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DOL Fiduciary Rule 3.0
Strikeout, Base Knock, or Home Run?

Antolin Reiber

Introduction

When it comes to America's pastime, everyone knows, it's 3 strikes and you're out, but legends are also made coming back from an 0-2 count. Could the words of the late great Chicago Cubs announcer, Harry Caray, "It might be… it could be… holy cow, it is, a home run…" echo through the halls of the Department of Labor and in the radios of the financial service professionals who are eagerly awaiting concrete guidance? Strikeout or homerun, that is what the newest edition of the fiduciary rule has come down to. Either way, anyone connected to law, policy, and financial services alike is hoping that the dust will settle, and the game will end so it can finally be determined where everyone stands.

In late 2023, the U.S. Department of Labor (DOL) published its newly proposed rule, commonly referred to as "Fiduciary 3.0," which is aimed at clarifying the Employee Retirement Income Security Act of 1974 (ERISA)[1] definition of "investment advice fiduciary."

The DOL claims that the proposed changes will help to clarify misconceptions regarding the definition of "investment advice fiduciary" and fill the gaps left behind from products that were not contemplated or in common use at the time of the original rule's conception, such as 401(k) plans and Individual Retirement Accounts (IRAs)[2] Although the goal of the proposed rule is to provide better protection for retirement investors, how it ultimately plays out in practice may very well cause more harm than good.

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1. [The] "[p]roposed amendment seeks to defin[e] when a person renders "investment advice for a fee or other compensation, direct or indirect" with respect to any moneys or other property of an employee benefit plan. The proposal also would amend the parallel regulation defining for purposes of Title II of ERISA, a "fiduciary" of a plan defined in Internal Revenue Code (Code) section 4975, including an individual retirement account. Additionally, the DOL is publishing elsewhere in today's Federal Register, proposed amendments to Prohibited Transaction Exemption 2020-02 (Improving Investment Advice for Workers & Retirees) and several other existing administrative exemptions from the prohibited transaction rules applicable to fiduciaries under Title I and Title II of ERISA." Retirement Security Rule: Definition of an Investment Advice Fiduciary, 88 FR 75890-01.

2. Press Release, *Dep't of Lab, US Department of Labor Announces Proposed Rule to Protect Retirement Savers' Interests by Updating Definition of Investment Advice Fiduciary* (2023), https://www.dol.gov/newsroom/releases/ebsa/ebsa20231031.

FIDUCIARY RULE – FIFTY YEAR HISTORY

The long-standing rule has been the five-part test, introduced by the DOL in 1975. The five-part test states that:

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

This test intended to protect investors by requiring financial advisors to act in the best interests of their clients, specifically, when providing advice on retirement accounts. The test stood for nearly forty-one years until 2016, when the DOL issued a final regulation. This regulation, commonly known as the "final rule" replaced the five-part test with significantly more inclusive guidance.[4] "The final rule treats persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of a plan or IRA as fiduciaries in a wider array of advice relationships."[5]

This final rule, however, proved to be far from final. Only two years after the final rule was instituted, a significant challenge came in the Fifth Circuit Court of Appeals in 2018, which ultimately vacated the 2016 final rule, and reinstated the five-part test. The Fifth Circuit, in *Chamber of Commerce of U.S.A., et al. v. U.S. Dep't of Labor* reasoned

> "that the Labor Department's new definition of "fiduciary" was inconsistent with the plain text of ERISA and the Internal Revenue Code, as well as with the common-law meaning of "fiduciary," which depends upon a special relationship of trust and confidence; that the Department impermissibly abused its authority to grant exemptions from regulatory burdens as a tool to impose expansive new duties that were beyond its power to impose; and that the rule

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3. Proskauer, *A Guide to the DOL's New Inv. Advice Fiduciary Rule Proposal –What Inv. Advisers and Managers Need to Know*, (Dec. 8, 2023), https://www.proskauer.com/alert/a-guide-to-the-dols-new-investment-advice-fiduciary-rule-proposal-what-investment-advisers-and-managers-need-to-know.

4. John J. Topoleski, CONG. RSCH. SERV., DOL's 2016 Fiduciary Rule on Investment Advice (2017).

5. Definition of the Term "Fiduciary"; Conflict of Int. Rule-Ret. Inv. Advice, 81 FR 20946.

> impermissibly created private rights of action against brokers and insurance agents when Congress had not authorized those claims."[6]

The Fifth Circuit's decision and the regression to the five-part test has raised several issues of confusion regarding the regulation of financial advice and advisors' fiduciary duties owed to their clients. *Chamber of Commerce also* highlighted the struggle to protect consumers from conflicts of interest while also preserving investors' access to advice regarding investment products. The financial services industry has been shaken by both the Fifth Circuit's decision and the general uncertainty surrounding where the DOL stands on the fiduciary rule. Many businesses had already taken steps to comply with the final rule, based on the DOL's guidance. These steps included moving to fee-based compensation models or implementing policies to avoid conflicts of interest. Yet, other firms criticized the regression to the five-part test as overly burdensome and even formally pushed back against its re-implementation.

The pushback received on the Fifth Circuit's decision and the confusion it created, not only centered around the new definition of "investment advice fiduciary," but also on the "two new exemptions (the Best Interest Contract Exemption and the Principal Transaction Exemption) as well as amendments to several existing class exemptions (including PTE 75-1, concerning transactions involving broker-dealers, reporting dealers and banks; PTE 84-24, concerning transactions involving insurance agents and brokers; and PTE 86-128, concerning executing securities transactions)."[7] Following this pushback, the DOL responded, among other mediums, via official interpretations and forum responses, and even went so far as to announce plans to rewrite the fiduciary rule in 2021, with the goal of creating a new rule that would better align with the Fifth Circuit's ruling, while remaining substantially the same. Many practitioners struggled to operate through the confusion caused by the lack of firm guidance on the issue, and as a result, started to push back on the interpretations, most significantly, the regular basis prong.[8]

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6. Gibson Dunn, *Fifth Circuit Vacates Labor Department's "Fiduciary Rule" "In Toto" in* Chamber of Com. of U.S.A., et al. v. U.S. Dep't of Lab.(Mar. 18, 2018) https://www.gibsondunn.com/fifth-circuit-vacates-labor-department-fiduciary-rule-in-toto/.

7. Peter E. Haller, *Fifth Circuit Issues its "Mandate" Formally Vacating the DOL Fiduciary Rule*, WILLKIE FARR & GALLAGHER LLP (June 22, 2018), https://www.willkie.com/-/media/files/publications/2018/06/fifth_circuit_issues_its_mandate_formally_vacating_the_dol_fiduciary_rule.pdf#:~:text=On%20Thursday%2C%20June%2021%2C%202018,amendments%20to%20certain%20existing%20prohibited.

8. The regular basis prong, according to the DOL is implicated when:

> An adviser has not previously provided advice but expects to regularly make investment recommendations with respect to an IRA as part of an ongoing relationship, a recommendation to roll assets out of an ERISA plan into an IRA would be the start of an advice relationship that satisfies the regular basis prong. Thus, the DOL stated

"In February 2022, two separate trade groups filed suit against the DOL in the U.S. District Court for the Northern District of Texas seeking to set aside the DOL's preamble guidance interpreting the regular basis prong of the five-part test."[9] In March of 2023, it was decided that the DOL's interpretation of the regular basis prong was arbitrary and capricious because it contradicted the DOL's 1975 regulations.[10]

Because of the confusion surrounding which fiduciary rule currently stands, what interpretation investors must follow, and which exemptions apply, the financial services industry remains in a state of uncertainty regarding the present state and the ultimate future of the fiduciary rule. Advocates for the creation of a new rule argue that it is necessary to protect investors from conflicts of interest that may arise when financial advisors receive commission for selling certain, specified and unspecified products. Opponents, however, argue that the creation of a rule would be overly burdensome and limit investors' access to certain types of advice and investment products. The DOL continues to attempt to answer these questions and provide a rule that serves the best interests of investors.

Fiduciary 3.0 – The Newest Revision

"On October 31, 2023, the DOL unveiled a new proposed regulation titled 'Retirement Security Rule: Definition of an Investment Advice Fiduciary' and proposed amendments to several prohibited transaction exemptions ("Fiduciary 3.0")."[11] Fiduciary 3.0 seeks to serve as the final voice on what constitutes fiduciary status. In the preamble of Fiduciary 3.0, the DOL states that the original five-part test is no longer suited to address the modern landscape of professional investment advice and that the "regular basis" and "mutual understanding" prongs exclude many circumstances in which an individual, for which the regulations are aimed, may reasonably assume that they were receiving investment advice in accordance with their best interests.[12]

> that an initial recommendation without a prior relationship can satisfy the regular basis prong and therefore be considered fiduciary investment advice under the five-part test. The DOL took the view that "it is appropriate to conclude that an ongoing advisory relationship spanning both the Title I Plan and the IRA satisfies the regular basis prong." The DOL reiterated this point in FAQ 7 of an FAQ issued in 2021.

Allison Itami, *A Condensed Hist. of the DOL's Fiduciary Rule*, PlanSponsor (Sept. 12, 2023), https://www.plansponsor.com/a-condensed-history-of-the-dols-fiduciary-rule/.

9. *Id.*

10. *Id.*

11. Erin K. Cho, et al., *DOL Releases New Proposed Regulation Regarding Investment Advice Fiduciaries*, Mayer Brown (Nov. 16, 2023), https://www.mayerbrown.com/en/insights/publications/2023/11/dol-releases-new-proposed-regulation-regarding-investment-advice-fiduciaries.

12. *Id.*

Under the 2023 Proposed Rule, Fiduciary 3.0, in lieu of the five-part test, a person would be considered an "Investment Advice Fiduciary" when that person makes an investment transaction or strategy recommendation involving securities or other investment property to a Retirement Investor; the advice or recommendation is provided for a fee or other compensation (direct or indirect), and the person meets *one* of the following requirements:

(1) The person has any discretionary authority or control, *whether or not* pursuant to a mutual understanding with respect to the purchasing or selling of securities or other investment property of the investor;

(2) The person (*or any affiliate of such person*) is in the business of providing investment recommendations to investors, and the investment advice is individualized to the Retirement Investor based on the particular needs of the Retirement Investor and may be relied on by the Retirement Investor in making investment decisions that are in the Retirement Investor's best interest; *or*

(3) The person has acknowledged that they are a fiduciary in providing the investment recommendations.[13]

Different from the five-part test, Fiduciary 3.0 would depart from the "mutual understanding" and "primary basis" concepts.[14] The changes to these concepts include:

> *Mutual Agreement or Understanding*. Fiduciary 3.0 proposes to eliminate the "mutual agreement or understanding" prong of the definition of investment advice and instead focuses on the retirement investor's reasonable expectations and the circumstances surrounding the recommendation. Fiduciary 3.0 explicitly states that disclaimers of fiduciary status will not be effective if other materials provided to, or interactions with, the retirement investor are indicative of a fiduciary relationship.
>
> *Primary Basis*. Fiduciary 3.0 would eliminate the existing requirement that the investment advice will serve as a "primary basis" for investment decisions. Instead, Fiduciary 3.0 focuses on whether circumstances indicate that the investor may rely upon the advice as a basis for investment decisions in the investor's best interest.[15]

Additionally, Fiduciary 3.0 comes with a recommendation requirement, which while not explicitly defined, would seem to apply to communication that based on its content, context, and presentation, would

13. *Id.*
14. *Id.*
15. Joseph A. Lifsics, et al., *Update on DOL's Proposed Rule Regarding Definition of "Investment Advice" Fiduciary*, KIRKLAND & ELLIS (Jan. 18, 2024), https://www.kirkland.com/publications/kirkland-alert/2024/01/proposed-rule-regarding-definition-of-investment-advice-fiduciary.

reasonably be viewed as a recommendation for the investor to take some specific course of action, such as making a specific investment or choosing a specific investment strategy.[16] Among several other changes, most notably, is the rejection of the difference in sales recommendations and investment advice when it comes to the retail market, eliminating the exception from protection for recommendations made to sophisticated investors.

Swinging for the Fences: Analyzing the Impact of Fiduciary 3.0

The end of the month of October usually marks the end of the baseball season, with the World Series in full swing. Will the October 31, 2023 Fiduciary 3.0 proposal also bring an end to the mass confusion among financial professionals and investors and provide these individuals with concrete guidance on what constitutes fiduciary advice?

The Fifth Circuit's decision in *Chamber of Commerce v. U.S. Department of Labor*, to vacate the final rule, and its guidance almost entirely, dealt the second strike, bringing the count to 0-2. The DOL, down to its third strike, is swinging for the fences with Fiduciary 3.0. The DOL, along with the entire financial services industry, eagerly awaits the pitch, hoping for a home run and a long-awaited end to the lingering confusion and are hopeful to strike a balance between protecting investors interests, while not creating an excessive burden on financial services professionals. However, any broadening of the definition of a fiduciary is going to cause confusion, and ultimately harm the industry as a whole. The bottom line is that under Fiduciary 3.0 most, if not all, financial services professionals who make recommendations regarding investments, will now be subject to an entirely different and significantly stricter set of requirements and regulations.

One potential solution to the greater issue is to focus on improving disclosure and transparency in the financial services industry. By requiring financial advisors to disclose any potential conflicts of interest and the fees and commissions associated with different investment products, investors can make more informed decisions about their investments and avoid being taken advantage of by unscrupulous advisors. Another approach, perhaps making the first solution even more effective if done in concert, is to focus on investor education and empowerment.[17] By providing investors with the tools and knowledge they need to make informed decisions about their investments, investors could then begin

16. Proskauer, *supra* note 4.

17. *See* Faster Capital, *Empowering Investors with Informed Decision Making, (Mar. 4, 2024)* https://fastercapital.com/content/Empowering-Investors-with-Informed-Decision-Making.html

to take a more active role in managing their finances and avoid relying too heavily on financial advisors.

Ultimately, the future of the fiduciary rule, and the regulation of financial advice more broadly, will depend on a range of factors, including: the ongoing and expected future legal challenges to Fiduciary 3.0 and its accompanying guidance, changes in the political climate, and the evolving needs and preferences of investors. However, by continuing to engage in dialogue about these issues, stakeholders in the financial services and legal industry, as well as individual investors, can work together to find solutions that balance and effectively serve the interests of investors and financial services professionals alike.

CONCLUSION

A grossly oversimplified interpretation of the DOL's Fiduciary Rule would make almost anyone working in the financial services industry a fiduciary. Though consumer protection is, or should be, the highest priority in transactions regarding retirement funds, subjecting a larger than necessary group to the highest standard of care, in that of a fiduciary, is not only unnecessary, but endangers the entire industry. Requiring people to operate with a higher level of care when performing normal job functions will only slow productivity, require higher levels of education, and raise the operating costs exponentially. These burdens will most certainly be passed onto the investor through higher costs for services offered or even the loss of access to guidance completely.

The role of a fiduciary is to manage another's investments, and most often this comes in the form of an active role. This relationship is one of utmost trust, and comes with lofty penalties if violated, which is why it should be reserved for only those transactions that involve that highest level of trust, and not unnecessarily imposed on all interactions potentially resembling it. The management of an investment portfolio is a substantially different function than selling an insurance policy. However, the DOL's fiduciary rule would seem to treat these the same, subjecting the insurance salesperson to an extreme duty of care that extends far beyond what is necessary.

The Fifth Circuit, in striking down the DOL's proposed rule and its accompanying guidance, made the right decision for the financial services industry as a whole, professionals, and customers alike. As the DOL seeks approval of its newly proposed rule, Fiduciary 3.0, which is essentially the same player as the final rule, just in a different uniform, the financial services industry eagerly awaits a final decision. If approved, even in part, it will most certainly draw similar apprehension before and further challenges in court. Any proposal that expands the

definition of a fiduciary, that ultimately encroaches on non-fiduciary functions, is in direct contrast with existing law and serves as a danger to the industry.

The DOL would be best served to chalk this one up as a loss and prepare for the next game by listening to the concerns of the financial services professionals and incorporating all the feedback into a new proposal that serves both the professionals and customers alike.