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The Final Fiduciary Rule Has Arrived… Finally

By Lisa B. Zimmer

On April 6, 2016, the Department of Labor (DOL) issued the highly anticipated final fiduciary rule. While the essence of the final rule remains the same as the rule proposed last year, it has been tweaked to address, or eliminate, some of the most controversial requirements. As expected, the final rule requires all financial advisors (including broker-dealers, registered investment advisers, and insurance agents) to put their clients' best interest before their own profits when they give retirement investment advice. The final rule applies when advising ERISA and non-ERISA retirement plans (but not non-ERISA state and local government pensions, church plans and some deferred compensation plans) and individual retirement accounts (IRAs). The rule also covers Medical and Health Savings Accounts and Coverdell Education Savings Accounts.

Today, investment advisers and their representatives are already deemed to be fiduciaries for purposes of federal and state securities laws, but broker-dealers and their representatives are subject to a different "suitability" standard, even though they are often providing similar investment recommendations. Under the suitability standard, broker-dealers are not required to put their clients' interests above their own when making investment recommendations. So long as the investment is suitable for the client based on the client's financial needs, objectives, and unique circumstances, it can be recommended to the client, even if the particular investment choice pays the broker-dealer or insurance agent a higher fee, commission, or other compensation than a comparable investment product.

Background

The DOL issued its first fiduciary rule proposal in 2010 and its second in April 2015. Both the financial industry and many members of Congress (from both parties) strongly opposed both proposals. Concerns centered primarily on the potential loss of investment advisory services to smaller retirement plans (including participants and beneficiaries) and, in particular, to IRA account holders.

The final fiduciary rule and related prohibited transaction exemptions reflect the extensive feedback received since April 2015 from financial services industry advocates, Congress, federal and state regulators, and others. The DOL took this input into account when refining the new rule's requirements. Revisions to the proposed rule should reduce the anticipated compliance burden for many advisors, while still protecting retirement savers. Nonetheless, the rule will apply to all advisors.

Highlights of New Rule

The new rule applies the same ERISA fiduciary standard of care to investment advisers, broker-dealers, insurance agents, banks, and other advisors to retirement plans and IRAs.

Fiduciary Definition. An investment fiduciary now includes persons who:

- give "covered investment advice" (described below) with respect to a retirement plan or IRA for a fee or other forms of compensation, regardless of whether it is paid directly by the client or indirectly by a third party (for example, a mutual fund or other investment or insurance product company paying trail commissions, 12b-1 fees, referral or solicitor fees, and revenue sharing); and

- trigger any one of the additional conditions described below.

Covered Investment Advice. The rule describes what is and what is not "covered investment advice."

Covered investment advice *includes*:

- **Recommendation.** A "recommendation" means a communication to a plan fiduciary, plan participant, and/or IRA owner 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 certain action with respect to securities, or other investment or insurance products. The more individually tailored the communication, the more likely the communication will be viewed as a

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recommendation. For example, call center employees who are paid only a salary will become fiduciaries if they make specific recommendations to plan participants and IRA owners. While not identical, the DOL's definition of recommendation closely follows the SEC's and FINRA's concept of "recommendation."

- **Rollovers.** Covered investment advice now also includes recommending 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. (The final rule overturns the DOL guidance issued in 2005 that stated it was not fiduciary advice to recommend taking a rollover, even if accompanied by an investment recommendation.)

Covered investment advice *does not include*:

- **Education.** General information and material about the terms or operation of the retirement plan or IRA, the available distribution options, fee and expense information, risk and return characteristics, and historical return information are not recommendations. The education exclusion also allows specific investment alternatives to be included as examples in presenting hypothetical asset allocation models or in interactive investment materials so long as these are designated investment alternatives selected and monitored by an independent plan fiduciary. In the IRA context, however, asset allocation models and on-line interactive tools (sometimes referred to as "robo advisors") must be generic; referencing specific investment alternatives would not be "education" because there is no independent fiduciary to monitor advice given to IRA account holders.

- **General Communications.** Newsletters, commentary in publicly broadcast talk shows, remarks and presentations in speeches and conferences, research prepared for general distribution, general marketing materials, and general market data are not recommendations. Specific investment or insurances products cannot be identified.

- **Platform Providers.** Marketing or making a platform of investment alternatives available without taking into account the individualized needs of a plan or participants, are not recommendations if the provider represents in writing to the plan fiduciary that it is not undertaking to provide impartial advice or to give advice in a fiduciary capacity.

- **Selection and Monitoring Assistance for Plan Fiduciaries.** These activities are not recommendations: identifying investment alternatives that meet objective criteria specified by the plan fiduciary; identifying investment alternatives in response to a request for proposal; or providing objective financial data and comparisons with independent benchmarks to the plan fiduciary. This provision does not apply to IRAs.

- **Plan Fiduciaries with Financial Expertise.** If the advisor knows or reasonably believes the independent plan fiduciary is a licensed and regulated provider of financial services (banks, insurance companies, registered investment advisers, broker-dealers), no ERISA fiduciary obligations are imposed on the advisor. In addition, the ERISA fiduciary rule does not apply to communications with an independent fiduciary who has responsibility for the management of at least $50 million in plan assets. This "seller's exception" exempts from the rule communications that might otherwise trigger fiduciary status. Communications with and marketing to institutional fiduciaries can be done without triggering fiduciary status, since these fiduciaries are presumed to understand a sales pitch is not necessarily in the plan's best interest.

- **Swap and Security-Based Swap Transactions.** Advice to an employee benefit plan from certain swap-dealers and security-based swap dealers is not fiduciary investment advice provided the plan is represented by an independent fiduciary; the dealer is not an advisor to the plan (under the Commodity Exchange Act or the Securities Exchange Act); the dealer does not receive a fee directly from the plan or the plan fiduciary for providing advice (as opposed to other services); and the dealer obtains a written representation from the plan fiduciary acknowledging the advice is not impartial and confirming the plan fiduciary is exercising independent judgment.

- **Employees of Plan Sponsor.** Employees working in a company's payroll, accounting, human resources, and financial departments who routinely develop reports and recommendations for the company and plan fiduciaries are not investment advice fiduciaries if the employees receive no fee or compensation for such activities beyond their normal compensation. In addition, this exclusion also covers communications between employees, such as human resources department staff members who communicate information about the plan to other employees, provided they are not registered or licensed advisors and receive only their normal compensation that is unrelated to investment recommendations or selections.

- **Hire Me.** Marketing and sales pitches of an advisor's own services, or the services of an affiliate, will not give rise to fiduciary status, so long as the advisor does not make any specific recommendations as part of the pitch.

Additional Conditions for Fiduciary Status. If an advisor gives covered investment advice as described above and the advisor is paid for the advice, either directly or indirectly, the advisor will be a fiduciary if he:

- Represents or acknowledges he is acting as a fiduciary;

- Renders advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the recipient's particular investment needs; or

- Directs the advice to a specific recipient regarding the advisability of a particular investment or management decision with respect to securities or other property of a retirement plan or IRA.

Prohibited Transaction Exemptions

Under ERISA and the Internal Revenue Code (Code), fiduciary investment advisors to plans and IRAs are not permitted to receive payments creating conflicts of interest (e.g., compensation that varies based on the investment advice), except as permitted under a prohibited transaction exemption (PTE). The final rule creates two new PTEs and modifies several existing PTEs. The new Best Interest Contract (BIC) PTE is summarized below. This is not an exemption from the new fiduciary standard of care, just permission to receive fully disclosed conflicted compensation under specified conditions.

Best Interest Contract PTE. The BIC PTE is available to investment fiduciaries (advisors, financial institutions, and their affiliates and related entities) providing nondiscretionary advice to plan participants and beneficiaries, IRAs, and non-institutional (retail) plan fiduciaries. Generally, the BIC PTE allows nondiscretionary investment fiduciaries to continue their current fee practices (including receipt of commissions, 12b-1 fees, and revenue sharing) if certain basic standards set forth in the BIC PTE are satisfied. The BIC PTE is not available to discretionary advisors generally. However, the DOL clarified that the exemption can still provide relief for advisers who are in the business of providing discretionary advice as long as the discretionary advice itself does not generate variable compensation.

The BIC PTE requires advisors to adhere to a "best interest" fiduciary standard of care with all retirement plan and IRA clients. Failure to adhere to the BIC PTE's standards and requirements will give rise to civil breach of contract claims (for IRAs and other non-ERISA plans) or statutory claims under ERISA (for ERISA plans, participants, and beneficiaries).

To qualify for the BIC PTE under the final rule, advisors must:

- Adhere to specific impartial conduct standards in rendering covered investment advice;

- Expressly acknowledge they are acting as fiduciaries under ERISA, the Code, or both;

- Adopt policies and procedures designed to ensure that individual advisors adhere to the impartial conduct standards;

- Disclose certain information relating to fees, charges, compensation-related incentives (e.g., recruiting signing bonuses and transition support), and material conflicts of interest (including creating and maintaining an internet website where these mandated disclosures can be accessed by the public);

- Retain records demonstrating compliance with the exemption; and

- Enter into a written contract with each IRA accountholder and non-ERISA plan client.

Fiduciaries that will receive only a "level fee" (i.e., a flat dollar amount or a basis point fee) paid by the client in connection with advisory or investment management services may comply with more streamlined conditions designed to target the conflicts of interest associated with such services. The ongoing receipt of a level fee from the client typically would not raise prohibited transaction concerns. The DOL noted, however, that certain transactions, such as rollover recommendations and switching from a commission-based account to a fee-based account, could give rise to conflict concerns because of the additional fees and charges resulting from the change. To qualify for the streamlined provisions of the BIC PTE, level fee advisers must:

- Adhere to specific impartial conduct standards in rendering covered investment advice;

- Expressly acknowledge they are acting as fiduciaries under ERISA, the Code, or both; and

- Document the specific reasons why a recommendation to rollover from an ERISA plan to an IRA, to rollover from another IRA, or to switch from a commission-based account to a level fee arrangement is in the best interest of the retirement investor.

Before receiving any compensation in reliance on the BIC PTE, the advisor also must notify the DOL of the intention to rely on the BIC PTE. The notice will remain in effect until revoked in writing. The notice will not need to identify any plan or IRA. (This disclosure requirement will not apply to level fee advisers, however.) This notice will enable the DOL to monitor the types of advisors relying upon the BIC PTE and will facilitate the DOL's audit and compliance assistance programs.

Other Exemptions. In addition to the BIC PTE, the DOL issued a PTE for Principal Transactions permitting investment 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 amended other existing exemptions, including:

- PTE 75-1 (to allow the receipt of fees in connection with the extension of credit to a plan or IRA by a broker-dealer to avoid failed securities transactions and to incorporate impartial conduct standards);

- PTE 86-128 (to allow certain fiduciaries to receive a fee directly from a plan for agency securities transactions and agency cross transactions; to incorporate impartial conduct standards; to require discretionary advisors to IRAs to satisfy all of the conditions of the exemption, and to exclude from the exemption nondiscretionary advisors to IRAs, forcing them to rely on the BIC PTE);

- PTEs 77-4, 80-83, and 83-1 (to incorporate the impartial conduct standards); and

- PTE 84-24 (to cover only fixed rate annuity contracts, to incorporate impartial conduct standards, and to eliminate the exemption for IRA purchases of investment company securities).

Transition and Effective Dates

To give firms time to come into full compliance, the DOL adopted a phased implementation approach. On April 10, 2017, the broader definition of fiduciary will take effect, including its application to IRA accounts. But, to take advantage of the BIC PTE, firms only will be required to comply with more limited transitional conditions, including acknowledging their fiduciary status, adhering to the best interest standard, and making basic disclosures of conflicts of interest. Full compliance with the BIC PTE will be required on January 1, 2018.

Next Steps for Investment Advisers, Broker-Dealers, and Insurance Agents

The new rule will particularly impact broker-dealers and insurance agents, and implementation will take significant time and resources. Hybrid financial service practices with both commission-based and fee-based services may require extensive client and service realignments. The impact of the new rule on many investment advisers may not be as substantial, but they will need to review their rollover procedures and processes. Third-party product and service providers may respond with changes to their retirement-related offerings, but given the long roll-out lead times for new products, they may not have them in place before the new rule becomes effective.

Litigation challenging the DOL's new rule may or may not occur and, even if filed, may or may not delay the rule's effective dates. So, with less than a year to analyze and implement significant changes to existing relationships and revenue streams with clients and third-party product and service providers – and likely changes to some business models – firms should promptly begin evaluating and developing project teams to:

- Assess the new rule's impact on current services and operations, including identifying all "covered investment advice" with respect to products and services sold to retirement plans and IRAs.

- Open dialogs with the firm's third-party product and service providers about their anticipated response to the DOL's new rule.

- Apprise and update the firm's representatives of (1) the impending impact on their compensation in response to the new rule, especially with respect to IRA accounts, (2) the required web-based public disclosure of their compensation-related information.

- Review, refine and strengthen the firm's supervisory controls over retirement plan related services, products and relationships.

- Map revenue streams to identify all instances of variable compensation with respect to retirement related services and products.

- Review and likely restructure compensation related incentives, policies and practices. Generally, firms should not use product or service specific production quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other actions or incentives that could cause advisors to make recommendations that are not in the best interest of retirement investors.

- Review and revise, as applicable, client services contracts and compliance policies and procedures.

- Create and adopt required disclosures (written statement of fiduciary status and general disclosures on compensation and conflicts).

- Create model BIC PTE contracts (or contract provisions) for IRA and non-ERISA plan clients (transition and full versions for non-level fees, and streamlined version for level fees), keeping in mind that the rollout process could be different for existing clients and new clients as of the effective date.

- Create a webpage that is open to the public and updated at least quarterly with descriptions and disclosures of the firm's business model, material conflicts of interest, schedule of fees and service charges, model contracts, compliance policy and procedures, compensation and incentive arrangements with advisors (including, if applicable, any incentives for recommending particular products, investments, or categories of investments).

- Establish recordkeeping practices and procedures for maintaining for six years those records required to demonstrate compliance with the BIC PTE.

- Prepare and provide training programs to advisors on the new fiduciary definition, BIC PTE, and the firm's policies and procedures for complying with the new rule.

- Explore partnering with third-party product and service providers to develop training programs about changes to their offerings.

Link to Final Rule and Exemptions

The full text of the final rule and the exemptions is available on the DOL website at: http://www.dol.gov/ebsa/regs/conflictsofinterest.html. ★