PSCA

Plan Sponsor Council of America

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The DOL Issues Long Awaited Final Rule on the Definition of an ERISA Fiduciary

After a drawn out and controversial regulatory review process, the United States Department of Labor (the "DOL") on April 6, 2016 issued final guidance that expands the definition of a "fiduciary" under the Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code regarding persons or entities that render investment advice for compensation, received directly or indirectly, with respect to assets held in retirement plans or individual retirement accounts ("IRA"). This rule replaces the original fiduciary rules that were adopted in 1975 shortly after ERISA was enacted, and reflects the DOL's belief that the retirement industry has evolved significantly since then, considering the explosive growth in participant-directed defined contribution retirement plans and IRAs nationwide.

The final rule essentially retains the same basic structure and approach as the DOL's initial proposal, which was released in 2015. However, the final rule includes significant changes and clarifications - more than were anticipated by the retirement plan industry. The DOL hopes these changes will make the rule more useable and will reduce compliance burdens. As a part of the review process, the DOL received a huge number of comment letters and held four days of public hearings. The scope of the DOL's subsequent revisions suggests the agency carefully considered the extensive comments in response to the proposed rule. PSCA joins with other industry observers to note the work that went into the review effort and to commend the DOL for its effort. PSCA, which submitted multiple comment letters on the proposed rule and participated in the public hearings, is gratified that many of its concerns were addressed in the changes made to the final rule.

The final rule was released along with several related pieces of guidance, including (1) the final form of the new best interest contract exemption ("BICE"); (2) an amendment to and a partial revocation of Prohibited Transaction Exemption 84-24; (3) and amendments to Class Exemptions 75-1, 77-4, 80-83 and 83-1. Upon the satisfaction of express conditions, the BICE provides conditional relief for common conflicted compensation arrangements, including commissions and revenue sharing, that advisers historically have received in connection with rendering investment advice. The other pieces of guidance are aimed at allowing certain broker-dealers, insurance agents, and other vendors that act as investment fiduciaries to continue to receive various forms of conflicted compensation that otherwise may be prohibited under ERISA.

<u>The New Rule—A Primer</u>.

The new rule establishes broader and stricter fiduciary standards for investment advisers providing services to retirement plans and IRAs—and in that respect aims to offer additional protection to plan sponsors, plan participants, and IRA owners. The rule extends the fiduciary

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standard contained in ERISA to investment advisers who until now have not been required to adhere to those standards or to contend with ERISA's related prohibited transaction rules.

Under the DOL's new rule, the basic standard is that an investment adviser generally will be deemed to be rendering investment advice subject to ERISA's fiduciary standards when that adviser makes a "recommendation" to a plan, plan fiduciary, plan participant or beneficiary, or IRA that reasonably would be viewed as a suggestion that the advice recipient engage or refrain from engaging in a particular course of action (i.e., a call to action") and when that adviser receives a fee or other compensation, directly or indirectly, for doing so. In addition, such an adviser generally would be considered a fiduciary if the adviser (a) makes a "recommendation" with respect to buying, holding, selling, or exchanging of securities or other investment property (including assets rolled over from a plan) or (b) makes a "recommendation" as to the management of securities or other investment property, investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or services, and/or with respect to rollovers, distributions, or transfers from a plan or IRA.

The rule retains a number of significant carve-outs that were contained in the proposed rule that identify situations in which advisers can act without being considered fiduciaries, including the following activities:

1. Providing an investment platform without regard to individualized investment needs, provided that the platform provider notifies the plan fiduciary (which must be independent of the provider) that the provider generally is not offering investment advice or serving as a fiduciary.

2. Identifying investment options that satisfy the pre-established investment criteria of an independent plan fiduciary (with a notice requirement keyed to any financial interest the provider has with respect to the identified options), responding to requests for proposals (with a similar notice requirement) and/or providing benchmarking information to a plan fiduciary.

3. Providing general investment communications that a reasonable person would not view as investment advice (e.g., newsletters, general marketing materials and general market data.

4. Providing investment education, including plan information, general financial, investment and retirement information (in this area of great importance to plan sponsors, the well–established distinction between investment advice and investment education largely has been preserved except for the identification of specific investment options within a plan's interactive asset models, as more fully discussed below).

In addition, the rule notes that an entity or person – other than an entity or person that acknowledges acting as a fiduciary – will not be treated as a fiduciary in the following situations:

1. An adviser provides advice to plan fiduciaries who the adviser reasonably believes to have requisite investment background [note here that with respect to certain unregulated plan fiduciaries, this exception applies only to plans with at least $50

million in assets, although PSCA continues to believe a lower standard should apply] to the extent the recipient of the advice is independent of the adviser and is properly informed that the adviser is not undertaking to impartially advise the plan and the provider does not receive any compensation for the advice directly from the plan or the plan fiduciary [note that this exception generally is referred to as the "seller's exception"].

2. An adviser who generally serves as a swap dealer provides advice to a plan to the extent that the plan is represented by an ERISA fiduciary; the adviser is not acting as an adviser to that plan and the adviser does not receive compensation directly from the plan or the fiduciary for the investment advice so provided. To complete this exclusion, the adviser must obtain a written representation from the plan fiduciary to the effect that the fiduciary understands that the adviser is not providing impartial investment advice with respect to the transaction and that the fiduciary is exercising independent judgment in evaluating the provider's recommendation.

3. An employee of a plan sponsor (or an affiliate thereof) or of a plan fiduciary who offers advice to a plan fiduciary or to employees of a plan sponsor to the extent such employee does not receive additional compensation in connection with the advice or is not licensed or does not have a job responsibility to deliver investment advice or investment recommendations.

The final rule makes it clear that an independent broker-dealer effecting transactions for a plan or an IRA generally will not be a fiduciary if the broker-dealer simply executes trades in the ordinary course of business based on a specific and specified set of trading parameters.

As noted above, the DOL also issued a new BICE pursuant to which advisers may continue to receive conflicted compensation under specified circumstances. The BICE is available to both qualified retirement plans and IRAs and provides needed relief from the otherwise applicable prohibited transaction provisions in ERISA that would otherwise apply if a participant is deemed to be a fiduciary. The BICE outlines the steps to be taken in order to gain relief. [As covered below, those necessary steps have been significantly streamlined in the final rule.]

Changes and Clarifications.

The DOL made a number of changes and clarifications to the final rule after considering the range of comments received. The general reaction within the industry is that the changes are helpful and practical, and seemed intended to lessen, though not eliminate, industry criticism about the rule. For those interested in further study, the DOL has prepared and posted a list of the changes that can be found online at http://www.dol.gov/ebsa/pdf/conflict-of-interest-chart.pdf.

The most significant changes include the following:

1. In the investment education carve-out, as described above, the final rule was revised so that interactive asset allocation models (and related investment materials) may identify specific designated investment alternatives in plans without being considered fiduciary advice if certain specified conditions are met, an area of change that PSCA pursued

throughout the comment period. Note that this new standard does not apply to IRAs.

2. The DOL added new language to clarify whether an adviser actually has made a "recommendation" that would trigger fiduciary liability. This is an area in the new rule that might benefit from further clarification, and PSCA expects to continue a dialogue with the DOL on these matters.

3. The DOL has revised the "seller's exception" so that it is available with respect to any independent plan fiduciary with at least $50 million in total assets under management compared to the $100 million threshold in the proposed rule, and eliminated the provision in the proposed rule that make the exception available to plans with 100 or more participants. It seems from a small-employer perspective this change might be a mixed bag of good and bad news.

4. The final rule clarifies that an adviser can market himself or herself for hire to provide advisory or asset management services without becoming a fiduciary merely because of the marketing.

5. Perhaps the most extensive changes were made under the BICE, including the following:

    (a) the exemption now applies to small employer plans;
    (b) the DOL made a number of changes to the contract requirement, such as:

        (i) limiting that requirement to IRAs and other non-ERISA plans,
        (ii) eliminating the requirement that such a contract must in effect be a tri-party agreement by and among the customer, the financial institution and the individual adviser (under the final rule, only the customer and the financial institution must execute the contract);
        (iii) allowing the contract to be incorporated into other account opening documents and entered into before or at the same time the recommended transaction is executed [the proposed rule required that the contract be executed prior to the time any advice would be provided]; and
        (iv) generally permitting the use of negative consent to complete contracts with existing customers.

    (c) the final rule eliminates a provision that extended the exemption only to recommendations to buy, sell, or hold specified types of assets, so long as the adviser meets the impartial conduct standards and other conditions of the exemption (note that the DOL warns in the preamble that financial institutions must exercise particular care when recommending investment products with unusual complexity, illiquidity, risk, lack of transparency or high fees or commissions);
    (d) the final rule streamlines the point of sale disclosure requirements by eliminating the need to produce projected costs at 1-, 5- and 10-year periods, by eliminating the annual disclosure requirement and by revising the website disclosure

requirements (in addition, the detailed data retention requirement also was eliminated); and

(e) the final rule adds a special exemption for level fee fiduciaries, which generally applies to recommendations to roll over assets from a plan into a fee-based account or to transfer assets from a commission-based account to an account that charges a fixed percentage of assets under management (note that it seems the DOL much prefers a level fee environment).

Transition Rules.

As a concession to the practical difficulties associated with compliance, the DOL has offered some useful delayed effective date provisions. While the new rule becomes effective 60 days after it is published in the Federal Register (i.e., June 7, 2016), the revised definition of fiduciary advice and the new and amended exemptions do not become applicable until April 10, 2017 (until then the current rules remain in effect). In addition, the BICE includes a transition period under which more limited conditions will apply until January 1, 2018.

Final Thoughts.

However significant, the changes made by the DOL may not resolve the concerns of the many critics of the expanded fiduciary standard. Legislative efforts to try to derail the new rule are expected, but that path forward is difficult because those efforts must run through the White House (and thus will encounter an expected veto by President Obama). Litigation also is expected, with a likely focus on the process under which the rule has been formulated and/or on the substantive features of the rule, particularly its application to IRAs. By its nature litigation takes time, so perhaps the final rule’s final story will not be written for a while.

Plans sponsors have until April 10, 2017 to decide how to best react to the new rule. Dealing with implications of the BICE, which has a later effective date, affords even more time. Plan sponsors are well advised to review all of their existing relationships with service providers to determine whether those service providers should be treated as fiduciaries under the new rule, including consideration of the carve outs and the BICE, and to revise their relationships accordingly. Plan sponsors should carefully review any new written documentation provided to them by their service providers in order to comply with the new rule. Although the deadlines are not imminent, the work of implementation should begin sooner rather than later.