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The DOL Issues Broader Fiduciary Adviser Definition: What Does it Mean for You?

Since the enactment of ERISA in 1974, there has been a dramatic shift in the retirement savings marketplace from employer-sponsored defined benefit plans to participant-directed 401(k) plans, coupled with the widespread growth of Individual Retirement Accounts and Annuities (IRAs). In fact, 401(k) plans did not exist at the time the Department of Labor (DOL) published its ERISA fiduciary rules governing retirement investment advice in 1975, while IRAs were just introduced in the same year. Until recently, these rules had not been meaningfully changed since 1975.

The DOL believes that many investment professionals, consultants, brokers, insurance agents, and other advisers operate within compensation structures that are "misaligned with their customers' interests and often create strong incentives to steer customers into particular investment products."[1] According to the DOL, these conflicts of interest result in the loss of billions of dollars a year for retirement investors. Specifically, the White House Council of Economic Advisers has determined that conflicts of interest lead, on average, to 1 percentage point lower annual returns on retirement savings or a total of $17 billion of losses every year for America's families.[2]

Accordingly, on April 6, 2016, the DOL issued a broader fiduciary investment adviser definition and conflict of interest final rule and related exemptions which protects investors by requiring all who provide retirement investment advice to plans to abide by a "fiduciary" standard which, according to the DOL, will make investment advisors "put their clients' best interest before their own profits."[3]

[1] DOL Fact Sheet, 4/6/16, http://www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html.
[2] White House Press Release (4/6/16), https://www.whitehouse.gov/the-press-office/2016/04/06/fact-sheet-middle-class-economics-strengthening-retirement-security
[3] DOL Fact Sheet, 4/6/16, http://www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html.

Summary of Final Rule

The final rule defines who is a fiduciary investment adviser, although its accompanying prohibited transaction class exemptions allow certain broker-dealers, insurance agents, and others that act as investment advice fiduciaries to continue to receive a variety of common forms of compensation as long as they are willing to adhere to certain fiduciary standards aimed at ensuring that their advice is impartial and in the best interest of their customers.

Under the final rule, those that provide investment advice to plans, plan sponsors, fiduciaries, plan participants, and beneficiaries must either avoid payments that create conflicts of interest or comply with the protective terms of an exemption issued by the DOL. Under new exemptions adopted under the final rule, financial institutions will be obligated to acknowledge their status and the status of their individual advisers as "fiduciaries." Furthermore, financial institutions and advisers will be required to make prudent investment recommendations without regard to their own interests, charge only reasonable compensation, and make no misrepresentations to their customers regarding recommended investments. Together, the rule and exemptions impose basic standards of professional conduct that are intended to address an annual loss of billions of dollars to ordinary retirement investors as a result of conflicted advice. The final rule amends the DOL regulatory definition of fiduciary investment advice in 29CFR 2510.3-21 (1975) to replace the former restrictive test with a new definition that according to DOL better comports with the statutory language in ERISA and the Internal Revenue Code (Code).

The former 1975 fiduciary investment adviser definition provided that a person is considered to be rendering “investment advice” to an employee benefit plan only if:

(i) Such person renders investment advice to the plan for compensation, direct or indirect; and

(ii) Such advice is individualized, provided on a regular basis, and serves as a primary basis for decision-making.

As more fully discussed below, under the final rule, any person receiving compensation for providing “investment advice” based on the particular needs of the person being advised (employer or trustee plan sponsor, plan participant or IRA owner) is a fiduciary investment adviser. There is no longer a requirement that such advice has to be “provided on a regular basis” or serve as the “primary basis” for decision-making.

What is Covered Investment Advice

The final rule describes the kinds of communications that would constitute investment advice and then describes the types of relationships in which those communications would give rise to fiduciary investment advice responsibilities.

Covered investment advice is defined as a recommendation to a plan, plan fiduciary, plan participant and IRA owner for a fee or other compensation, direct or indirect, as to the advisability of buying, holding, selling, or exchanging securities or other investment property, including recommendations as to the investment of securities or other property after the securities or other property are rolled over or distributed from a plan or IRA.

Covered investment advice also includes recommendations as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (*e.g.*, brokerage versus advisory); or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer, or distribution should be made.

Under the final rule, the fundamental threshold element in establishing the existence of fiduciary investment advice is whether a "recommendation" occurred. 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. The more individually tailored the communication is to a specific advice recipient or recipients, the more likely the communication will be viewed as a recommendation.

The types of relationships that must exist for such recommendations to give rise to fiduciary investment advice responsibilities include recommendations made either directly or indirectly (*e.g.,* through or together with any affiliate) by a person who:

- Represents or acknowledges that they are acting as a fiduciary within the meaning of ERISA or the Code;
- Renders advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the advice recipient; or
- Directs advice to a specific recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.

The recommendation must be provided in exchange for a "fee or other compensation" received from any source in connection with or as a result of the recommended purchase or sale of a security or the provision of investment advice services including, but not limited to, commissions, loads, finder's fees, and revenue sharing payments.

What is Not Covered Investment Advice

According to the DOL, not all communications with financial advisers will be covered fiduciary investment advice. As a threshold issue, if the communications do not meet the definition of "recommendations" as described above, the communications will be considered nonfiduciary in nature. The final rule includes the following examples of communications that would not rise to the level of a recommendation and therefore would not constitute a fiduciary investment advice communication.

Education

The DOL believes that education about retirement savings and general financial and investment information is not only beneficial and helpful to plans, plan participants, and IRA owners, but may not rise to the level of recommendations as defined in the final rule.

Education as defined in the rule will not constitute advice regardless of who provides the educational information (*e.g.*, the plan sponsor or service provider), the frequency with which the information is shared, or the form in which the information and materials are provided (*e.g.*, on an individual or group basis, in writing or orally, via a call center, or by way of video or computer software). The education provision allows specific investment alternatives to be included as examples in presenting hypothetical asset allocation models or in interactive investment materials intended to educate participants and beneficiaries as to what investment options are available under the plan, so long as they are designated investment alternatives selected or monitored by an independent plan fiduciary and other conditions are met. In contrast, because there is no similar independent fiduciary in the IRA context, the investment education provision in the rule does not treat asset allocation models and interactive investment materials with references to specific investment alternatives as merely "education."

General Communications

Similarly, general communications that a reasonable person would not view as an investment recommendation, including general circulation newsletters; commentary in publicly broadcast talk shows; remarks and presentations in widely attended speeches and conferences; research or news reports prepared for general distribution; general marketing materials, and general market data including data on market performance, market indices, or trading volumes, price quotes, performance reports, or prospectuses would not constitute communications that are considered recommendations.

Platform Providers

Service providers, such as record-keepers and third-party administrators, often offer a "platform" or selection of investment alternatives to plan fiduciaries who choose the specific investment alternatives that will be made available to participants for investing funds in their individual accounts. Simply making available a platform of investment alternatives without regard to the individualized needs of the plan, its participants, or beneficiaries if the plan fiduciary is independent of such service provider would not constitute communications that would be considered recommendations under the final rule – provided that such provider also represents in writing to the plan fiduciary that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

Transactions with Independent Plan Fiduciaries with Financial Expertise

Under the final rule, ERISA fiduciary obligations are not imposed on advisers when communicating with independent plan fiduciaries if the adviser knows or reasonably believes that the independent fiduciary is a licensed and regulated provider of financial services (*e.g.*, banks, insurance companies, registered investment advisers, broker-dealers) or those that have responsibility for the management of $50 million in assets, and other conditions are met. The conditions are designed to make sure this exclusion is limited to true arm's length transactions between advisers and investment professionals or large asset managers who do not have a legitimate expectation that they are in a relationship where they can rely on the other adviser for impartial advice.

This carve-out is only available for counterparty transactions. Advisers who receive a fee or other compensation directly from a plan or plan fiduciary for investment advice do not qualify for this fiduciary investment adviser exception. The DOL believes that if a plan pays a fee for advice the “essence of the relationship” is advisory and subject to ERISA and the Code. According to DOL, a person may not charge a plan a direct fee to act as an adviser and then disclaim responsibility as a fiduciary investment adviser by asserting that he is merely an arm’s length counterparty.

Swap and Security-Based Swap Transactions

Communications and activities made by advisers to ERISA-covered employee benefit plans in swap or security-based swap transactions do not result in the advisers becoming investment advice fiduciaries to the plan if certain conditions are met. This provision in the final rule has been coordinated with both the SEC and the Commodity Futures Trading Commission (CFTC) to be sure there is no conflict with the swap and security-based swap rules promulgated by those agencies under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Employees of Plan Sponsors, Affiliates, Employee Benefit Plans, Employee Organizations, or Plan Fiduciaries

Employees working in a company's payroll, accounting, human resources, and financial departments who routinely develop reports and recommendations for the company and other named fiduciaries of the sponsors' plans are not investment advice fiduciaries if the employees receive no fee or other compensation in connection with any such recommendations beyond their normal compensation for work performed for their employer.

Further, this exclusion also covers communications between employees, such as human resources department staff who communicate information to other employees about the plan and distribution options in the plan, as long as they meet certain conditions, *i.e.*, they are not registered or licensed advisers under securities or insurance laws and receive only their normal compensation for work performed by the employer.

The Best Interest Contract Exemption (BICE)

In order to ensure that retirement investors receive advice that is in their best interest while also allowing advisers to continue receiving commission-based compensation, the DOL has issued a Best Interest Contract Exemption (BICE). Under ERISA and the Code, individuals providing fiduciary investment advice to plan sponsors, plan participants, and IRA owners are not permitted to receive payments creating conflicts of interest without a prohibited transaction exemption (PTE), which, under ERISA, is granted by the DOL.

The Best Interest Contract Exemption permits firms to continue to rely on many current compensation and fee practices, as long as they meet specific conditions intended to ensure that financial institutions mitigate conflicts of interest and that they, and their individual advisers, provide investment advice that is in the best interests of their customers. Specifically, in order to align the adviser's interests with those of the plan or IRA customer, the exemption requires the financial institution to acknowledge fiduciary status for itself and its advisers. The financial institution and advisers must adhere to basic standards of impartial conduct, including giving prudent advice that is in the customer's best interest, avoiding making misleading statements, and receiving no more than reasonable compensation. The financial institution also must have policies and procedures designed to mitigate harmful impacts of conflicts of interest and must disclose basic information about their conflicts of interest and the cost of their advice.

The Best Interest Contract Exemption includes disclosure requirements, including descriptions of material conflicts of interest, fees or charges paid by the retirement investor, and a statement of the types of compensation the firm expects to receive from third parties in connection with recommended investments. Investors also have the right to obtain specific disclosure of costs, fees, and other compensation upon request. In addition, a website must be maintained and updated regularly that includes information about the financial institution's business model and associated material conflicts of interest, a written description of the financial institution's policies and procedures that mitigate conflicts of interest, and disclosure of compensation and incentive arrangements with advisers, among other information.

The exemption provides for enforcement of the standards it establishes. When providing advice to an IRA owner, the financial institution must commit to these protective conditions as part of an enforceable contract. ERISA plan investors will be able to rely on their advisers' fiduciary acknowledgement to assert their rights under ERISA's statutory protections. If advisers and financial institutions do not adhere to the standards established in the exemption, retirement investors will have a way to hold them accountable either through a breach of contract claim (for IRAs and other non-ERISA plans) or under the provisions of ERISA (for ERISA plans, participants, and beneficiaries).

According to the DOL, investors will not be able to use this enforcement mechanism "simply because they did not like how an investment turned out."[4] The DOL believes that "consistent with long-existing ERISA jurisprudence, advisers can usually prove they have acted in their clients' best interest by documenting their use of a reasonable process and adherence to professional standards in deciding to make the recommendation and determining it was in the customer's best interest, and by documenting their compliance with the financial institution's policies and procedures required by the Best Interest Contract Exemption."[5] This helps retirement savers get the best interest financial advice while leaving the adviser and financial institution the flexibility and discretion necessary to determine how best to satisfy the exemption's standards in light of the unique attributes of their business.

Additional Exemptive Relief

In addition to the Best Interest Contract Exemption, the DOL issued a Principal Transactions Exemption, which permits investment advice fiduciaries to sell or purchase certain recommended debt securities and other investments out of their own inventories to or from plans and IRAs. As with the Best Interest Contract Exemption, this requires, among other things, that investment advice fiduciaries adhere to certain impartial conduct standards, including obligations to act in the customer's best interest, avoid misleading statements, and seek to obtain the best execution reasonably available under

[4] DOL Fact Sheet (4/6/16).
[5] DOL Fact Sheet (4/6/16).

the circumstances for the transaction.

The DOL also finalized an amendment to an existing exemption, PTE 84-24, which provides relief for insurance agents and brokers, and insurance companies, to receive compensation for recommending fixed rate annuity contracts to plans and IRAs. As amended, PTE 84-24 contains increased safeguards for the protection of retirement investors. According to the DOL, this exemption has more streamlined conditions than the Best Interest Contract Exemption, which will facilitate access by plans and IRAs to these relatively simple lifetime income products. More complex products, such as variable annuities and indexed annuities, will be able to be recommended by advisers and financial institutions under the terms of the Best Interest Contract Exemption.

Applicability Date

Compliance with the new requirements will not begin to be required until April 2017 (one year after the final rule was published in the Federal Register). The DOL has determined that an applicability date of one year is appropriate and provides adequate time for plans and their affected financial services and other service providers to adjust to the change from nonfiduciary to fiduciary status.

The DOL has adopted a "phased" implementation approach for the Best Interest Contract Exemption and the Principal Transactions Exemption. Both exemptions provide for a transition period, from the April 2017 applicability date to Jan. 1, 2018, under which fewer conditions apply. This period is intended to give financial institutions and advisers time to prepare for compliance with all the conditions of the exemptions while safeguarding the interests of retirement investors. During this period, firms and advisers must adhere to the impartial conduct standards, provide a notice to retirement investors that, among other things, acknowledges their fiduciary status and describes their material conflicts of interest, and designate a person responsible for addressing material conflicts of interest and monitoring advisers' adherence to the impartial conduct standards. Full compliance with the exemption will be required as of Jan. 1, 2018.

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