Plan: Defined Benefit Plan*, INTERNAL REVENUE SERV., <https://www.irs.gov/retirement-plans/choosing-a-retirement-plan-defined-benefit-plan> [<https://perma.cc/P6B5-2YGV>] (last updated Sept. 21, 2016).

returns.<sup>57</sup> While defined benefit plans still exist, they are much less prevalent than other retirement plans.<sup>58</sup>

Today, the most common retirement plan for employed individuals is a defined *contribution* plan, under which the amount of retirement income available for an investor depends on how much money he originally invested and how much money his investment returned.<sup>59</sup> This type of plan, which requires workers to invest their own savings, starkly contrasts the defined benefit plans of the past. Older generations using defined benefit plans receive a defined, and therefore certain, amount of money postretirement, while workers using defined contribution plans make defined contributions to a plan that will later yield an undefined, and therefore uncertain, amount of money postretirement. The amount these contribution plans yield depends on a variety of factors, including the value of both the employer's *and* the employee's contributions, the performance of the account's investments, and the length of time the funds remain invested.<sup>60</sup>

One example of a defined contribution plan is a 401(k) plan, named for Section 401(k) of the Internal Revenue Code.<sup>61</sup> A 401(k) is a retirement plan "under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash."<sup>62</sup> The trust is "nonforfeitable,"<sup>63</sup> and employees and other beneficiaries receive 401(k) funds when they end the employment, reach age 59½, die, or become disabled, but not "merely by reason of the completion of a stated period of participation or the lapse of a fixed number of years."<sup>64</sup> In other words, under no circumstances would an employee forfeit all the money he invested in a 401(k); however, should he withdraw funds from a 401(k) prior to reaching age 59½, he would face a

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<sup>57</sup> *See id.*

<sup>58</sup> *See* Fiduciary Definition Final Rule, *supra* note 6, at 20,954.

<sup>59</sup> EFFECTS OF CONFLICTED INVESTMENT ADVICE, *supra* note 4, at 2.

<sup>60</sup> *See Types of Retirement Plans*, U.S. DEP'T LAB., <https://www.dol.gov/general/topic/retirement/typesofplans> [<https://perma.cc/FG5Z-TVAV>]; *Defined Benefit Plans Versus Defined Contribution Plans*, MY RETIREMENT PAYCHECK, <http://www.myretirementpaycheck.org/retirement-plans/defined-benefit-plans.aspx> [<https://perma.cc/8G35-SMW5>].

<sup>61</sup> *See* EFFECTS OF CONFLICTED INVESTMENT ADVICE, *supra* note 4, at 2; *see also* 26 U.S.C. § 401(k) (2012).

<sup>62</sup> 26 U.S.C. § 401(k)(2)(A).

<sup>63</sup> *Id.* § 401(k)(2)(C) ("[A]n employee's right to his accrued benefit derived from employer contributions made to the trust pursuant to his election is nonforfeitable."). Nonforfeitable benefits are "[b]enefits that are vested, meaning that they belong fully to the employee and may not be rescinded." *Nonforfeitable Benefits*, INVESTOR WORDS, [http://www.investorwords.com/5682/nonforfeitable\\_benefit.html](http://www.investorwords.com/5682/nonforfeitable_benefit.html) [<https://perma.cc/MJ6N-HN5T>].

<sup>64</sup> 26 U.S.C. § 401(k)(2)(B).

penalty of 10% of the amount withdrawn.<sup>65</sup> 401(k) plans are established and controlled by the employer. ERISA governs the standard of care required of investment advisers to 401(k) plans and generally classifies them as fiduciaries.

Another example of a defined contribution plan is an IRA. Unlike 401(k) plans, individuals, rather than employers, establish and control IRAs.<sup>66</sup> The Code regulates who may contribute to IRAs, how much money they may contribute, and when account holders may and must withdraw funds.<sup>67</sup> Individuals may not hold IRA funds indefinitely and must begin taking “required minimum distributions” after reaching the age of 70½.<sup>68</sup> Individuals can withdraw funds from their IRAs at any time but may face penalties for withdrawing funds prior to attaining age 59½.<sup>69</sup> The Code also governs the standard of care required of advisers to IRA investors. Unlike investment advisers to 401(k)s, advisers to IRAs are not always considered fiduciaries of the investor. Advisers are not fiduciaries when they are simply “charging a commission on a transaction separate from providing advice.”<sup>70</sup> This is problematic because when an investor regularly receives advice from an adviser, the investor may believe that the adviser is always a fiduciary. In reality, however, the adviser is only legally obligated to act in the investor’s best interest when providing advice directly related to a transaction for which the adviser will receive a commission.

Employers create and control 401(k) plans, but upon employment termination, the employee may need to cash out the funds in his 401(k) account or transfer them to another account.<sup>71</sup> If the former employee has not yet reached the age of

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<sup>65</sup> *Beware of Cashing Out Your 401(k)*, FIDELITY (May 31, 2016), <https://www.fidelity.com/viewpoints/retirement/cashing-out> [<https://perma.cc/3EDV-WHXU>].

<sup>66</sup> See Stephanie Powers, *11 Things You May Not Know About Your IRA*, INVESTOPEDIA (Sept. 11, 2014), <http://www.investopedia.com/articles/retirement/08/11-things-to-know-iras.asp> [<https://perma.cc/4B8A-5C5G>].

<sup>67</sup> See *Traditional and Roth IRAs*, INTERNAL REVENUE SERV., <https://www.irs.gov/retirement-plans/traditional-and-roth-iras> [<https://perma.cc/5B3E-76WB>] (last updated Jan. 30, 2017).

<sup>68</sup> *Id.*; *Retirement Topics—Required Minimum Distributions (RMDs)*, INTERNAL REVENUE SERV., <https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-required-minimum-distributions-rmds> [<https://perma.cc/F3DB-7CC7>] (last updated Feb. 15, 2017).

<sup>69</sup> *Traditional and Roth IRAs*, *supra* note 67.

<sup>70</sup> Tobie Stanger, *Look for an Adviser with Fiduciary Duty to Save Money on Your IRA*, CONSUMER REP. (July 7, 2015), <http://www.consumerreports.org/cro/news/2015/07/look-for-an-adviser-with-fiduciary-duty-to-save-money-on-your-ira/index.htm> [<https://perma.cc/8TMT-QCBV>].

<sup>71</sup> See *Deciding What to Do with Your 401(k) Plan When You Change Jobs*, AMERIPRISE FIN., <https://www.ameriprise.com/research-market-insights/financial-articles/retirement/what-to-do-with-your-401k-plan-when-you-change-jobs> [<https://perma.cc/TLT7-CTLF>].

59½, the age at which an investor may cash out his 401(k) without penalty, he must transfer his 401(k) plan into an IRA or into a 401(k) with another company.<sup>72</sup> In fact, "the overwhelming majority of money flowing into IRAs comes from rollovers from an employer-based retirement plan [like 401(k)], not direct IRA contributions."<sup>73</sup> According to the DOL, "[a]s baby boomers retire, they are increasingly moving money from ERISA-covered plans [like 401(k)s], where their employer has both the incentive and the fiduciary duty to facilitate sound investment choices, to IRAs where both good and bad investment choices are myriad and advice that is conflicted is commonplace."<sup>74</sup> This means that when an employee reaches a point where he must decide what to do with his 401(k), it is imperative that he receives trustworthy—and not conflicted—advice from a professional. It is at that stage where the ERISA-protected 401(k) plan participant, whose advisers always had fiduciary obligations, must now seek advice from a new adviser, unrelated to his previous employment, whose fiduciary status is unknown or ambiguous.<sup>75</sup> Unversed in these complex investment regulations, the investor is often unaware that his new adviser does not have the same obligations, leaving him vulnerable to making important decisions based on conflicted advice.

Another retirement investment option to help investors achieve lifetime income is an annuity contract, which guarantees a client's return investment.<sup>76</sup> Under an annuity contract, the beneficiary gives the insurance company a set amount or a series of payments in exchange for the insurer's promise to

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<sup>72</sup> See *id.*; *401(k) vs. IRA*, DIFFEN, [http://www.diffen.com/difference/401\(k\)\\_vs\\_IRA](http://www.diffen.com/difference/401(k)_vs_IRA) [<https://perma.cc/BHQ8-VT5J>].

<sup>73</sup> EFFECTS OF CONFLICTED INVESTMENT ADVICE, *supra* note 4, at 2.

<sup>74</sup> Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,932.

<sup>75</sup> EFFECTS OF CONFLICTED INVESTMENT ADVICE, *supra* note 4, at 8 ("At the point of rollover, savers are making decisions about large quantities of money relative to the sums involved in other more common financial decisions. Many savers may not have full knowledge about their options or a complete understanding of the detailed regulatory differences between their employer plan and an IRA—most notably that advice to roll money out of the plan into an IRA is generally subject to much lower standards of care than advice received in the plan.").

<sup>76</sup> See The Guardian Life Insurance Company of America, Comment Letter on Proposed Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice Under 29 C.F.R. Pts. 2509–10, at 6–7 (July 21, 2015), <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32-2/00767.pdf> [<https://perma.cc/37NH-NSEB>] [hereinafter Guardian Life Insurance, Comment Letter on 2015 Proposal]; see also *Annuities: What Is an Annuity?*, ST. FARM MUT. AUTO. INS. CO., <https://www.statefarm.com/finances/annuities/what-is-an-annuity> [<https://perma.cc/9RAC-R359>] ("With a Fixed Annuity, money is placed in fixed-rate investments such as bonds, where it will earn a fixed interest rate for a certain period of time. For most fixed annuities, a minimum interest rate is guaranteed. With a Fixed Annuity, the insurance company is taking the investment risk.").

provide the beneficiary with a series of periodic payments beginning immediately or in the future.<sup>77</sup> Unlike employee benefit plans, annuities are unrelated to a person's employment. There are three categories of annuities: fixed annuities, indexed annuities, and variable annuities.<sup>78</sup> In a fixed annuity, the beneficiary contracts to receive a specified amount of money for a specified period of time.<sup>79</sup> Because the benefits are stated and therefore not reliant on other factors, the beneficiary is guaranteed to receive the funds for the specified period. The amount a beneficiary pays to an annuity is typically tax-deferred, meaning the beneficiary is not taxed on the income until it is removed from the annuity (i.e., paid out).<sup>80</sup> According to State Farm, “[d]eferred annuities can also be a good way to help increase your retirement savings [because t]he tax-deferral and compounding of interest provided by an annuity can help it to grow larger than an equal investment in a taxable account.”<sup>81</sup> Annuities also help investors “protect against the risk of outliving their incomes.”<sup>82</sup>

Investors saving for retirement have many investment options from which to choose. Furthermore, investors often need to utilize more than one option over the course of their investing.<sup>83</sup> Retirement investors' vulnerability in weighing their options and making decisions demonstrates the need for trustworthy advisers. Consequently, advisers should operate under a uniform standard of care when recommending retirement saving options. An adviser with fiduciary obligations must provide recommendations in the client's best interest, without taking into consideration the adviser's own financial gains.<sup>84</sup> Despite investors' vulnerability in managing retirement investments, the previous definition of fiduciary under ERISA did not provide sufficient protections.

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<sup>77</sup> *Fast Answers: Annuities*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/annuity.htm> [<https://perma.cc/M8F8-KGMM>] (last updated Apr. 6, 2011).

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> *See Annuities: What Is an Annuity?*, *supra* note 76.

<sup>81</sup> *Id.*

<sup>82</sup> Ed Perlmutter, House of Reps, Comment Letter on Proposed Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice Under 29 C.F.R. Pts. 2509–10 (Sept. 9, 2015), <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32-2/02751.pdf> [<https://perma.cc/4GR8-U7GY>] [hereinafter Ed Perlmutter, Comment Letter on 2015 Proposal].

<sup>83</sup> For example, when an investor must decide what to do with a 401(k) plan upon employment termination prior to retirement.

<sup>84</sup> *See* Fiduciary Duties, 29 U.S.C. § 1104(a)(1) (2012).

## II. PROBLEMS WITH THE FORMER DEFINITION OF “FIDUCIARY”

As originally enacted, ERISA afforded broad protections to retirement investors. It broadly imposed fiduciary obligations on many categories of advisers. Subsequent interpretation, however, significantly decreased this protection. The later addition of a five-part test to determine when an adviser is a fiduciary narrowed which advisers must abide by the best interest standard of care. Under this test, investment advice must satisfy five conditions to impose fiduciary obligations on the adviser. This rigorous test allows many advisers, whose clients think they are fiduciaries and who *should* be considered their fiduciaries, to avoid legal fiduciary obligations. Problematically, this left retirement investors vulnerable to manipulation and exploitation by their advisers. The incoherence among advisers to IRAs, which are regulated by the Code, and 401(k)s, which are regulated by ERISA, further confused investors. To combat this confusion, the DOL promulgated a new regulation to broaden which advisers constitute fiduciaries, making it more congruous with the broad protections the legislature intended ERISA to afford.<sup>85</sup>

### A. *Broad Protections of ERISA as Originally Enacted*

As originally enacted, ERISA broadly classified most advisers as plan fiduciaries. Section 3(21)(A) of ERISA lays out two general categories of individuals who are considered “fiduciaries” of an employee benefits plan.<sup>86</sup> A person is a fiduciary of an ERISA-covered plan to the extent she exercises discretionary authority or control over the plan’s management or administration.<sup>87</sup> This category covers the team that the employer, as 401(k) plan sponsor, selects to administer and manage the plan.<sup>88</sup> The employer’s administrative team includes service providers, plan trustees, and anyone who exercises discretion over the management of the plan (i.e., directors or human resources members).<sup>89</sup> The first category makes clear that anyone who exercises control or discretion

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<sup>85</sup> See Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,928.

<sup>86</sup> See Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 3(21)(A), 88 Stat. 829, 836 (codified at 29 U.S.C. § 1002(21)(A)).

<sup>87</sup> *Id.*

<sup>88</sup> See U.S. DEP’T OF LABOR, MEETING YOUR FIDUCIARY RESPONSIBILITIES 1 (2012), <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/meetingyourfiduciaryresponsibilities.pdf> [<https://perma.cc/9P66-52Y7>].

<sup>89</sup> See *id.* at 1–2.

over a plan is the plan's fiduciary.<sup>90</sup> ERISA defines the second category—the plan's advisers—much more vaguely.

Section 3(21)(A)(ii) provides that a person is a fiduciary to the extent that “he 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.”<sup>91</sup> The investment advice rule attaches a fiduciary duty to investment advisers who may not exercise authority or control over the plan.<sup>92</sup> This is important because plan sponsors and beneficiaries typically lack the investment expertise necessary to make investment decisions without receiving advice from outside experts. Because recipients rely so heavily on outside advisers, and place a heightened level of trust in them due to the nature of retirement planning, certain investment advisers must be considered plan fiduciaries—and provide advice solely in the investor's best interest—in order to protect the investor. According to the DOL, the ERISA definition “reflect[s] Congress' recognition in 1974 of the fundamental importance of such advice to protect savers' retirement nest eggs.”<sup>93</sup> The goal of protecting investors' retirement savings has not changed; however, the law itself has undergone changes that undercut the realization of that goal.<sup>94</sup>

### *B. Five-Part Test Excludes Crucial Advisers from Fiduciary Obligations*

In 1975, the DOL significantly narrowed ERISA's investment advice rule by enacting 29 C.F.R. 2510.3-21(c), which provides certain instances where a person “renders investment advice” under ERISA § 3(21)(A)(ii).<sup>95</sup> The 1975 interpretation provides a five-part test for determining whether an adviser is a fiduciary:

for advice to constitute “investment advice,” an adviser who is not a fiduciary under another provision of the statute must—(1) render advice as to the value of securities or other property, or make recommendations as to the advisability of 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 plan or a plan fiduciary that (4) the advice will serve as a primary basis for

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<sup>90</sup> See *id.*; Employment Retirement Income Security Act of 1974 § 3(21)(A).

<sup>91</sup> Employment Retirement Income Security Act of 1974 § 3(21)(A)(ii) (codified at 29 U.S.C. § 1002(21)(A)(ii)).

<sup>92</sup> See *id.*

<sup>93</sup> Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,933.

<sup>94</sup> See, e.g., 29 C.F.R. § 2510.3-21(c) (2014).

<sup>95</sup> *Id.*

investment decisions with respect to plan assets, and that (5) the advice will be individualized based on the particular needs of the plan or IRA.<sup>96</sup>

A person is *only* considered a “fiduciary” for rendering investment advice under ERISA § 3(21)(A)(ii) if she meets those five requirements.<sup>97</sup> This test significantly narrowed the class of advisers who constitute an investor’s fiduciary.<sup>98</sup>

The language of ERISA § 3(21)(A)(ii) itself, as originally enacted, was very broad, and included any adviser who falls within its ambit, regardless of the nature of the adviser’s relationship with the particular investor.<sup>99</sup> The wording of the statute does not contemplate the elements of the 1975 interpretation’s five-part test. The language does not mention the frequency with which the adviser renders advice to the particular investor, the agreement between the adviser and the investor, or the importance of the advice to investment decisions.<sup>100</sup> Thus, the five-part test limits which advisers constitute fiduciaries by providing three additional conditions not present in the rule itself.<sup>101</sup> The DOL expressed concerns “that the specific elements of the five-part test—which are not found in the text of the Act or the Code—now work to frustrate statutory goals and defeat advice recipients’ legitimate expectations.”<sup>102</sup> Investors expect their advisers to act in their best interest. The five-part test frees some advisers from fiduciary obligations, minimizing the broad protections investors once enjoyed under ERISA.

### C. *Conflicts of Interest Undercut the “Fiduciary” Definition*

The former fiduciary definition excluded some advisers who should fall under that classification for rendering the type of advice ERISA intended to protect. This left the public vulnerable to advisers with conflicting interests who do not have the heightened duties and liabilities of fiduciary advisers.<sup>103</sup> One

<sup>96</sup> Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,933; see 29 C.F.R. § 2510.3-21(c); see also Employment Retirement Income Security Act of 1974 § 3(21)(A)(ii) (supplying the language of the investment advice rule).

<sup>97</sup> See 29 C.F.R. § 2510.3-21(c).

<sup>98</sup> Compare Employment Retirement Income Security Act of 1974 § 3(21)(A), with 29 C.F.R. § 2510.3-21(c).

<sup>99</sup> See Employment Retirement Income Security Act of 1974 § 3(21)(A).

<sup>100</sup> See *id.*

<sup>101</sup> See Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,933; 29 C.F.R. § 2510.3-21(c); see also Employment Retirement Income Security Act of 1974 § 3(21)(A)(ii) (supplying the language of the investment advice rule interpreted by 29 C.F.R. § 2510.3-21(c)).

<sup>102</sup> Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,933.

<sup>103</sup> See Employment Retirement Income Security Act of 1974 § 3(21)(A); Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,930.

main cause of this problem is the five-part test's narrow interpretation of the investment advice rule. Because the statutory language has been interpreted so narrowly, the practical effect of the five-part test is that it is easy to get out of fiduciary duties simply by proving that one element is missing.<sup>104</sup> Without that fiduciary protection in place, retirement savers are vulnerable to receiving guidance from advisers whose interests are related to the suggested investment. The DOL is particularly concerned that nonfiduciary advisers will "give imprudent and disloyal advice; steer plans and IRA owners to investments based on their own, rather than their customers' financial interests; and act on conflicts of interest in ways that would be prohibited if the same persons were fiduciaries."<sup>105</sup> Nonfiduciary advisers have limited liability for their clients' losses, so there is less to deter them from providing self-interested advice.<sup>106</sup>

Further, nonfiduciary advisers need not disclose some conflicts of interest, leaving investors vulnerable to conflicts they did not know existed.<sup>107</sup> "[D]irect and substantial conflicts of interest" exist between plan beneficiaries and nonfiduciary advisers when advisers receive compensation for promoting certain investments.<sup>108</sup> Problematically, this incentivizes advisers to recommend investments that generate the most revenue to the advisers, even if those investments will generate lower returns for the investors.<sup>109</sup> "Conflicted payments are payments to the adviser that depend on the actions taken by the advisee," while nonconflicted payments include "an hourly rate, a percentage of assets, or other similar fees that do not directly depend on the investment decisions made by the client."<sup>110</sup> The United States Council of Economic Advisers, in its report, *The Effects of Conflicted Investment Advice on Retirement Savings*, found that retirement "[s]avers receiving conflicted advice earn returns roughly 1 percentage point lower each year," meaning "conflicted advice reduces what would be a 6 percent return to a 5 percent return."<sup>111</sup> The Council also found that, "[a] retiree who receives conflicted advice when rolling over a 401(k) balance to an IRA at retirement will lose an estimated 12 percent of the value of his or her savings if drawn down over 30 years," meaning "his or her savings would run out more than 5

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<sup>104</sup> See 29 C.F.R. § 2510.3-21(c).

<sup>105</sup> See Fiduciary Definition Final Rule, *supra* note 6, at 20,946.

<sup>106</sup> See *id.*

<sup>107</sup> See *id.*

<sup>108</sup> See Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,930.

<sup>109</sup> *Id.*

<sup>110</sup> EFFECTS OF CONFLICTED INVESTMENT ADVICE, *supra* note 4, at 6.

<sup>111</sup> *Id.* at 2.

years earlier.”<sup>112</sup> It is often imperative for investors to transition from ERISA-protected 401(k) plans to other retirement savings options that may not oblige advisers to adhere to the fiduciary standard of care.<sup>113</sup> Moreover, at this stage, many future retirees are inexperienced investors. In its report, the Council further pointed out that “for many Americans making decisions about their IRA investments will be one of the only times they must confront the full set of investment products available in the marketplace and as such will be one of the most complicated savings decisions they will face in their lifetime.”<sup>114</sup> The statement was based on the Survey of Consumer Finances, which found that while about half of Americans saved for retirement through employee benefits plans and IRAs, outside of those plans, “only 14 percent held individual stocks, only 8 percent held mutual funds or other pooled investment funds, and even fewer held CDs, individual bonds, or other managed assets.”<sup>115</sup> Obtaining trustworthy professional advice is important because investors are typically inexperienced with the multitude of options available. The effects of conflicts of interest, in conjunction with the necessity for investors to utilize multiple retirement savings options and their vulnerability at that stage, evidence the dire need for new regulation to protect the savings of retirement investors.

*D. Inconsistencies Between Advisers to IRAs and 401(k)s Exacerbates Confusion*

The former regulatory scheme makes it difficult for investors to know when their advisers are fiduciaries, and thus not vulnerable to conflicts of interest. The Code regulates IRAs while ERISA regulates 401(k) plans. This creates confusion for investors, especially those transferring funds from a 401(k) plan into an IRA.<sup>116</sup> While all fiduciaries are held to the same, prudent man standard of care,<sup>117</sup> who classifies as a fiduciary varies between IRAs and 401(k) plans. ERISA imposes fiduciary obligations on advisers who provide recommendations to 401(k) investors for a fee.<sup>118</sup> The Code, however, classifies an adviser as a fiduciary based on his actions with respect to the particular

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<sup>112</sup> *Id.* at 3.

<sup>113</sup> *See supra* Section I.B.

<sup>114</sup> EFFECTS OF CONFLICTED INVESTMENT ADVICE, *supra* note 4, at 8.

<sup>115</sup> *Id.* at 8 n.6.

<sup>116</sup> *See supra* Section I.A.

<sup>117</sup> *See supra* note 35 and accompanying text.

<sup>118</sup> Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 3(21)(A)(ii), 88 Stat. 829, 836 (codified at 29 U.S.C. § 1002(21)(A)(ii) (2012)).

IRA at hand, i.e., whether he is acting as an adviser or just a broker.<sup>119</sup> A person is an investor's fiduciary when acting as an adviser, but is not a fiduciary when acting as a broker.<sup>120</sup> An investment adviser is:

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.<sup>121</sup>

The Financial Industry Regulatory Authority (FINRA) holds brokers to the less-protective suitability standard.<sup>122</sup> A broker is "any person engaged in the business of effecting transactions in securities for the account of others."<sup>123</sup> Some individuals are authorized as investment advisers *and* as brokers; which standards govern their behavior depends on its nature, whether they are acting as an adviser or a broker.<sup>124</sup> When an adviser provides any advice unrelated to the value of securities or whether an investor should invest, purchase, or sell, that adviser is considered a broker and not an investment adviser.<sup>125</sup> This can easily confuse an investor if he meets with his adviser as a fiduciary on one occasion, and then the next time he meets with his adviser, unbeknownst to the client, the adviser is not providing advice sufficiently connected to the transaction to be considered his fiduciary.<sup>126</sup> For example, consider a retirement investor who meets with an adviser to address his retirement needs. He pays the adviser a fee of a percentage of the funds he wishes to invest and requests advice pertaining to which retirement savings options would be most beneficial. The investor ends up investing in Investment X. Throughout this transaction, the adviser is the investor's fiduciary. Now

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<sup>119</sup> See Rodgers, *supra* note 32.

<sup>120</sup> See *infra* notes 34–40 and accompanying text.

<sup>121</sup> Investment Advisers Act of 1940, Pub. L. No. 112-90, § 202(a)(11), 54 Stat. 847, 848 (2012) (codified at 15 U.S.C. § 80b-2(a)(11) (2012)).

<sup>122</sup> Rodgers, *supra* note 32.

<sup>123</sup> 15 U.S.C. § 78c(a)(4)(A).

<sup>124</sup> See Sean Ross, *Career Advice: Stockbroker vs. Financial Adviser*, INVESTOPEDIA (Sept. 29, 2015), <http://www.investopedia.com/articles/professionals/092915/career-advice-stockbroker-vs-financial-advisor.asp> [<https://perma.cc/9NQY-RDB4>]; see generally Ethan S. Braid, *Is My Financial Advisor a Fiduciary or a Stockbroker?*, HIGH PASS ASSET MGMT. (Mar. 2013), <http://www.highpassasset.com/blog/58-is-my-financial-advisor-a-fiduciary-or-a-stockbroker.html> [<https://perma.cc/SJZ4-F3CW>] (comparing the nature and obligations of advisers and brokers).

<sup>125</sup> See § 202(a)(11), 54 Stat. 847, 848 (2012) (codified at 15 U.S.C. § 80b-2(a)(11)).

<sup>126</sup> See, e.g., Braid, *supra* note 124.

imagine that our investor, a few weeks later, calls the adviser and requests she move his funds from Investment *X* to Investment *Y*. While Investment *Y* is a suitable investment for our investor, the move is not in his best interest. The adviser knows this, but also knows that Investment *Y* pays a high commission, so she simply transfers the funds. The investor loses money. During the second transaction, the adviser was acting only as a broker and thus was not governed by the fiduciary standard—despite the fact that the same adviser had been the investor’s fiduciary just weeks earlier.

The former regulatory scheme was riddled with problems. The five-part test excludes many surprising advisers from fiduciary obligations. Furthermore, many investors receive guidance from advisers who may receive financial compensation for recommending certain investments. Finally, different rules govern advisers to investors holding IRAs and those holding 401(k) plans. This makes it nearly impossible for retirement investors to keep track of which standard of care governs their investment advisers.

### III. THE NEW FIDUCIARY RULE

To combat the problems with the former fiduciary rule, the DOL has been working since 2010 to amend the definition.<sup>127</sup> The DOL proposed a new regulation in 2010 (the 2010 proposal) in an attempt to remove the five-part test and broaden the definition of fiduciary.<sup>128</sup> The 2010 proposal was met with widespread criticism and was ultimately withdrawn.<sup>129</sup> The DOL proposed a new regulation in 2015 (the 2015 proposal) to accomplish the same purpose as the 2010 proposal.<sup>130</sup> The DOL considered the notes and comments submitted for the 2015 proposal, and amended it to promulgate the final fiduciary rule (the final rule).<sup>131</sup> The final rule provides a more inclusive regulation for determining which advisers and types of advice require heightened duties of care. The new rule protects retirement investors from the harmful effects of receiving conflicted advice. Additionally, it applies ERISA’s fiduciary standard uniformly to all advisers who provide retirement

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<sup>127</sup> See Definition of the Term “Fiduciary”, 75 Fed. Reg. 65,263, 65,263 (proposed Oct. 22, 2010, withdrawn Apr. 20, 2015) [hereinafter *Fiduciary Definition 2010 Proposal*].

<sup>128</sup> See *id.* Compare 29 C.F.R. § 2510.3-21(c)(1)(ii)(B) (2014), with *Fiduciary Definition 2010 Proposal*, *supra* note 127, at 65,263.

<sup>129</sup> See *Fiduciary Definition 2015 Proposal*, *supra* note 3, at 21,928.

<sup>130</sup> See *id.*

<sup>131</sup> See *Fiduciary Definition Final Rule*, *supra* note 6, at 20,946–47.

investment advice. This removes investors' confusion over when their advisers owe them fiduciary obligations. The final rule is more congruous with investors' expectations and the broad protections the legislature intended ERISA to afford.

### A. *The 2015 Proposal*

The 2015 proposal attempted to broaden the definition of investment advice that imposes fiduciary obligations on advisers.<sup>132</sup> Specifically, it provides that advisers render investment advice sufficient to classify them as fiduciaries by providing investment recommendations and either (1) "acknowledging the fiduciary nature of the advice" or (2) providing the recommendation under a mutual understanding that the advice is individualized to that particular client.<sup>133</sup> This would subject many advisers to fiduciary obligations they did not have prior to the 2015 proposal. The proposal's definition has two parts: one which defines the types of investment advice that would trigger fiduciary status and another defining certain actions the adviser must take to be considered a fiduciary.<sup>134</sup>

Starting with the first part, the four categories of advice that will render an adviser a plan fiduciary are:

- (i) A recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
- (ii) A recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
- (iii) An appraisal, fairness opinion, or similar statement whether verbal or written concerning the value of securities or other property if provided in connection with a specific transaction or transactions involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA;
- (iv) A recommendation of a person who is also going to receive a fee or other compensation for providing any of the types of advice described in paragraphs (i) through (iii) . . .<sup>135</sup>

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<sup>132</sup> Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,936.

<sup>133</sup> *Id.* at 21,929.

<sup>134</sup> *See id.* at 21,956–57.

<sup>135</sup> *Id.*

According to the definition, rendering advice outside of those four categories does not trigger fiduciary status.<sup>136</sup> In that manner, the DOL transcended from precluding specific advisers and brokers from receiving commission-based compensation, to precluding specific types of *advice*. This shift of focus from a person to a category of advice represents the DOL’s belief that it is the type of advice being given that should trigger the heightened level of care, rather than the relationship established between the particular investor and adviser at a particular moment with regard to a particular transaction.

The second part of the definition lays out certain actions the adviser must take in order to become a fiduciary.<sup>137</sup> Three different actions trigger fiduciary status.<sup>138</sup> An adviser constitutes a fiduciary when providing one of the preceding four categories of advice if she also provides the advice in exchange for compensation *and* either (1) acknowledges that the advice she is providing typically accompanies a fiduciary status, or (2) provides the advice under a mutual understanding with the investor that the advice is individualized to that particular investor.<sup>139</sup> This test to determine whether an adviser has fiduciary obligations is much broader than the five-part test.

This new definition essentially turns the five-part test—which only designates as fiduciaries advisers who (1) render advice (2) regularly (3) pursuant to an understanding with a plan fiduciary that (4) decisions will be made primarily on the advice (5) that is individualized to the particular plan<sup>140</sup>—into a two-part test requiring only the first and last factors. Removing three conditions from the fiduciary definition undoubtedly renders the definition more likely to apply in a greater number of situations. This was the exact intention of the DOL: to apply fiduciary status in more situations, especially those involving retirement investors, so as to better protect the American public.<sup>141</sup> Under the new proposal, an adviser could be considered a fiduciary where he previously would not, (1) despite having provided advice on a strictly one-time basis (no “regular basis” requirement), (2) if the advice is specific or individualized but not provided to serve as a “primary basis” for decisions (no “primary basis” requirement), and (3) even if the adviser and

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<sup>136</sup> *See id.*

<sup>137</sup> *See id.*

<sup>138</sup> *See id.*

<sup>139</sup> *See id.* at 21,929.

<sup>140</sup> *See id.* at 21,933; 29 C.F.R. § 2510.3-21(c) (2014); *see also* Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 3(21)(A)(ii), 88 Stat. 829, 836 (2012) (codified at 29 U.S.C. § 1002(21) (2012)).

<sup>141</sup> *See* Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,928.

investor are not operating under a mutual agreement that the advice will serve as a primary basis for making investment decisions (no “mutual” requirement).<sup>142</sup> Though the 2015 proposal would impose fiduciary obligations on many more advisers than the five-part test, the proposal also provides for situations where advisers who would be classified as fiduciaries are able get out of those fiduciary obligations as long as certain protections are in place. One example is the education carve-out, which exempts from fiduciary obligations certain categories of investment education materials.<sup>143</sup> Another example is the BIC exemption, which allows advisers to receive commissions for certain investments, despite their status as fiduciaries, as long as they satisfy various conditional protective measures.<sup>144</sup>

### 1. Education Carve-Out

To soften the blow to advisers, the 2015 proposal defines various carve-outs and exemptions to the proposed fiduciary definition.<sup>145</sup> The practical application of these carve-outs is that they remove the fiduciary classification of a party who would otherwise be classified as a fiduciary under the two-part test.<sup>146</sup> The carve-outs, in general terms, cover (1) certain counterparty or seller’s transactions, (2) employees providing advice in exchange for nothing more than their typical employment salary, (3) certain platform providers, (4) non-individualized selection and monitoring assistance, (5) certain financial reports and valuations, and (6) various categories of investment education materials.<sup>147</sup> If an adviser’s actions meet the conditions of one of the carve-outs, he will not be considered a fiduciary under ERISA or the Code despite meeting the conditions of the proposed fiduciary definition.<sup>148</sup>

The education carve-out specifically excludes from the fiduciary definition six categories of investment education information and materials as long as they “do not include (standing alone or in combination with other materials) recommendations with respect to specific investment products or specific plan or IRA alternatives, or recommendations on

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<sup>142</sup> See *id.* at 21,933; 29 C.F.R. § 2510.3-21(c); see also Employment Retirement Income Security Act of 1974 § 3(21)(A)(ii).

<sup>143</sup> See Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,941–51.

<sup>144</sup> See Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21,960, 21,984 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550).

<sup>145</sup> See Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,941–51.

<sup>146</sup> See *id.* at 21,941.

<sup>147</sup> See *id.* at 21,941–45.

<sup>148</sup> See *id.* at 21,941.

investment, management, or value of a particular security or securities, or other property.”<sup>149</sup> But, it excludes from the carve-out (or in other words, imposes fiduciary liability upon) information describing the terms or operation of an employee benefits plan or IRA, information or materials explaining retirement income needs, and historical return information.<sup>150</sup> Also excluded from the carve-out are asset allocation models that “include or identify any specific investment product or specific alternative available under the plan or IRA.”<sup>151</sup> Thus, it excludes things like specific product information, even if it is not individualized to a plan or IRA.<sup>152</sup>

## 2. Best Interest Contract (BIC) Exemption

In addition to the carve-outs, which remove fiduciary classification to advisers in certain situations, the proposal included exemptions to the fiduciary definition.<sup>153</sup> The exemptions trigger a less rigorous form of fiduciary classification, one that allows the adviser to receive commission-based compensation provided that the adviser adheres to various safety measures.<sup>154</sup> One such exemption is the Best Interest Contract exemption, which

permits Advisers, Financial Institutions, and their Affiliates and Related Entities to receive compensation for services provided in connection with a purchase, sale or holding of an Asset by a Plan, participant or beneficiary account, or IRA, as a result of the Adviser’s and Financial Institution’s advice to any of the following “Retirement Investors:”

- (1) A participant or beneficiary of a Plan subject to Title I of ERISA with authority to direct the investment of assets in his or her Plan account or to take a distribution;
- (2) The beneficial owner of an IRA acting on behalf of the IRA; or
- (3) A plan sponsor as described in ERISA section 3(16)(B) (or any employee, officer or director thereof) of a non-participant-directed Plan subject to Title I of ERISA with fewer than 100 participants, to the extent it acts as a fiduciary who has authority to make investment decisions for the Plan.<sup>155</sup>

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<sup>149</sup> *See id.* at 21,958.

<sup>150</sup> *See id.*

<sup>151</sup> *See id.*

<sup>152</sup> *See id.*

<sup>153</sup> *See id.* at 21,941–51.

<sup>154</sup> *See id.*

<sup>155</sup> Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21,960, 21,984 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550).

Under the 2015 proposal, advisers under the BIC exemption would not be held to the normal fiduciary standards as outlined in ERISA § 404(a) and 29 U.S.C. § 1104(a). The normal fiduciary standard prohibits the exchange of advice on a commission-based model.<sup>156</sup> Instead, advisers under the BIC exemption would be required to “contractually acknowledge fiduciary status, commit to adhere to basic standards of impartial conduct, warrant that they have adopted policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest, and disclose basic information on their conflicts of interest and on the cost of their advice.”<sup>157</sup> In addition, they must avoid misleading the investor and providing advice and recommendations outside of the investor’s best interest.<sup>158</sup> The BIC exemption dictates that if an adviser enacts the stated protective measures, and provides advice that is in the investor’s best interest, the adviser can receive commission-based compensation.<sup>159</sup> Advisers are only permitted, however, to receive reasonable amounts of commission-based compensation.<sup>160</sup>

While the proposal imposes fiduciary obligations on many more advisers than former regulation imposed, advisers can also retain their commission-based compensation models by agreeing to act in their clients’ best interest.<sup>161</sup> This compromise reduces the burden on advisers participating in the BIC exemption while increasing the protection afforded to retirement investors. The 2015 proposal, however, went too far in its protections. Under its rules, individualized education materials would not trigger fiduciary status when they only provide objective factual information. This would reduce the educational materials available for investors. The final rule provides a better compromise of increasing protection while maintaining investors’ access to educational materials.

### *B. The Final Rule*

The final fiduciary rule broadly preserves the structure and substance of the 2015 proposal, mostly clarifying focal provisions that many commenters opposed or misunderstood.<sup>162</sup> According to the DOL, the final rule more closely conforms to

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<sup>156</sup> See *id.*; Fiduciary Duties, 29 U.S.C. § 1104 (a)(1) (2012); see *supra* Section I.A.

<sup>157</sup> Proposed Best Interest Contract Exemption, 80 Fed. Reg. at 21,961.

<sup>158</sup> See *id.*

<sup>159</sup> See *id.* at 21,941–51.

<sup>160</sup> See *id.* at 21,961.

<sup>161</sup> See *id.*

<sup>162</sup> See Fiduciary Definition Final Rule, *supra* note 6, at 20,960–61.

ERISA’s “broad scope” of protections.<sup>163</sup> Under the final rule, an adviser provides “investment advice” sufficient to render him a fiduciary if he provides one of two categories of investment recommendations to a retirement investor in exchange for compensation.<sup>164</sup> The first ERISA category of investment recommendations, Section 3(21)(a)(1)(i), covers recommendations pertaining to the advisability of holding assets in a plan or IRA.<sup>165</sup> The second category, Section 3(21)(a)(1)(ii), covers recommendations pertaining to the management, and transfer of assets held in a plan or IRA.<sup>166</sup>

“Under the final rule, whether a ‘recommendation’ has occurred is a threshold issue and the initial step in determining whether investment advice has occurred.”<sup>167</sup> One main departure from the 2015 proposal is the final rule’s focus on a recommendation as the focal point of the analysis.<sup>168</sup> A recommendation is “a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action.”<sup>169</sup> This definition highlights the DOL’s goal of preventing advisers from subtly influencing investors not to make decisions in their best interest. For example, the rule advises that an adviser makes a recommendation by “[p]roviding a selective list of securities to a particular advice recipient as appropriate for that investor,” even if the adviser does not specifically point out any securities on the list.<sup>170</sup> Moreover, various actions that would not individually constitute recommendations may constitute a recommendation when considered together.<sup>171</sup> The DOL advises that “the more individually tailored the communication is to a specific advice recipient or recipients about, for example, a security, investment property, or investment strategy, the more likely the communication will be viewed as a recommendation.”<sup>172</sup> The inquiry into whether an adviser made a recommendation is an objective, rather than subjective, inquiry.<sup>173</sup> To make the

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<sup>163</sup> *Id.* at 20,946; *see supra* Section II.A.

<sup>164</sup> *See* Fiduciary Definition Final Rule, *supra* note 6, at 20,960–61.

<sup>165</sup> *Id.* at 20,961.

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* at 20,962.

<sup>169</sup> *Id.* at 20,997–98 (to be codified at 29 C.F.R. § 2510.3-21(b)(1)).

<sup>170</sup> *See id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* at 20,997.

determination, the fact finder must consider all available “facts and circumstances.”<sup>174</sup>

The final rule excludes four categories of objective educational materials the DOL categorizes as less influential over investors from the definition of recommendation.<sup>175</sup> The four categories include (1) providing platforms which allow investors to select or monitor investment alternatives, as long as certain conditions are met;<sup>176</sup> (2) providing assistance with selection and monitoring of investment alternatives;<sup>177</sup> (3) sending investors general communications;<sup>178</sup> and (4) furnishing nonparticularized investment education materials.<sup>179</sup> Advisers may provide any of the foregoing four categories of materials without providing a recommendation.<sup>180</sup> This means that advisers may provide these educational materials without undertaking fiduciary obligations.<sup>181</sup> The education carve-out exempts four categories of educational information from the definition of recommendation: plan information, general information, asset allocation models, and interactive investment materials. The final rule’s exclusions provide adequate protection for investors while maintaining their access to helpful tools and educational materials.

The DOL’s Regulatory Impact Analysis found that requiring advisers to disclose conflicts of interests was ineffective, by itself, to combat conflicts and protect investors.<sup>182</sup> This is because, as the DOL paternalistically explained, “most investors have little understanding of their advisers’ conflicts of interest, and little awareness of what they are paying via indirect channels for the conflicted advice.”<sup>183</sup> The final rule will effectively accomplish the DOL’s goals of combating conflicts and protecting investors by more broadly categorizing which types of advice will create a fiduciary relationship between the adviser and the investor.<sup>184</sup> The DOL expects the rule to save investors “between \$33 billion and \$36 billion over 10 years and

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<sup>174</sup> *Id.* at 20,962.

<sup>175</sup> *See id.* at 20,998 (to be codified at 29 C.F.R. § 2510.3-21(b)(2)).

<sup>176</sup> *See id.* at 20,998 (to be codified at 29 C.F.R. § 2510.3-21(b)(2)(i)).

<sup>177</sup> *See id.* at 20,998 (to be codified at 29 C.F.R. § 2510.3-21(b)(2)(ii)).

<sup>178</sup> *See id.* at 20,998 (to be codified at 29 C.F.R. § 2510.3-21(b)(2)(iii)).

<sup>179</sup> *See id.* at 20,998 (to be codified at 29 C.F.R. § 2510.3-21(b)(2)(iv)).

<sup>180</sup> *See id.* at 20,998 (to be codified at 29 C.F.R. § 2510.3-21(b)(2)).

<sup>181</sup> *See id.*

<sup>182</sup> DEPT OF LABOR, REGULATING ADVICE MARKETS 8 (2016) [hereinafter REGULATORY IMPACT ANALYSIS], <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf> [<https://perma.cc/4YW9-2YCG>].

<sup>183</sup> *Id.* at 9.

<sup>184</sup> *See* Fiduciary Definition Final Rule, *supra* note 6, at 20,950.

between \$66 and \$76 billion over 20 years," by eliminating the conflicts that arise when advisers receive varying compensation for recommending certain mutual funds.<sup>185</sup>

The final rule was published on April 8, 2016, and became effective on June 7, 2016.<sup>186</sup> The rule had an applicability date of April 10, 2017, which gave affected advisers one year in which to prepare new policies in accordance with the rule.<sup>187</sup> Shortly after the final rule was published, the House and Senate approved a resolution to defeat the rule.<sup>188</sup> Former President Barack Obama vetoed the resolution, asserting that the final rule's promulgation "is critical to protecting Americans' hard-earned savings and preserving their retirement security."<sup>189</sup> Shortly after President Donald Trump took office, he published a memorandum for the Secretary of Labor in the Federal Register.<sup>190</sup> He advised that the final rule "may significantly alter the manner in which Americans can receive financial advice, and may not be consistent with the policies of [his] Administration."<sup>191</sup> The memorandum directs the DOL to analyze whether the final rule reduces retirement investors' access to advice and informative materials.<sup>192</sup> If the DOL should find that the rule does reduce such access, the memorandum directs the DOL to publish a new proposal amending or rescinding the rule for notice and comment.<sup>193</sup> The final rule should be enacted as written because it protects retirement investors from the dire consequences of receiving untrustworthy advice.

#### IV. HOLDING ADVISERS ACCOUNTABLE

The new fiduciary rule accomplishes two things simultaneously: it widens the pool of advisers and types of advice that require heightened duties of care and it lowers the burden that such duties impose on the advisers, rendering it the ultimate compromise. The previous regulation, with its five-part test, has been interpreted far too narrowly to adequately protect retirement investors. The new rule protects retirement investors

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<sup>185</sup> REGULATORY IMPACT ANALYSIS, *supra* note 182, at 10.

<sup>186</sup> Fiduciary Definition Final Rule, *supra* note 6, at 20,946.

<sup>187</sup> *See id.*

<sup>188</sup> *See* Mark Schoeff Jr., *Obama Vetoes Resolution Against DOL Fiduciary Rule; Court Sets Date for NAFA's Lawsuit*, INV. NEWS (June 8, 2016), <http://www.investmentnews.com/article/20160608/FREE/160609915/obama-vetoes-resolution-against-dol-fiduciary-rule-court-sets-date> [<https://perma.cc/LUX4-VJV2>].

<sup>189</sup> *Id.*

<sup>190</sup> Memorandum for the Secretary of Labor, 82 Fed. Reg. 9675 (Feb. 3, 2017).

<sup>191</sup> *Id.*

<sup>192</sup> *Id.*

<sup>193</sup> *Id.*

from the harmful effects of receiving conflicted advice. Additionally, it applies ERISA's fiduciary standard uniformly to all advisers who provide retirement investment advice. This removes investors' confusion over when their investors owe them fiduciary obligations. While critics argue that the new rule may harm investors through higher expenses and restricted access to advice, products, and services, the benefits of the new rule outweigh those concerns. Furthermore, investors will not lose access to *all* advice, products and services; rather, they will only lose access to advice not in their best interest. The multitude of retirement saving options available to investors, and the need for investors to utilize more than one option,<sup>194</sup> evidences the importance of a uniform standard of care for advisers who recommend retirement saving options. Moreover, the vulnerability of retirement investors in weighing their options evidences the need for their advisers to be fiduciaries who must provide advice that is in the investors' best interest, without taking into consideration the adviser's own financial gains.<sup>195</sup> The new rule encourages advisers to provide retirement investors with only those recommendations in their best interest. This gives retirement investments the protection they deserve.

A. *The Final Rule Increases Investor Protection*

The final rule widens the pool of advisers and types of advice that trigger fiduciary obligations, protecting investors from the problems discussed in Part II, *supra*.<sup>196</sup> Specifically, the new rule will minimize the prevalence of conflicted advice and remove investors' confusion over when their retirement investment advisers are their fiduciaries. The new rule also makes advice more reliable by ensuring that advisers' standards of care match up with investors' expectations. As discussed above, under the previous regulation, some advisers were able to receive compensation for promoting certain investments.<sup>197</sup> Problematically, this incentivized advisers to recommend investments that generate the most revenue to the advisers, even if those investments would generate lower returns for the investors.<sup>198</sup> These conflicted payments—"payments . . . that

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<sup>194</sup> For example, when an investor must decide what to do with a 401(k) plan upon employment termination prior to retirement.

<sup>195</sup> See Fiduciary Duties, 29 U.S.C. § 1104(a)(1) (2012).

<sup>196</sup> See *supra* Sections III.B, III.C.

<sup>197</sup> See *supra* Section II.C.

<sup>198</sup> See Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,930.

depend on the actions taken by the advisee"<sup>199</sup>—"encourage investment recommendations that generate higher fees for the advisers at the expense of their customers and often result in lower returns for customers even before fees."<sup>200</sup> The DOL enacted the final rule to restrict those conflicts of interest.<sup>201</sup> It accomplishes this goal by removing the five-part test for determining when an adviser is a plan's fiduciary.<sup>202</sup> The five-part test allowed advisers to remove fiduciary liability simply by proving that one element was missing (i.e., by proving that they did not provide advice to that client on a regular basis, or that there was no mutual understanding that the advice would be the primary basis for investment decisions).<sup>203</sup> Nonfiduciary advisers—those who were able to prove that one element of the five-part test was absent—have limited liability for their clients' losses. Fiduciary liability, on the other hand, holds advisers personally liable for violating the best interest standard of care.<sup>204</sup> This means that they must compensate their clients personally for any losses resulting from recommending investments outside of their clients' best interest. By holding more advisers personally liable for violating the best interest standard of care, the new rule deters advisers from providing self-interested advice. The DOL's Regulatory Impact Analysis focused on the losses realized from retirement account managers receiving conflicted payments.<sup>205</sup> The study concluded that if only half of the DOL's proposed gains were realized by retirement investors, IRA holders would gain between \$20 and \$22 billion over ten years.<sup>206</sup> The new rule's deterrence of conflicted advice will help investors protect their hard-earned retirement savings.

The new rule also clears investors' confusion about when their retirement investment advisers have fiduciary obligations. It accomplishes this goal by applying ERISA's fiduciary standard uniformly to all advisers who provide recommendations to retirement investors. Under the previous regulatory scheme, it was difficult for investors to know when their advisers were their

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<sup>199</sup> EFFECTS OF CONFLICTED INVESTMENT ADVICE, *supra* note 4, at 6.

<sup>200</sup> Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,930.

<sup>201</sup> *See id.*

<sup>202</sup> The five-part test imposes fiduciary obligations on only those advisers who (1) give advice (2) on a regular basis (3) under a mutual understanding (4) that the advice is individualized and (5) will be the primary basis for investment decisions. *See supra* note 30 and accompanying text.

<sup>203</sup> *See supra* text accompanying note 104.

<sup>204</sup> *See supra* Section I.A.

<sup>205</sup> *See* Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,930–31.

<sup>206</sup> *See id.*

fiduciaries.<sup>207</sup> This was especially confusing at times when they were switching from ERISA-covered plans (i.e., 401(k)s) to plans governed by the Code (i.e., IRAs). The new rule applies ERISA's fiduciary standard to all retirement investment accounts, including IRAs. This removes investors' confusion over when their advisers are their fiduciaries. This "standards-based approach aligns the adviser's interests with those of the plan or IRA customer, while leaving the adviser and employing firm the flexibility and discretion necessary to determine how best to satisfy these basic standards in light of the unique attributes of their business."<sup>208</sup>

*B. Investor Protection Outweighs the Burden on the Investment Industry*

Despite the overwhelming advantages, critics of the new rule argue that it may increase the cost of obtaining investment advice and reduce investors' access to advice. Critics of the new rule argue that middle-class investors do not invest enough money to make it worth it to compensate advisers. The middle class faces different retirement options than its wealthier counterpart. In its simplest form, the problem is that small, middle class investors have less money to invest, rendering the task of managing their investments more expensive than managing larger accounts. As explained above, advisers employ two major payment schemes: a commission-based model<sup>209</sup> and an assets-under-management model.<sup>210</sup> Authorities vary on which method is most beneficial to investors.<sup>211</sup> Typically, however, the assets-under-management model is more beneficial for active investors who engage in frequent trading transactions because the yearly fee is often less than the sum of commissions generated by frequent trading.<sup>212</sup> On the other hand, investors with a less diverse portfolio or those investors

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<sup>207</sup> See *supra* Section II.D.

<sup>208</sup> Fiduciary Definition 2015 Proposal, *supra* note 3, at 21,948.

<sup>209</sup> In a commission-based model, the investor pays a one-time commission on each transaction the adviser performs for his investment plan. See *supra* Section I.A.

<sup>210</sup> In an assets-under-management model, the investor pays the adviser a portion of his assets under the management of the adviser (typically 1%–1.5%) each year in exchange for the adviser's maintenance services. See *id.*

<sup>211</sup> See *Fee Based Financial Advice vs. Commission: Which Choice Pays?*, FIRST EQUITABLE (Aug. 30, 2015), <http://www.first-equitable.com/fee-based-financial-advice-vs-commissions-which-is-the-best> [<https://perma.cc/SA2V-EGKM>] ("The debate over fees versus commissions, and ultimately which is best for clients, is an age-old debate."); Kaufman, *supra* note 41 ("There is no easy nor obvious answer to the fee-based vs. commission-based conundrum.").

<sup>212</sup> See Kaufman, *supra* note 41.

who do not plan to trade very frequently may benefit more from a commission-based payment model because it would avoid paying yearly fees for services they may not use.<sup>213</sup>

Many advisers receiving payment on an assets-under-management basis set minimum asset requirements for their clients.<sup>214</sup> In its comment letter in response to the 2015 proposal, State Farm explained that the assets-under-management model does not provide enough incentive for investment advisers to manage mutual fund accounts worth less than \$22,000.<sup>215</sup> This is because the yearly fees, based on a portion of the amount invested,<sup>216</sup> “will not generate sufficient income . . . to cover the costs of the product and risk undertaken.”<sup>217</sup> This argument is unpersuasive because it assumes that a commission-based payment model will be unavailable for smaller investors. The new rule does not upend advisers’ practice of earning commission-based compensation. Rather, it prevents them from providing recommendations that are not in the investor’s best interest. As long as advisers provide only those recommendations that are in their clients’ best interest, they will face no additional liability.

The new rule broadens the definition of “investment advice,” making many services count as investment advice that the financial industry considers to be simple product selling.<sup>218</sup> Providing investment advice triggers the fiduciary standard of care, requiring advisers to recommend only those investments in their clients’ best interest.<sup>219</sup> Economists Robert Litan and Hal Singer argue that middle-class investors would be harmed through loss of access to products and advice, higher costs for small plan services, and fewer opportunities for greater

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<sup>213</sup> See Jason Van Bergen, *Paying Your Investment Advisor—Fees or Commissions?*, INVESTOPEDIA, <http://www.investopedia.com/articles/basics/04/022704.asp> [<https://perma.cc/GSH5-ARYJ>].

<sup>214</sup> See John Berlau, *Don’t Let Team Obama ‘Protect’ Your Retirement Account the Way It Has ‘Protected’ Your Health Care*, FOX NEWS (July 6, 2015), <http://www.foxnews.com/opinion/2015/07/06/don-t-let-them-obamacare-your-retirement-account.html> [<https://perma.cc/3YLE-449A>].

<sup>215</sup> See State Farm Mutual Automobile Insurance Company, Comment Letter on Proposed Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice Under 29 C.F.R. Pts. 2509–10, at 9 (July 21, 2015), <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32-2/00646.pdf> [<https://perma.cc/2HPU-6VHB>] [hereinafter State Farm, Comment Letter on 2015 Proposal].

<sup>216</sup> In the example of an account worth \$22,000, the yearly fee at State Farm’s typical rate of 1.48% would only generate \$326 per year. See *id.*

<sup>217</sup> *Id.*

<sup>218</sup> See Guardian Life Insurance, Comment Letter on 2015 Proposal, *supra* note 76, at 7.

<sup>219</sup> See *supra* Section II.A.

retirement savings.<sup>220</sup> Similarly, a comment letter by Congressman Ed Perlmutter emphasized his concern that the proposal “could lead to a decrease in affordable investment advice, products and services” and therefore unintentionally impede beneficiaries’ access to guaranteed lifetime income products like annuities.<sup>221</sup> These products and services include, for example, State Farm’s practice of “providing consumers valuable educational communications and access to investment professionals with whom to discuss their individual circumstances and investment options,”<sup>222</sup> and “coaching to stay invested through market downturns, and assistance in portfolio rebalancing.”<sup>223</sup> While it is true that the new rule may reduce investors’ access to certain services, it should only reduce access to recommendations outside of the investors’ best interest. The only reduction in products and services should be through advisers deciding not to offer those services that may result in a recommendation to a client that is not in his best interest. Reducing investors’ access to persuasive materials that recommend poor investment choices will help investors more than it will harm them.

In addition to those services, many insurance companies also come up with algorithms and other tools of predicting various financial calculi. In a comment letter in opposition to the 2015 proposal, the Guardian Life Insurance Company of America argued that its “agents typically interact with prospective clients through the use of a proprietary data aggregation tool[,] . . . [which] helps the agent and prospective client gather thorough information about a prospective client’s assets and liabilities so that together they can evaluate possible product solutions and financial decisions.”<sup>224</sup> The company is concerned that the new rule renders the agent conducting that prospective client meeting an investment advice fiduciary, even

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<sup>220</sup> See ROBERT LITAN & HAL SINGER, ECONOMISTS INC., GOOD INTENTIONS GONE WRONG: THE YET-TO-BE RECOGNIZED COSTS OF THE DEPARTMENT OF LABOR’S FIDUCIARY RULE 15–23 (2015), <http://www.ei.com/wp-content/uploads/2015/07/LitanSingerFiduciary.pdf> [<https://perma.cc/5JYC-JKfy>] (listing the harm to middle class investors as “(1) small savers losing access to human financial advisers (because small accounts would become uneconomic to serve, and expose advisory firms to new liability risks), (2) small savers being forced into fee-based advisory relationships that cost more than current commission-based arrangements, and (3) small savers and firms not being encouraged to save more, take full advantage of employer matches, or create retirement plans in the first place”).

<sup>221</sup> Ed Perlmutter, Comment Letter on 2015 Proposal, *supra* note 82.

<sup>222</sup> State Farm, Comment Letter on 2015 Proposal, *supra* note 215, at 13.

<sup>223</sup> LITAN & SINGER, *supra* note 220, at 2.

<sup>224</sup> Guardian Life Insurance, Comment Letter on 2015 Proposal, *supra* note 76, at 5.

before any relationship has been established.<sup>225</sup> The DOL, however, included the education carve-out to ensure that investors would not lose access to valuable educational materials. It accomplishes this goal by excluding from the definition of "recommendation" various categories of educational materials. Asset allocation models and interactive investment materials are important educational tools for investors.<sup>226</sup> They help retirement investors "connect the dots" in understanding the different retirement options available to them.<sup>227</sup> But critics argue that "without the ability to include specific investment products, participants could have a hard time understanding how the educational materials relate to specific investment options."<sup>228</sup>

The DOL appreciates this important concern. The final rule allows advisers to use specific investment information in interactive materials and asset allocation models for employee benefits plans but not for IRAs.<sup>229</sup> The DOL's main concern about particularized educational materials is that the adviser's selection of which particular investments to include constitutes a recommendation, which may influence the investor's decision.<sup>230</sup> But the concerns that an investor will be influenced by an impermissible recommendation are alleviated for employee benefit plans by the plan fiduciary's obligation under ERISA to monitor and oversee service providers to the plan.<sup>231</sup> Thus, the DOL rationalizes treating employee benefit plans differently from IRAs because of the heightened obligations of benefit plan fiduciaries to review the selection of options.<sup>232</sup> "[A] responsible plan fiduciary would also have . . . an obligation to evaluate and periodically monitor the asset allocation model and interactive materials being made available to the plan participants and beneficiaries as part of any education program."<sup>233</sup> This obligation includes ensuring that the materials provided to investors "are in fact unbiased and not designed to influence investment decisions towards particular investments that result in higher fees or compensation being

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<sup>225</sup> See *id.* ("An unintended consequence of the Proposal is that individuals will lose access to the use of this beneficial tool.")

<sup>226</sup> See Fiduciary Definition Final Rule, *supra* note 6, at 20,977.

<sup>227</sup> *Id.* (internal quotations omitted).

<sup>228</sup> *Id.*

<sup>229</sup> *Id.* at 20,978.

<sup>230</sup> See *id.*

<sup>231</sup> See *id.*

<sup>232</sup> See *id.*

<sup>233</sup> *Id.*

paid to” advisers.<sup>234</sup> As such, the new rule largely preserves investors’ access to reliable advice.

The new rule will serve to best protect those Americans saving and investing for retirement. It will prevent expert and cunning investment advisers from using their expertise—the very expertise that investors are paying them for—in a way that benefits the adviser rather than the investor. This is imperative to remove the losses retirement investors suffer due to receiving conflicted advice. The new rule is necessary to protect retirement investors from being exploited for their adviser’s financial gain.

## CONCLUSION

The new fiduciary rule is crucial for investors to save for a worry-free retirement. Under the former regulatory scheme, the rigorous five-part test allowed many advisers to avoid fiduciary obligations. This exposed retirement investors to advisers with conflicting interests who were not legally obligated to recommend only those investments in their best interest. The new fiduciary rule broadens ERISA’s protective provisions, requiring all retirement investor advisers to abide by the prudent man standard of care. This protects investors from the harmful effects of receiving conflicted advice. Additionally, it removes investors’ confusion over when their advisers are their fiduciaries. Investors expect their advisers to act in their best interest. The new rule makes advice more reliable by aligning advisers’ obligations with investors’ expectations. Requiring all retirement investment advisers to abide by the best interest standard closely follows the broad protections the legislature intended ERISA to afford.

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<sup>234</sup> *Id.*

† J.D. Candidate, Brooklyn Law School, 2017; B.A., Purdue University, 2012. Thank you to my parents, Chris and Christine, for inspiring my love for learning and teaching me to always dream bigger. I would also like to thank my brothers, Tony and Travis, for their unwavering encouragement, and Dylan Martin, for making law school such a happy experience. Finally, I would like to thank my talented colleagues on the *Brooklyn Law Review* for their diligence in editing my note.