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US Department of Labor's Fiduciary Rule Introduces a Brave New World

Final rule reflects some concessions, but its broad scope and compliance costs will cause financial services advisers to re-evaluate their business models.

On April 6, 2016, the US Department of Labor (the DOL) released the final version of regulations (the Final Rule) that redefine who is a "fiduciary" of an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 (Code). The Final Rule additionally creates new, and amends certain, "prohibited transaction" exemptions. The Final Rule represents both an implementation challenge and a business opportunity for issuers and distributors of financial products as to who can most effectively develop and distribute products that are tailored to fit the new paradigm.

The Final Rule expands the definition of fiduciary to include a wide range of persons who, in an array of advice relationships, provide investment advice or recommendations with respect to ERISA-covered plans, as well as plans ERISA does not cover, including individual retirement accounts and annuities, health savings accounts, Archer MSA and Coverdell education savings accounts (collectively referred to as IRAs). Once the Final Rule becomes fully effective, firms that historically were subject to less stringent standards (including insurance agents and broker-dealers) will be considered "fiduciary investment advisers" when advising plans or IRAs, and held to more rigorous standards intended to address conflicts of interest.

Determining who is a fiduciary is of central importance under ERISA and the Code's prohibited transaction rules, as many of ERISA's and the Code's protections, duties and liabilities follow from the fiduciary status. For example, under ERISA, fiduciaries who provide investment advice are prohibited from receiving payments that create conflicts of interest. As a result of the expanded definition of a fiduciary under the Final Rule, firms that provide investment advice to plans, sponsors, participants, beneficiaries, fiduciaries, IRAs and IRA owners will need to comply with an exemption in order to continue to receive common forms of compensation in connection with their advice (such as brokerage or insurance commissions, "12b-1 fees"[1] and revenue sharing payments from affiliates or other preferred partners), or to sell proprietary products.

The Final Rule includes several exemptions from these requirements, including what the DOL believes is likely to be the most commonly used exemption: the "Best Interest Contract Exemption" (BIC exemption), which allows investment firms to continue to receive what would otherwise be prohibited forms of

compensation, so long as the firms comply with several specific requirements. In addition, "Level Fee Fiduciaries" that receive only fixed-fee compensation that does not vary based on investment recommendations, would be able to continue to recommend "Proprietary Products" and other investments that generate compensation from third parties.

Since the Final Rule was released on April 6, 2016, the Securities Industry and Financial Markets Association (SIFMA) has voiced concern that the Final Rule "could force significant changes to current relationships, which may leave clients without the help they need to prepare for retirement," and has characterized the DOL's methodology in developing the Final Rule as "greatly flawed and lacking sufficient empirical basis."[2] Other commentators have expressed disappointment that the DOL released the Final Rule without waiting for the Securities and Exchange Commission (SEC) to propose a uniform fiduciary standard applicable to broker-dealers and investment advisers. Furthermore, how the Final Rule would interact with the uniform fiduciary standard, which the SEC expects to release later this year, remains unclear. The Final Rule has also generated Congressional opposition, and on April 28, 2016, the House of Representatives passed resolution H.J. Res. 88 ("Disapproving the rule submitted by the Department of Labor relating to the definition of the term 'Fiduciary'"), which would nullify the Final Rule under the authority of the Congressional Review Act. The Senate would need to pass a similar resolution for the opposition to the Final Rule to proceed, and President Barack Obama is expected to veto any bill that would nullify the Final Rule.

The Final Rule is less onerous than the DOL's prior rule proposals in 2010 and 2015, due primarily to the BIC exemption and the requirements for Level Fee Fiduciaries. However, the Final Rule will likely lead to a sea change in industry participants' business models, and impose substantial compliance costs on firms that are subject to the Final Rule's requirements.

This *Client Alert* focuses on the Final Rule's general impact and the fiduciary definition. Subsequent *Client Alerts* will focus on the BIC exemption and the new prohibited transactions aspects of the Final Rule.

Impact on Financial Services Companies

The Final Rule represents a dramatic shift in the retirement advice landscape by expanding the scope of the fiduciary definition. Financial services companies will need to reassess practices that historically would not have created a fiduciary relationship, and determine the impact on their business models. Because of the broad sweep of the definition, this reassessment will need to include everything from what is commonly considered the provision of investment advice, to the marketing and educational materials, and even call center protocols.

In addition, investment professionals servicing retirement investors through brokerage accounts will be subject to a fiduciary duty standard for the first time, which absent compliance with an exemption, will prohibit them from receiving fees and commissions they historically have received in connection with recommending certain investments. More extensive prohibited transactions will also impact investment advisory relationships. Documentation and compliance procedures for affected relationships under either regime will need to be revisited.

While some useful exemptions to the Final Rule exist, most notably in the form of the BIC exemption and the Level Fee Fiduciary exemption, we expect that the compliance cost will drive many retirement accounts that previously were serviced under a commission structure into a fee-based advisory account structure. These accounts could then still utilize the Level Fee Fiduciary exemption to continue to earn compensation for recommending proprietary products, and receiving third-party payments.

However, this migration is not without its challenges, especially in the context of smaller accounts or those that are less frequently traded. Even a level fee of 1% a year, for example, could represent a significant increase in a retirement investor's costs as compared to the commissions previously associated with less frequently traded accounts. Creative solutions, such as partial fee waivers for a transitionary period or lower cost robo-advisory services may help meet these investors' needs. Additionally, as SIFMA has warned, the lower revenues associated with smaller accounts could lead certain firms and professionals to avoid those customers altogether, as the profit margins on such accounts could be exceedingly thin or even negative, given the significantly expanded liability and compliance costs.

Large investment firms dually registered as an investment adviser and broker-dealer are likely best positioned to deal with the transition from commission-based to fee-based accounts, and should be better equipped to efficiently address the compliance costs associated with the Final Rule. Dually registered firms may be the only real winner here, as the Final Rule could lead to significant industry consolidation. Nonetheless, financial advisors who wish to convert a client to a fee-based account structure may have difficulty providing a sufficient rationale, as required by the rule, for such conversion. For example, buy and hold strategies may not align well with fee-based account structures, where regulators have warned against so-called "reverse churning."

The Final Rule also includes a "seller's exemption" that would allow, for example, industry professionals to pitch particular investment ideas to independent plan fiduciaries without being subject to a fiduciary duty themselves. However, as described in more detail below, this exemption is limited in scope. Accordingly, interactions with plan fiduciaries that do not qualify for the seller's exemption must be carefully monitored. In addition, industry professionals can still distribute certain educational materials, including asset allocation models and interactive investment materials (such as tools that estimate future income streams based on inputs from investors) to plan fiduciaries, plan participants or IRA owners, without creating a fiduciary relationship subject to the limitations more fully described below.. Again, the exemption is narrower than many common practices in this area, and firms will need to reassess their policies and procedures.

The Final Rule represents both an implementation challenge and a business opportunity for issuers and distributors of financial products as to who can most effectively develop and distribute products that are tailored to fit the new paradigm. While certain products that were previously attractive due to their ability to generate high commissions may fall by the wayside, the long-term nature of retirement investing (and relatively certain demand for retirement advice) virtually assures that other products, from robo-advice to structured notes, will have an opportunity to fill the resulting void and increase their current reach.

Background

ERISA regulates the conduct of employee benefit plan fiduciaries, and specifies certain "prohibited transactions" in which fiduciaries and other parties related to the plan cannot engage without penalty. Similar rules apply to IRAs under the Code. If an ERISA plan fiduciary fails to abide by ERISA's fiduciary standards, the fiduciary may be held responsible for restoring losses to the benefit plan, and if the fiduciary engages in a prohibited transaction, the fiduciary will be subject to excise taxes. IRA fiduciaries who engage in prohibited transactions are also subject to excise taxes, and such conduct could also jeopardize the IRA's tax-exempt status.

ERISA and the Code broadly define a fiduciary as a person to whom any of the following apply:

- Exercises any discretionary authority or discretionary control respecting management of a plan, or exercises any authority or control respecting management or disposition of its assets

- Renders *investment advice* for a fee or other compensation, direct or indirect, with respect to any moneys or other property of a plan, or has any authority or responsibility to do so

- Has any discretionary authority or discretionary responsibility in the administration of the plan[3]

Under existing regulations issued in 1975, a person provided "investment advice" only when five specific factors were met, including the requirement that the advice had to serve as a primary basis for the investment decision and had to be individualized based on the particular needs of the plan. These factors significantly narrowed the scope of advisers who were considered fiduciaries under ERISA and the Code.

In April 2015, the DOL issued proposed regulations redefining fiduciary (the 2015 Proposed Rule), and replacing the five-part test. The publication of the 2015 Proposed Rule was followed by a notice and comment period, which resulted in over 3,000 comment letters, over 300,000 submissions made as part of 30 separate petitions submitted on the proposal, and a public hearing at which more than 75 speakers testified. The Final Rule is the culmination of the DOL's notice and comment rulemaking process.

New Definition of Fiduciary

The Final Rule defines the types of advice and relationships that would cause a person to be considered a fiduciary under ERISA and the Code.

First, the person must provide advice to a plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner that includes a "recommendation" as to any of the following:

- The advisability of holding, disposing of, or exchanging, securities or other investment property

- How securities or other investment property should be invested after being rolled over, transferred or distributed from the plan or IRA

- 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 and selection of investment account arrangements (*e.g.,* brokerage versus advisory)

- 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[4]

Second, the person must receive a fee or other compensation, direct or indirect, in connection with such advice.[5] The term "fee or other compensation, direct or indirect" is extremely broad and includes:

- Any explicit fee or compensation for the advice received by the person (or by an affiliate) from any source

- Any other fee or compensation received from any source in connection with or as a result of the purchase or sale of a security or the provision of investment advice services, including, though not limited to, commissions, loads, finder's fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, underwriting compensation, payments to brokerage firms in return for

shelf space, recruitment compensation paid in connection with transfers of accounts to a registered representative's new broker-dealer firm, gifts and gratuities, and expense reimbursements

Third, the recommendation must be provided either directly or indirectly (*e.g.,* through or together with any affiliate) by a person who:

- Represents or acknowledges that the person is acting as a fiduciary
- Renders the advice pursuant to a written or verbal understanding that the advice is based on the particular investment needs of the recipient
- Directs 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[6]

What Constitutes a Recommendation

Under the Final Rule, a person is a fiduciary only if the person provides advice that includes a recommendation, which is defined as "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."[7]

The definition of a recommendation is broad, and merely providing a list of "appropriate" securities to a particular advice recipient would be a recommendation as to the advisability of acquiring securities, even if no recommendation is offered for any particular security.

The Final Rule also tracks Financial Industry Regulatory Authority (FINRA) guidance in that the more individually tailored a communication is to a particular recipient, the more likely the DOL would view that communication as a recommendation. A series of actions could also be considered a recommendation when viewed in the aggregate, even if no action would amount to a recommendation when considered individually.

As discussed in more detail below, the Final Rule also provides a non-exclusive list of communications that would *not* be considered recommendations (provided that certain requirements are met), which broadly speaking include:

- "Platform providers" merely making available to plan fiduciaries a platform of investment alternatives without regard to the individualized needs of the plan, its participants or beneficiaries, and certain services typically offered by platform providers to assist plan fiduciaries in selecting and monitoring investment alternatives offered to plan participants (*e.g.,* identifying investment alternatives that meet objective criteria selected by the plan fiduciary; providing objective financial data regarding investment alternatives)
- "General communications" such as general circulation newsletters, commentary in publicly broadcast talk shows, remarks and presentations at widely attended speeches and conferences, research or news reports prepared for general distribution, general marketing materials and general market data
- Certain "educational materials" such as plan information, general financial, investment and retirement information, asset allocation models, and interactive investment education materials such as those that estimate future retirement income needs

As mentioned above, firms will need to take care in developing and distributing marketing materials and educating outside-facing personnel (for example, call center employees) to ensure these communications are not considered recommendations, given the expansive definition in the Final Rule.

Exclusions from Fiduciary Status

The Final Rule also contains a few exclusions from the scope of what is considered investment advice giving rise to a fiduciary duty, even if such communications would constitute recommendations under the Final Rule.

First, an exemption exists for interactions with larger independent plan fiduciaries.[8] The DOL referred to this as the "seller's exemption," mentioned above which is meant to exempt other industry professionals, such as brokers or other service providers who may pitch a particular investment product or service to a plan fiduciary. However, this exemption is available only if the plan fiduciary is a bank, insurance company, registered investment adviser, registered broker-dealer, or person responsible for at least US$50 million in assets under management. In addition, the plan fiduciary must be capable of evaluating risks independently, and informed of the existence and nature of the industry professional's financial interest in the transaction. Also, the industry professional must not receive a fee directly from the plan or plan fiduciary for the provision of investment advice in connection with the transaction. While the Final Rule does not define independence in this context, the preamble to the Final Rule suggests that independence might not exist where the industry professional and the fiduciary are under common ownership or control. The independence requirement presents a particular risk to those who provide arm's-length services to retirement plan asset managers, where both the industry professional and plan fiduciary could be deemed to be under common control. These models must be reviewed to determine whether the facts and circumstances jeopardize a finding of independence, such that fiduciary liability may extend to both parties in an otherwise arm's-length relationship.

Second, the Final Rule also confirms that persons acting as swap dealers, security-based swap dealers, major swap participants and major security-based swap participants, do not become investment advice fiduciaries during swap or security-based swap transactions regulated under the Dodd-Frank Wall Street Reform and Consumer Protection Act or the Securities Exchange Act of 1934 and applicable Commodity Futures Trading Commission and SEC rules and regulations, provided certain conditions are met.[9]

Third, an employee of a (1) plan sponsor, (2) affiliate of a plan sponsor, (3) employee benefit plan, (4) employee organization or (5) plan fiduciary, is not considered a fiduciary solely as a result of providing advice to a plan fiduciary. This exclusion applies as long as the advice is provided in his or her capacity as an employee and as long as the employee does not receive any fee or other compensation, direct or indirect, in connection with the advice beyond his or her normal compensation for work performed by the employer.[10]

Evolution from 2015 Proposed Rule – Notable Clarifications

The Final Rule is less onerous than the 2015 Proposed Rule, reflecting some compromise on the part of the DOL in response to feedback received during the notice and comment process.

Definition of Investment Advice Clarified

The Final Rule maintains the general structure of the 2015 Proposed Rule, splitting investment advice into two categories (advice as to the investment of plan assets, and advice as to the management of plan assets) but includes several clarifications.

- *Appraisals*. The Final Rule states that appraisals, fairness opinions or other similar statements (Appraisals) will be addressed in a future regulation, whereas the 2015 Proposed Rule would have resulted in Appraisals being considered investment advice that could give rise to fiduciary obligations.

- *Proprietary investment products included.* While the Final Rule clarifies that certain recommendations are not investment advice, it also makes clear that recommendations as to other products — including proprietary investment products — constitute investment advice. Despite commenter concerns that subjecting insurers to fiduciary investment advice duties would impede their ability to provide participants and IRA owners guidance about lifetime income guarantees and other insurance features in their proprietary products, the Final Rule does not include a carve-out for these products. The basis for the omission is that special treatment is not warranted, particularly in light of the "carefully crafted exemptions from the prohibited transaction rules" (*i.e.*, BIC exemption).[11]

- *Clarification of the meaning of "management."* The Final Rule clarifies the meaning of the term "management," including by adding additional examples to differentiate investment recommendations from investment management recommendations.

- *"Hire me" recommendations excluded.* The Final Rule exempts a person or firm's recommendation of their own advisory or investment management services or those of any other person the investor knows to be, or the adviser fairly identifies as, an affiliate. However, the DOL noted that marketing that "effectively includes a recommendation on how to invest or manage plan or IRA assets" would be considered investment advice — a potentially significant trap for the unwary.

- *Assets without investment component; non-fiduciary assistance excluded.* The Final Rule clarifies that (1) recommendations as to assets without an investment component (*e.g.*, advice as to the purchase of health, disability and term life insurance policies), and (2) professional assistance that traditionally has been performed in a non-fiduciary capacity (*e.g.*, legal and actuarial advice, and advice rendered by human resources personnel or plan service providers who have no power to make decisions as to plan policy, interpretations, practices or procedures, but whose functions are purely administrative) do not constitute investment advice.

- *Service providers engaged for non-fiduciary purposes excluded.* The preamble to the Final Rule further clarifies that an employer or plan sponsor will not become an investment advice fiduciary merely because the employer or plan sponsor engages a service provider to provide investment advice, or because a service provider engaged to provide investment education provides investment advice in any particular case. However, the Final Rule notes that the ERISA fiduciary responsibilities still apply to the engagement of those service providers.

Definition of Recommendation Clarified

The existence of a recommendation is the gating element to establishing whether a communication constitutes fiduciary investment advice. While the Final Rule does not change the definition of recommendation from the 2015 Proposed Rule, it does clarify the nature of communications that constitute recommendations and provides a non-exclusive list of examples of communications that do not constitute recommendations.

- *A recommendation is individually tailored.* The Final Rule tracks FINRA guidance in providing that individually tailored communications are indicative of a recommendation.

- *A recommendation is a call-to-action.* The Final Rule clarifies that a call-to-action is a necessary element of a recommendation. In particular, the call-to-action must be a communication that a

reasonable person would believe was a suggestion to make or hold a particular investment or pursue a particular investment strategy.

- *Communication Exclusions; Limited scope for IRAs*. The Final Rule identifies four broad examples of communications that are ***not*** recommendations: (1) investment platforms; (2) selection and monitoring assistance; (3) general communications; and (4) investment education. Notably, in setting out these exceptions (in particular, the investment platforms and investment education exceptions), the Final Rule differentiates between ERISA Title I plans and individually directed brokerage accounts/IRAs, limiting the scope of exceptions available to the latter category. The limitations stem largely from the lack of a separate independent fiduciary with financial expertise in the individually directed brokerage account/IRA context to protect the account owners' interests in the selection of investments presented.

- *Investment platform exclusion; RFPs*. Within the investment platform exclusion, the Final Rule responds to commenters and explicitly clarifies that a request-for-proposal (RFP) response with a sample lineup of investments is not a recommendation, subject to certain conditions intended to avoid the appearance of a fiduciary relationship.

- *Investment education exclusion; Limited scope for IRAs.* The Final Rule confirms the four broad categories of educational materials listed in the 2015 Proposed Rule, and generally states that these materials must be free of specific investment recommendations: (1) information and materials that describe investments/plan alternatives without specifically recommending particular investments/strategies; (2) general financial, investment and retirement information (*e.g.*, a newsletter; commentary on television, radio or public media talk shows; remarks given in widely attended speeches and conferences; research papers; marketing materials; and general market data); (3) asset allocation models; and (4) interactive investment materials.

  Note that asset allocation models and interactive investment materials cannot identify any specific investment product, investment alternative or distribution option available under the plan or IRA, except that (1) investment alternatives or options that the plan participant, beneficiary or IRA owner specifies, can be included in interactive investment materials; and (2) in the case of a plan (but not an IRA), asset allocation models and interactive investment materials can identify "designated investment alternatives" available under a plan, subject to an independent plan fiduciary's oversight, and provided that the model or materials also identify all other designated investment alternatives available under the plan with similar risk and return characteristics.

  The Final Rule expressly confirms that merely providing information about features, terms, fees and expenses, and other characteristics of investment products available to an investor (in both the IRA and ERISA Title I plan context) falls within the "investment education" exclusion from the Final Rule.

Phased Implementation Period

The Final Rule will become effective in April 2017; however, not all requirements need to be satisfied by that date. In order to give the industry time to comply, the DOL has provided transition relief from the prohibited transaction rules under the BIC exemption and other prohibited transaction exemptions through January 1, 2018. During the transition period, investment advisers will still have to acknowledge their fiduciary status, adhere to the best-interest standard and provide basic disclosures of conflicts of interest. In addition, the DOL has indicated it will adopt a compliance, rather than an enforcement, approach through the transition period.

Conclusion

The Final Rule represents the culmination of a rulemaking process that stretched over six years, and solidifies the most significant change to the scope of ERISA's duties and protections since ERISA itself was enacted over 40 years ago.

While the Final Rule reduces the compliance burden for investment professionals as compared to the 2015 Proposed Rule, it still imposes significant burdens and implementation challenges for financial institutions that service retirement accounts. The Final Rule will likely dramatically impact the financial services industry and the business models by which client accounts are serviced (encouraging a transition away from commission-based brokerage accounts to fee-based advisory accounts), and significantly change the universe of products advisers recommend to retirement investors, delivering challenges and opportunities to the attendant stakeholders.

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Endnotes

1 17 CFR 270.12b-1. Rule 12b-1 permits funds to pay distribution fees out of fund assets, such as fees paid for marketing and selling fund shares, or compensating brokers and others who sell fund shares.

2 http://www.sifma.org/newsroom/2016/sifma-statement-on-dol%E2%80%99s-final-fiduciary-rule/

3 ERISA Section 3(21)(A); Code Section 4975.

4 Federal Register Volume 81, No. 68 at page 20997; 29 CFR 2510.3-21(a)(1).

5 Federal Register Volume 81, No. 68 at page 20997; 29 CFR 2510.3-21(a)(1).

6 Federal Register Volume 81, No. 68 at page 20997; 29 CFR 2510.3-21(a)(2).

7 Federal Register Volume 81, No. 68 at page 20997; 29 CFR 2510.3-21(b)(1).

8 Federal Register Volume 81, No. 68 at page 20999-21000; 29 CFR 2510.3-21(c)(1).

9 Federal Register Volume 81, No. 68 at page 21000; 29 CFR 2510.3-21(c)(2).

10 Federal Register Volume 81, No. 68 at page 21000; 29 CFR 2510.3-21(c)(3)(i).

11 In addition to proprietary investment products, the Final Rule sweeps into the scope of investment advice recommendations as to 403(b) plans, SIMPLE-IRA plans, SEPs, fraternal benefit societies, and health savings accounts, as well as bank certificates of deposit (CDs) and other similar bank deposit accounts. However, note that recommendations as to 403(b) contracts and custodial accounts purchased or provided under a program that is either a "governmental plan" under section 3(32) of ERISA or a non-electing "church plan" under section 3(33) of ERISA are not subject to the Final Rule, as such plans are excluded from coverage under Title I of ERISA.