LEGAL UPDATE

# Impact of Platform Provider Carve-Out on 401(k) Plans Remains Unclear

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In recognition of the broad scope of its new fiduciary rule and "investment advice" definition, the DOL conflicts of interest proposal would include six so-called carve-outs from the fiduciary definition. As long as a plan service provider falls under one of these six categories, it will not be deemed a fiduciary even when providing investment-related recommendations to retirement clients. The carve-out relief for platform providers is aimed at recordkeepers and third party administrators (TPAs) that offer a "platform" or selection of investment vehicles to their plan clients most of which are 401(k) plans.

Generally speaking, recordkeepers and TPAs do not have the discretionary authority or responsibility that would cause them to be classified as a plan fiduciary and have historically declined to accept any such fiduciary responsibility. If the recordkeeper or TPA makes an error, it is the plan sponsor, in its capacity as the plan's legal administrator under Section 3(16) of ERISA, that is subject to a fiduciary penalty.

## How the Carve-Out Operates

The platform provider carve-out from the proposed fiduciary definition enables recordkeepers and TPAs to maintain this nonfiduciary status on the condition it is clearly understood that in offering an investment platform, a recordkeeper or TPA is not purporting to provide impartial investment advice and has financial or other relationships with the investment providers represented on the platform that could cause any incidental information it does provide to be conflicted. If the requirements of the carve-out are met, the platform provider will be permitted to receive variable compensation, such as commissions or 12b-1 fees, from investment providers represented on the platform that would otherwise be prohibited by ERISA.

## Requirements

Technically, this carve-out applies to persons who market or make available securities or other property to any kind of employee benefit plan (but especially to defined contribution plans with participant-directed investments) through a platform or similar mechanism. The investment funds on the platform may, in turn, be offered as investment alternatives to participants under the plan. To qualify for the carve-out, the platform provider would need to market these investments without regard to the individualized needs of the particular plan or its participants.

Under the proposed carve-out, the platform provider would be permitted to identify investment alternatives meeting objective criteria specified by the plan fiduciary, such as investment funds of a certain size or with expense ratios below a particular threshold. The provider could also respond to requests for identification of investment alternatives with a particular type of asset or credit quality. In addition, the provider would be permitted to provide objective financial data for investment alternatives as well as benchmark comparisons. The provision of this information is intended to assist plan sponsors in selecting and monitoring investment alternatives, but this activity is actually subject to a second carve-out restricting the activities of platform providers in this regard. The net result is to impose more responsibility on plan fiduciaries.

In the preamble to the proposed regulation, the DOL states that furnishing such information is a common practice, and it would appear that it views this development to have been beneficial, provided the disclosures discussed above are made. The DOL also stated its view that historically platform providers have often passed on general financial information to their plan clients that fell short of constituting investment advice, such as information on the historic performance of asset classes and of the investments available on the platform.

To qualify for the carve-out, the provider would also need to disclose in writing that it is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity. Note, however, that this new disclosure only concerns the nature of the provider's advice. The platform provider does not need to disclose its compensation arrangements to qualify for the carve-out. As a separate matter, there is already an obligation for service providers, including investment platforms, to disclose their direct and indirect compensation under the 408(b)(2) regulations that went into effect in 2012.

## Scope of Carve-Out

The proposal's preamble also confirms that the platform provider carve-out would apply to ERISA-covered 403(b) plans, but would not apply to IRAs or other non-ERISA plans. The exclusion of IRAs and non-ERISA plans may be subject to change, however, since the DOL has requested comments on the topic. On the other hand, the DOL has also invited comments on whether the scope of the platform provider carve-out should be limited to large plans, similar to the seller's

carve-out. Presumably, the rationale for such a restriction would be that the plan fiduciaries of small plans (*i.e.*, plans with fewer than 100 participants) lack the sophistication and experience to properly evaluate the information provided by a platform provider or to discern that the information may be affected by a conflict on the part of the platform provider.

## Effect on Providers and Sponsors

The platform provider carve-out, as currently proposed, has an antecedent in a similar exception under the DOL's prior fiduciary advice proposal issued in 2010 which was subsequently withdrawn. Like its predecessor, the new carve-out would likely have a substantial impact on platform providers that deliver advisory services regarding the selection of plan investment alternatives. This activity would prevent them from relying on the carve-out, even if the required disclaimers were made. This would be especially true for those platform providers delivering such services in exchange for any type of direct or indirect compensation. These providers could provide nonconflicted advice by adopting an asset-based fee, although this change would require the provider to become registered as an investment adviser. The alternative would be to restrict the advice rendered in accordance with the proposed carve-out and continue to receive variable compensation.

It is too early to tell what effect the platform provider carve-out will have on plan sponsors. The carve-out will tend to reduce the scope of the information offered by platform providers, although many larger plans now have independent consultants to advise them on general investment matters as well as the selection and monitoring of the investment menu. If the carve-out were not available to eliminate the expanded fiduciary status of recordkeepers and TPAs, 401(k) plan sponsors would likely see fee increases from these service providers.

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