APRIL 7, 2016

Department of Labor Issues Final Fiduciary Rule

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The Department of Labor (DOL) has issued a final rule to re-define who is rendered a "fiduciary" of an employee benefit plan under the Employee Retirement Income Security Act (ERISA) by providing investment advice to a plan or its participants or beneficiaries. More than five years in the making, issuance of a final rule to address conflicts-of-interest in retirement advice has been a priority for the White House and DOL to advance its "middle-class economics" agenda in the face of criticism in Congress and by a number of stakeholders. According to a DOL fact sheet, "this final rulemaking fulfills the Department's mission to protect, educate, and empower retirement investors as they face important choices in saving for retirement in their IRAs and employee benefit plans."

Under ERISA and the Internal Revenue Code, a person is a fiduciary to a plan or IRA to the extent her or she engages in specified plan activities, including rendering "investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan…[.]" As the final rule explains, ERISA safeguards plan participants by imposing trust law standards of care and undivided loyalty on plan fiduciaries, and by holding fiduciaries accountable when they breach those obligations. In addition, fiduciaries to plans and IRAs are not permitted to engage in "prohibited transactions," which "pose special dangers to the security of retirement, health, and other benefit plans because of fiduciaries' conflicts of interest with respect to the transactions." The final rule replaces 1975 regulations on fiduciary investment advice with a definition that, according to the DOL, "better reflects the broad scope of the statutory text and its purposes and better protects plans, participants, beneficiaries, and IRA owners from conflicts of interest, imprudence, and disloyalty." DOL separately issued new exemptions to ERISA's "prohibited transaction" rules, notably a "Best Interest Contract Exemption."

Definition of "Fiduciary Investment Advice"

The final rule describes the kinds of communications that would constitute investment advice and then describes the types of relationships in which such communications give rise to fiduciary investment advice responsibilities. Covered investment advice is defined as a "recommendation" to a plan, plan fiduciary, plan participant and beneficiary, 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. Such advice also includes 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 or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA. Thus, the threshold question is whether a communication is deemed to be a "recommendation."

The final rule sets forth the types of relationships that must exist for such "recommendations" to give rise to fiduciary investment advice responsibilities—in other words, who is deemed a fiduciary. People who make recommendations in exchange for a fee or compensation will be considered a fiduciary if they:

- Represent or acknowledge that they are acting as a fiduciary within the meaning of ERISA or the Internal Revenue Code (Code);
- Render 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
- Direct the 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 final rule contains specific examples of communications that would not rise to the level of a recommendation, and therefore would not constitute fiduciary investment advice. The question of where to draw the line between investment advice and investment education was a subject of significant concern with the proposal. The final rule specifies that the following educational information and materials do not fall within the definition of fiduciary investment advice: (1) plan information, (2) general financial, investment, and retirement information, (3) asset allocation models, and (4) interactive investment materials. The final rule does allow educational asset allocation models and interactive investment materials provided to participants and beneficiaries in plans to reference "hypothetical" specific investment alternatives. However, the rule does not create such a broad safe harbor from fiduciary status for such "hypothetical" examples in the IRA context.

The proposed rule provided a carve-out (referred to as the "seller's" or "counterparty" carve-out) from the general definition for incidental advice provided in connection with an arm's length sale, purchase, loan, or bilateral contract between an expert plan investor and the adviser. While the final rule does not use the term "carve-out," it excludes from fiduciary investment advice communications in arm's length transactions with certain plan fiduciaries who are licensed financial professionals (broker-dealers, registered investment advisers, banks, insurance companies, etc.) or plan fiduciaries who have at least $50 million under management. The DOL lowered the threshold for the amount under plan sponsor management in the final rule from $100 million to half that amount, meaning that more plans will fall under the exclusion.

Service providers, such as recordkeepers and third-party administrators, are not considered to be making "recommendations" simply by virtue of offering a "platform" or selection of investment alternatives if certain conditions are met. The plan fiduciary must be independent of the person who markets or makes available the investment alternatives and the person marketing or making available the investment alternatives discloses in writing to the plan fiduciary that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

The proposed rule included a carve-out intended to make it clear that communications and activities engaged in by counterparties to ERISA-covered employee benefit plans in swap and security-based swap transactions did not result in the counterparties becoming investment advice fiduciaries to the plan. Significant concerns have been raised about the harmonization, or lack thereof, of the DOL's fiduciary rule with rulemaking by the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC) pursuant to Dodd-Frank. While the "carve-out" was not included, the final rule sets forth in a footnote that "[t]he Department has provided assurances to the CFTC and the SEC that the Department is fully committed to ensuring that any changes to the current ERISA fiduciary advice regulation are carefully harmonized with the final business conduct standards, as adopted by the CFTC and the SEC, so that there are no unintended consequences for swap and security-based swap dealers and major swap and security-based swap participants who comply with the business conduct standards." Despite these assurances, concerns are likely to remain.

Best Interest Contract and Other Prohibited Transaction Exemptions

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. In a notable departure from its prior proposal, the 2015 proposed fiduciary rule created a "Best Interest Contract Exemption" to allow firms to continue to set their own compensation practices so long as they meet a set of stringent, but not clearly defined, requirements. The final rule adopts, with some modifications, the proposed Best Interest Contract Exemption for financial advisors and institutions that make investment recommendations to retail retirement investors, including plan participants and beneficiaries, IRA owners, and non-institutional fiduciaries.

As a condition of receiving compensation that would otherwise be prohibited, the exemption requires financial institutions and advisors to acknowledge their fiduciary status in writing. The financial institution and advisers must adhere to enforceable standards of fiduciary conduct and fair dealing—"Impartial Conduct Standards"—with respect to their advice, including a reasonable compensation standard. 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.

In the case of IRAs and non-ERISA plans, the exemption requires that the standards be set forth in an enforceable contract with the retirement investors. The exemption does not similarly require the financial institution to execute a separate contract with ERISA investors (which includes plan participants, beneficiaries, and fiduciaries). However, the financial institution must acknowledge its fiduciary status and that of its advisers, and ERISA investors can directly enforce their rights to proper fiduciary conduct under ERISA sections 502(a)(2) and (3).

The DOL explains that, in response to comments, the exemption in the final rule eliminated the proposal's contract requirement altogether in the ERISA context and simplified the mechanics of contract formation for IRAs and plans not covered by Title I of ERISA. The Department also cites the "streamlined" conditions for "Level Fee Fiduciaries" that give ongoing advice on a relatively un-conflicted basis. A Level Fee is defined in the exemption as a fee or compensation that is provided on the basis of a fixed percentage of the value of the assets or a set fee that does not vary with the particular investment recommended, rather than a commission or other transaction-based fee. The 2015 proposal limited the asset classes covered by the Best Interest Contract Exemption. In another modification in response to comments, the final exemption covers recommendations concerning any investment product if the conditions of the exemption are satisfied. While DOL did make modifications to its proposal, it concluded: "[t]he negative comments that offered their own original analysis, and whose conclusions contradicted the Department's, also are generally unpersuasive on balance in the context of this present analysis." Accordingly, much of the basic structure of the proposed BICE exemption appears to have remained intact.

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. The DOL also finalized an amendment to an existing exemption, PTE 84-24, that provides relief for insurance agents and brokers, and insurance companies, to receive compensation for recommending fixed rate annuity contracts to plans and IRAs.

Applicability Date

The final fiduciary rule becomes applicable on April 10, 2017. DOL explains: "in light of the importance of the final rule's consumer protections and the significance of the continuing monetary harm to retirement investors without the rule's changes, an applicability date of April 10, 2017, is adequate time for plans and their affected financial services and other service providers to adjust to the basic change from non-fiduciary to fiduciary status."

The prohibited transaction exemptions will generally become available upon the applicability date of the rule. However, the Department 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 January 1, 2018, under which fewer conditions apply. During this transition 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 exemptions will be required as of January 1, 2018.

In crafting the final rule, the DOL noted its efforts to seek input from interested stakeholders. The DOL's Secretary of Labor Thomas Perez touted changes made to the proposal in response to feedback through four days of public hearings, over 3,000 comments, and more than 100 meetings. Based on this input, a White House Fact Sheet on the final rule explains: "DOL has streamlined and simplified the rule to minimize the compliance burden and ensure ongoing access to advice, while maintaining an enforceable best interest standard that protects savers."

As plan sponsors, financial institutions, advisors, service providers and other stakeholders digest the sweeping new rule, the debate over striking the right balance will surely continue. We will be sending out additional information and analysis on the impact of the new rule and what it means for your organization. A copy of the final rule and supporting material is available at: http://www.dol.gov/ebsa/regs/conflictsofinterest.html.

Littler will be conducting a complimentary webinar on the new fiduciary rule on Tuesday, April 26 at 10:00 a.m. PT/ :00 p.m. ET. Information on how to register for this webinar will soon be available on Littler's Events page.