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DEPARTMENT OF LABOR'S NEW INVESTMENT ADVICE FIDUCIARY RULE – THE NEW NORMAL FOR RETIREMENT PLAN SPONSORS AND ADVISERS

On April 6, 2016, the Department of Labor (DOL) issued its long-awaited and controversial final regulation package that greatly expands the scope of who is a fiduciary by reason of providing investment advice to employee benefit plans subject to ERISA, IRAs and certain other accounts (including their respective plan fiduciaries, plan participants and owners). The new rule begins to be applicable April 10, 2017, but is not fully applicable until 2018. This article provides a brief summary of the new rule and its possible consequences, primarily from the perspective of retirement plan sponsors.

Brief Summary of New Investment Advice Fiduciary Rule

Under ERISA, an adviser is a fiduciary with respect to an employee benefit plan if the adviser renders investment advice for a fee or other direct or indirect compensation with respect to any property of the plan. The new rule replaces a prior rule published more than 40 years ago, when defined benefit pension plans, often invested by sophisticated in-house fiduciaries, were the norm, participant-directed defined contribution plans were unusual, and 401(k) plans had not yet been "invented".

Under the new rule, a person is an investment advice fiduciary of a plan if the person:

- provides a recommendation (essentially a call to action) to the plan, a plan fiduciary (such as the plan's trustee or plan administrator) or a plan participant concerning, among other things, investment policies, products or services, or rollovers and distributions from a plan, including whether, in what amount, in what form and to what destination (such as a particular IRA) such a rollover or distribution should be made;
  and

- (i) represents or acknowledges that it is a fiduciary; *or* (ii) renders the advice pursuant to an agreement, arrangement, or understanding that the advice is based on the particular investment needs of the recipient; *or* (iii) 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.

Significantly, the new rule omits the requirements that were included under the prior rule that the advice be provided to the plan on a *regular basis pursuant to a mutual agreement, arrangement or understanding* that the advice will serve as a *primary basis* for plan-related investment decisions. By omitting these requirements, the new rule significantly expands the class of advisers who will be treated as fiduciaries. *As a practical matter, the new rule will make nearly all retail brokers, pension consultants and insurance agents who deal with plans ERISA fiduciaries.*

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[1] Since the focus of this article is employer-sponsored, ERISA-covered retirement plans, we generally omit references to IRAs. However, the new rule covers advice provided to IRA beneficiaries.

Consequences of Being an ERISA fiduciary

Fiduciary status under ERISA subjects the adviser to special limitations and obligations in dealing with a plan. Among other things:

- A fiduciary must categorically avoid certain specified transactions with a plan and must avoid any direct or indirect transactions involving a plan that involve self-dealing, conflict of interest or third-party payments (so-called "prohibited transactions") unless the transaction is subject to a prohibited transaction exemption (PTE) granted by ERISA or by the DOL;
- All advice that a fiduciary provides to a plan must be "prudent," i.e., expert advice that is solely in the interest of plan participants; and
- A fiduciary has personal liability for any breach of fiduciary duty.

Absent an exemption, a fiduciary's receipt of a fee that varies based on the fiduciary's recommendation is a prohibited transaction. This would include:

- recommending an investment that causes the plan to pay a higher fee to the fiduciary instead of a lower-fee investment, or
- recommending an investment that results in the fiduciary receiving a commission, revenue sharing or 12b-1 fee from a third party.

Registered broker-dealers and registered investment advisers are subject to standards of conduct under federal securities laws that are quite different from ERISA's fiduciary obligations. In general, ERISA's fiduciary obligations are much more extensive and difficult to satisfy than the applicable standards of conduct under securities laws.

Best Interest Contract (BIC) Exemption and Other Exemptions

Recognizing that it is common for investment advisors to receive variable compensation that would otherwise be prohibited under ERISA, in conjunction with the release of the new rule, the DOL issued a new prohibited transaction exemption – the "Best Interest Contract (BIC) Exemption". The BIC Exemption would allow investment adviser fiduciaries to receive such compensation if several demanding conditions are satisfied that are intended to protect the interests of plans and plan participants. To qualify for the exemption the adviser must, among other things, (i) acknowledge that it is a fiduciary and is obligated to give advice that adheres to certain impartial conduct standards described in the BIC Exemption, (ii) provide certain disclosures and (iii) receive only reasonable compensation, in a manner that does not mislead the client about the services that are being provided and the compensation received by the adviser.

The BIC Exemption allows investment advisers who charge a level fee (Level Fee Fiduciary) to comply with a reduced set of conditions, referred to by some as "BIC Light." A level fee would include, for example, a fixed percentage of plan assets under management (AUM), a retainer fee or an hourly fee. We expect that some broker-dealers will seek to restrict their offerings to level fee arrangements such as the traditional advisory model (or the new robo-advisory model) in order to fit within the definition of a Level Fee Fiduciary.

Notably, the BIC Exemption is only available for financial institutions and their affiliates. The BIC Exemption is not available for unregistered pension consultants and advisers that are not affiliated with a financial institution that otherwise comply with the exemption. However, the BIC Exemption provides a mechanism whereby an

entity, which is not a financial institution within the meaning of the exemption, can apply to the DOL for an individual PTE that would allow the entity to receive exemptive relief under the same conditions as the BIC Exemption.

The new rule package also amends several long-standing prohibited transaction exemptions previously issued by the DOL. For example, the new rule significantly narrows the exemptive relief currently available under PTE 84-24 for the sale of insurance and annuity products to plans. With respect to the sale of annuities, the amendment limits the scope of the exemption to fixed rate annuity contracts and conditions exemptive relief on compliance with impartial conduct standards, as with the BIC Exemption. Thus, advisors will generally have to rely on the BIC Exemption for compensation received for recommending indexed or variable annuities.

Issues for Plan Sponsors

The new rule package is extremely long and complicated. The only prediction that can be made with certainty is that when the new rule becomes effective, there will be a sea change in the way the retirement plan investment advice community behaves.

Beyond impacting plan service providers, the new rule will also affect employers that maintain plans, i.e., plan sponsors. A plan sponsor is generally a fiduciary in its own right under existing law. As such, when designating any service provider for its plan (whether or not the service provider is a fiduciary), a plan sponsor must act prudently and solely in the interest of plan participants, and the plan sponsor has a continuing obligation to thereafter monitor the prudence of the designation.

Here are some of the consequences and issues arising as a result of the new rule that we believe plan sponsors should be aware of:

- Disclosures and Revisions to Existing Services Agreements. Since the new rule and the accompanying new or amended prohibited transaction class exemptions change the rules of the game for ERISA plan service providers and are heavy on disclosures and acknowledgements, plan sponsors are likely to be on the receiving end of a lot of paper, including:

  - various disclosures, such as the adviser's best interest standard of care owed to the plan and the adviser's material conflicts of interest;
  - amendments to existing service agreements; and
  - requests that the plan sponsor make new representations and warranties.

  Some service providers can be expected to revise their service agreements in an effort to avoid fiduciary status and to otherwise limit their liability. For example, advisers or recordkeepers may move toward investment education or investment research models (see "Investment Education" below). Other service providers may accept fiduciary status and seek additional fees for acting as such. Still others may seek to move to a flat fee arrangement. A plan sponsor's ongoing duty to monitor the plan's service providers requires that the plan sponsor monitor and understand the nature of the services provided and the aggregate compensation, including indirect compensation, received by the plan's service providers to ensure that the service provider's compensation is reasonable and remains competitive. For example, the plan sponsor should keep an eye out for updated ERISA Section 408(b)(2) disclosures concerning changes to service providers' compensation arrangements.

  Plan sponsors will need to review any revised service agreements, perhaps with their counsel, to ensure that their plan's interests are protected, and that the revisions are otherwise appropriate from the

plan's and the plan sponsor's perspective.

- New Fiduciary Status; Co-Fiduciary Liability. As part of their prudence and monitoring duties, plan sponsors will need to be aware that some currently non-fiduciary service providers may be considered fiduciaries under the new rule. Such service provider relationships will need to be evaluated through a new lens.

  - The plan sponsor will need to consider whether additional or different representations and undertakings of the service provider are appropriate.

  - A plan sponsor's designation of a fiduciary service provider to the plan may give rise to co-fiduciary liability for the plan sponsor if the plan sponsor knowingly participates in, conceals or fails to make reasonable efforts to remedy a known breach by the service provider. By expanding the universe of a plan's fiduciaries, the new rule may have the collateral effect of increasing the possibility of co-fiduciary liability for the plan sponsor. Where a fiduciary service provider acts imprudently or in violation of the prohibited transaction rules, the on-going engagement of the service provider by the plan sponsor could give rise to co-fiduciary liability. For example, vendor communications to terminated plan participants concerning distributions and rollovers – which are generally fiduciary in nature under the new rule – present a risk of co-fiduciary liability.

Additional Points

- Investment Education. The new rule allows plan sponsors and service providers to continue to provide investment education to plan participants without such education being considered fiduciary investment advice. Consequently, certain service providers may try to avoid fiduciary status by recasting their services so that they are characterized as merely providing investment education.

  The following qualify as non-fiduciary investment education, if certain conditions are satisfied:

  - general information about the plan;

  - general financial, investment and retirement information and

  - hypothetical asset allocation models and interactive investment materials, in each case, that do not identify specific investment alternatives unless the plan is subject to oversight by an independent plan fiduciary, and participants are provided certain additional disclosures.

  Interestingly, in the preamble to the new rule, the DOL observes that since only *investment advice for a fee or other compensation* falls within ERISA's definition of fiduciary investment advice, even if a plan sponsor communication crosses the line from investment education to actual investment advice, the fact that the plan sponsor is not receiving a fee or other compensation would generally preclude a finding that the communication constituted fiduciary investment advice. However, in light of the possibility of co-fiduciary liability and to evaluate whether models are in fact unbiased (among other things), plan sponsors should monitor any investment education materials provided by third party vendors to its plan's participants.

- Plan Sponsor Employees. Under the new rule, employees of the plan sponsor (e.g., human resources employees) generally will not be investment advice fiduciaries. More specifically, the following activities by employees of the plan sponsor, who are acting in such capacity and who receive only their normal compensation, will not cause them to be investment advice fiduciaries:

  - providing advice to a plan fiduciary (e.g., the plan's investment committee), and

  - providing advice to another employee of the plan sponsor in his or her capacity as a plan participant, as long as the advising employee is not employed to provide investment advice and the employee is not registered or licensed (or otherwise required to be registered or licensed) under securities or insurance law.

- Platform Marketing. Marketing or making available to a plan fiduciary a platform of investment alternatives will not constitute fiduciary investment advice under the new rule, so long as:

  - the plan fiduciary is independent of the person who markets or makes available the platform,

  - the platform is without regard to the individualized needs of the plan or its participants, and

  - the platform provider discloses in writing to the plan fiduciary that the provider is not providing impartial investment advice or acting in a fiduciary capacity.

- Selection and Monitoring Assistance; RFPs. Similarly, the following activities will not result in fiduciary status:

  - identifying investment alternatives that meet objective criteria specified by the plan fiduciary;

  - in response to a request for proposal on behalf of the plan, identifying a limited or sample set of investment alternatives based on only the size of the employer or plan, the current investment alternatives designated under the plan, or both,

    in each case, as long as the provider discloses in writing the existence and nature of any financial interest it has in any of the identified investment alternatives; or

  - providing objective financial data and comparisons with independent benchmarks to the plan fiduciary.

Conclusions for Plan Sponsors

The DOL's new investment advice fiduciary rule faces a number of challenges. Both the House and the Senate passed a resolution to kill the new rule, though not by veto-proof supermajorities. As expected, President Obama vetoed the resolution. In early June, the Chamber of Commerce and other business groups filed law suits against the DOL to void the new rule. Moreover, if a Republican is elected to the White House, it is questionable whether the new administration would allow the new fiduciary rule to become applicable in its present form.

If the new rule does become applicable, the most significant impact will fall on the financial services industry. Many members of that industry will have to adjust the services they provide, the way that they charge for their services, and/or the disclosure that they provide to their pension and 401(k) plan clients. For their part, plan sponsors, in consultation with counsel, will need to review revised arrangements from a new perspective.

Employers that maintain plans will have to ensure that their plan's interests are protected, and that the revisions are compliant with the new rules and otherwise beneficial to the plan and the plan sponsor.

If you have any questions or need support in adjusting to the "new normal," please feel free to call upon us.

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