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A Plan Sponsor's Overview of DOL's Fiduciary/Conflict of Interest Rule

The DOL recently released its long anticipated final regulation broadening the definition of fiduciary investment advice and setting forth conflict of interest rules. The final guidance includes some changes responsive to plan sponsor critiques of DOL's 2015 proposal. Under specified circumstances, DOL will not consider a plan's use of asset allocation models or interactive investment materials that identify specific plan investment options to be fiduciary investment advice. DOL also confirmed that the definition of fiduciary investment advice excludes many common plan sponsor employee interactions.

The final rule is not applicable until 2017, and a new presidential administration or courts could modify the final rule before it goes into effect. In the meantime, however, in response to the final rule, it may make sense for plan sponsors to review their investment education material. Investment fiduciaries' attendance at fiduciary training with a focus on selection and monitoring duties could also be helpful as the rule's impact becomes more clear under various factual scenarios.

Background

ERISA requires plan fiduciaries to act prudently and solely in the interest of participants and beneficiaries, and sets forth a series of "prohibited transactions" that restrict fiduciary self-dealing. Fiduciaries can be held personally liable for losses in the case of a breach of duty.

An ERISA plan fiduciary includes any party that "renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority to do so." Since 1975, the DOL has treated a person as an investment advice fiduciary only if all of the following criteria are met:

- The person renders investment advice about the value of securities or other property, or makes recommendations on the advisability of investing in, purchasing or selling securities or other property.
- The advice is provided on a regular basis.
- The advice is provided pursuant to a mutual agreement, arrangement or understanding with the plan or a plan fiduciary.
- It is intended that the advice will serve as a primary basis for investment decisions regarding plan assets.
- It is intended that the advice will be individualized based on the particular needs of the plan.

In 2010, DOL sought to expand the types of investment advice that trigger fiduciary status, but DOL ultimately withdrew that proposal following substantial pushback from the financial services industry. See our *For Your Information* from November 11, 2010. In April 2015, DOL re-proposed the regulation (2015 proposal), broadening the fiduciary definition to include a wider scope of investment advice relationships while including several important “carve-outs” from that definition. See our April 21, 2015 *For Your Information*.

This year, on April 6, DOL released its final regulation, along with the Best Interest Contract Exemption, five additional documents on affected prohibited transaction exemptions, and supporting material. See our April 6, 2016 *FYI Alert*.

Functional Definition for Fiduciary Investment Advice

The final rule, like the 2015 proposal, first describes the types of communications that constitute fiduciary investment advice and then the types of types of relationships that must exist for such communications to trigger fiduciary status. Factual context is key to determining fiduciary status.

Fiduciary Communications

The final rule defines an investment advice fiduciary as a person who provides, to a plan, fiduciary, participant, beneficiary, IRA, or IRA owner, *for a fee or other compensation* (direct or indirect):

Investment recommendations, which means recommendations on buying, holding, selling or exchanging securities/other property, or on how to invest securities/other property after a contribution, rollover, transfer or distribution from a plan or IRA; or

Investment management recommendations, which means recommendations on investment policies or strategies, portfolio composition, selection of others to provide investment advice or investment management services, and election of investment account arrangements (such as brokerage versus advisory), or recommendations concerning rollovers, transfers or distributions from a plan or IRA — such as the amount, form and destination of a rollover, transfer or distribution

According to the final regulation, “recommendation” means “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.” The more individually tailored the communication is to a specific recipient, the more likely DOL is to view it as a recommendation.

Covered Plans

In addition to ERISA plans and IRAs, a “plan” for purposes of the final rule includes health savings accounts (HSAs), Archer MSAs, Coverdell Education Savings Accounts, and ERISA-covered 403(b) plans. Plan sponsors had asked about the regulation’s applicability to welfare plans and HSAs. While acknowledging that HSAs generally hold fewer assets and may exist for shorter durations than IRAs, DOL determined that they are subject to the scope of the final rule. Thus, entities dealing with HSAs should review their operations to determine if, and the extent that, their role might cause them to be an investment fiduciary and whether an applicable prohibited transaction exemption may apply. On the other hand, DOL clarified that the final rule does not apply to recommendations to welfare plans (such as health plans, disability plans or term life insurance) where they do not contain an investment component.

Appraisals

The 2015 proposal included an appraisal or fairness opinion on an investment as part of the definition of fiduciary advice and a carve-out for appraisals and other valuations provided to an employee stock ownership plan (ESOP). The final rule does not include valuations and appraisals as a category of fiduciary investment advice. Instead, after reviewing the comments, DOL decided to address appraisals (including an analysis of ESOP appraisals) in a separate rulemaking project.

Fiduciary Relationships

To give rise to fiduciary status under the final rule, the party giving the investment advice described above must do one of the following:

- Represent or acknowledge they are acting as a fiduciary pursuant to ERISA or the Code
- Provide investment advice under a written or verbal agreement, arrangement or understanding that the advice is based on the particular needs of the advice recipient
- Direct the advice on the advisability of a particular investment or investment management decision to a specific recipient

Communications That Are Not Covered Investment Advice

In the final rule, DOL dropped the reference to “carve-outs” that it used in the 2015 proposal from the definition of fiduciary investment advice. Instead, it provided what it described as a non-exhaustive list of non-fiduciary communications examples.

Not a Recommendation

Under the final rule, the following types of communications do not meet the definition of a “recommendation,” and, therefore, do not constitute fiduciary investment advice:

Investment Education. The final rule generally adopts the 2015 proposal’s provisions on investment education, stating that a plan sponsor, fiduciary, service provider and others can provide an array of investment educational information to a plan, participant, beneficiary or IRA owner without stepping into a fiduciary role. This includes information about financial concepts such as risk and return, diversification, dollar cost averaging, and how to estimate future retirement income needs, historic returns of different asset classes, as well as the different forms of distributions, including rollovers, annuitization and other forms of lifetime income payment options typically used in retirement. The information can also include asset allocation models demonstrating an appropriate mix of stocks and bonds based on age and income, and use interactive technologies. The material constitutes investment education regardless of who furnishes it, how frequently it is provided and by whom, and whether or not different categories of information are provided together.

A "designated investment alternative" is an investment option chosen by defined contribution plan fiduciaries as available for selection by participants and beneficiaries.

Consistent with current law under Interpretive Bulletin 96-1 and unlike the 2015 proposal, however, the final rule does allow investment education asset allocation models and interactive investment materials to identify specific investment alternatives offered by the plan — including a description of objectives, risk and return characteristics of each of those options — under certain conditions. Specifically, (1) the alternative must be a plan designated investment alternative (DIA) (which excludes brokerage accounts), (2) the alternative must be subject to fiduciary oversight by a plan fiduciary independent of the person developing or marketing the alternative, (3) the models and interactive material must identify all other plan DIAs that have similar risk and return characteristics, and (4) a statement must be provided identifying where to obtain information about those alternatives.

Comment. Plan sponsors criticized the 2015 proposal's position on asset allocation models or interactive investment materials identifying specific plan investment alternatives or distribution options (unless affirmatively inserted by a participant, beneficiary or IRA owner) — even when accompanied by a statement of investment alternatives. They argued, apparently persuasively given the terms of the final rule, that this type of information is a critical step in "connecting the dots" for plan investors to apply educational information to the specific options available under their plan.

On the other hand, DOL stuck to its stance in the 2015 proposal excluding mention of specific investments in the case of IRA owners. In doing so, DOL distinguished the IRA context from that of an ERISA plan — where there is an independent plan fiduciary responsible for overseeing the plan's investment line up. It viewed an advisor selecting investment options out of the universe of investments (in contrast to the plan's limited universe — i.e., its investment line-up) as essentially amounting to a specific investment recommendation.

The final rule also states that providing information and materials that describe plan investments without specifically recommending any particular investment or strategy is not fiduciary investment advice.

Responding to plan sponsor concerns that DOL's guidance could chill efforts to provide investment education to participants and beneficiaries, DOL pointed out that plan sponsors do not generally receive a fee or other compensation connected to their investment education communications — a necessary aspect of investment advice under the final rule. In doing so, DOL rejected the notion that any "incidental economic advantages" an employer may accrue by

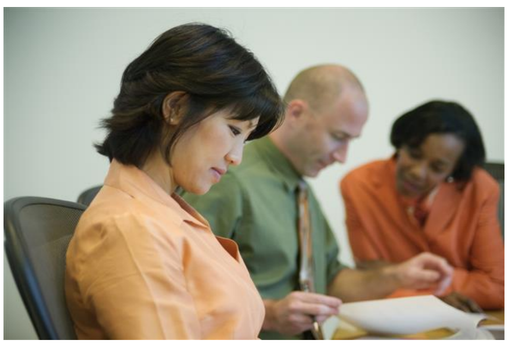
Call Centers and Fiduciary Liability?

According to DOL, the final rule does not significantly expand plan sponsors' fiduciary or co-fiduciary obligations for service providers who are, or become, investment advice fiduciaries. Sponsors were concerned in particular about potential liability under the 2015 proposal where administrative services are handled in-house or through a plan service provider operating a participant call center that such administrator might, despite training and supervision to the contrary, inadvertently provide information that could be deemed fiduciary investment advice. In that scenario, the plan sponsor's exposure appears limited to existing fiduciary duties in training in-house administrators and selecting and monitoring service providers.

sponsoring an employee benefit plan could be construed as a fee or other compensation for purposes of the final rule.

> **Comment.** This means that plan expenses paid out of an ERISA budget account that are funded with revenue sharing from plan investments generally would not be considered advice for a fee or other compensation under the final rule.

Platform Providers. Under the final rule, service providers like recordkeepers and third-party administrators to participant-directed individual account plans that also offer a "platform," or selection, of investment alternatives to plans are not providing fiduciary investment advice just by offering these alternatives, as long as the information provided does not incorporate a plan or participant's individualized needs. To qualify for this exclusion, the plan fiduciary must be independent of the service provider, and the service provider must represent in writing that it is not providing fiduciary advice or impartial investment advice. This exclusion from the definition of "recommendation" does not apply to IRAs or brokerage accounts, since they lack an independent fiduciary who interacts with the service provider.



Selection and Monitoring Assistance. In connection with plan fiduciaries' duty to select and monitor plan investment options, subject to certain disclosure obligations, a platform provider can also identify investment alternatives that meet criteria specified by the plan fiduciary without becoming a fiduciary. An RFP response that identifies a limited or sample set of investment alternatives based only on the size of the plan or of the employer, the current plan investment options, or both, is also not a fiduciary investment recommendation if proper disclosures are made. This exclusion from the definition of "recommendation," like the exclusion for platform providers described above, does not apply in the IRA or brokerage window context for recommendations to individuals.

General Communications. In response to concerns that general communications like those made in newsletters, media commentary, or by media personalities could be treated as fiduciary investment advice, DOL clarified that a "general communication that a reasonable person would not view as an investment recommendation" is not a "recommendation" under the final rule.

Activities Not Considered Investment Advice

DOL does not consider the following activities fiduciary investment advice even if they meet the final rule's definition of "recommendation":

Employees of the Plan Sponsor. A plan sponsor's employee does not become an investment advice fiduciary either by providing advice to a plan fiduciary or to another employee as long as he or she does not receive compensation in exchange for this advice-related function that is above and beyond his or her normal compensation. DOL crafted this exclusion to address plan sponsor concerns that the proposal may have drawn in employees in the payroll, accounting, human resources and finance departments who routinely produce reports and recommendations for the company and the plan's fiduciaries, even if they do not communicate directly with plan fiduciaries.

> **For example**, DOL does not consider a finance department employee who prepares reports for the company's CFO that the CFO, in turn, communicates to the plan's fiduciaries an investment advice fiduciary.

This exclusion also covers communications between a plan sponsor's employee and his or her fellow employees in their capacity as plan participants and beneficiaries, subject to certain conditions. The employee's job functions must not involve providing investment advice or recommendations, the employee must not be a registered or licensed investment advisor, the advice he or she provides must not require registration or licensing, and the employee must not receive compensation in exchange for the advice above and beyond his or her normal compensation.

> **For example**, DOL does not consider a human resources representative who discusses plan distribution options with a retiring coworker an investment advice fiduciary.

> **Comment.** DOL retained the restrictions for employees who are investment professionals to preclude "situations designed to evade" the spirit of the final rule. For example, an employer hiring an investment professional to provide investment advice to participants would not escape fiduciary obligations and would remain in the category of providing fiduciary investment advice.

"Seller's" Exclusion. Similar to the 2015 proposal, the final rule provides that arm's-length sales pitches to plan or IRA fiduciaries with financial expertise are not fiduciary investment advice. The final "seller's" exclusion applies to recipients that are banks, insurance carriers, registered investment advisors, broker-dealers and to fiduciaries with total assets under management of at least $50 million (as proposed, it applied to fiduciaries of plans with 100 or more participants or responsible for managing at least $100 million in assets).

Swap Transactions. As with the 2015 proposal, the final rule excludes offers or recommendations by swap dealers or security-based swap dealers acting as a counterparty to a swap or security-based swap transaction with a plan.

Best Interest Contract and Other Exemptions

The DOL set forth new exemptions to the prohibited transaction rules — most prominently, the "Best Interest Contract Exemption" (the BIC, also known as the BICE). According to the DOL, the BIC is designed to allow firms and advisors to continue using compensation arrangements that would otherwise be prohibited so long as they commit to putting their clients' best interest first. To do so, they must take a number of steps such as acknowledging fiduciary status, adopting policies and procedures designed to mitigate conflicts of interest, and disclosing information about their conflicts of interest and the cost of their advice. If firms and advisors violate the BIC's requirements, investors in IRAs and other non-ERISA plans can bring a breach of contract claim.

The final BIC contains a number of changes from the hotly contested proposed version — which many commenters had described as "unworkable." For example, it makes the BIC available for any asset type, eliminates the contract requirement for advisors to ERISA plans, permits negative consent for existing contract holders, simplifies processes for advisors that receive only a level fee, streamlines pre-transaction disclosure, and eliminates certain annual disclosures.

An exemption for principal transactions allows fiduciaries to sell or buy certain recommended debt securities and other investments out of their own inventories to or from plans and IRAs. In the final rule, DOL broadened the types of assets that can be traded on a principal basis. Additionally, to ensure that purchases of variable and indexed annuity contracts will be covered under either the BIC or the seller's exception, DOL limited the situations where recommendations on insurance products or proprietary mutual funds can rely on PTE 84-24 — which covers insurance and annuity contracts transactions. This exemption is no longer available for recommendations of variable annuities, indexed annuities and similar contracts to IRAs or plans.

Applicability Date and Potential Challenges

The applicability date for the final rule, changes to existing exemptions, and certain aspects of the BIC and principal transaction exemption is April 10, 2017 — just over one year from the date the final rule was published in the *Federal Register*. Other exemption requirements apply as of January 1, 2018.

Between now and the applicability date, congressional Republicans are expected to attempt overturning the final rule, pass overriding legislation, and/or use the appropriations process to de-fund DOL's implementation of the rule. Indeed, this week, Sen. Johnny Isakson (R-GA) with more than 30 co-sponsors, introduced a resolution of congressional disapproval under the Congressional Review Act to overturn the rule. The House followed suit with a similar resolution introduced by Rep. Phil Roe (R-TN) and over a dozen co-sponsors. (Watch for more on these developments in our April 25 issue of *Legislate*.) These efforts are not expected to be successful, however, as President Obama will veto any such legislation that Congress manages to pass. See our April 11, 2016 *Legislate*. The final rule may ultimately face challenges in court, perhaps based on the theory that DOL did not take all necessary procedural steps or arguments that it exceeded the scope of its authority in regulating IRAs as if they were ERISA plans. However, it is unlikely that courts will rule on these issues before the final rule and exemptions' applicability dates.

Considerations for Plan Sponsors

As discussed above, DOL responded favorably to many of the concerns plan sponsors expressed with the 2015 proposal. While most of the risk areas identified in connection with the 2015 proposal appear relatively limited in scope under the final rule, plan sponsors should consider the following actions to promote compliance:

Review and analyze investment education material. Now is a good time to take a close look at the investment education information the plan makes available to participants and beneficiaries and make sure it comports with the requirements of the final rule. In particular, plan sponsors should ensure that asset allocation models or interactive investment materials that identify specific plan investments satisfy the conditions DOL has set forth — which are more extensive than those currently required under Interpretive Bulletin 96-1.

Fiduciary training with a focus on selection and monitoring duties. While noting that the final rule does not significantly expand plan sponsors' fiduciary or co-fiduciary obligations for service providers who are, or become, investment advice fiduciaries, DOL emphasized plan fiduciaries' existing fiduciary duties in selecting and monitoring service providers. As the rule begins to take hold in practice, training can help fiduciaries better understand their general fiduciary duties and these specific responsibilities, naturally subject to the facts of any given situation.

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Be prepared for investment advice service providers to request revised contractual terms. Because of the increased risk exposure that accompanies this role, they may seek contractual changes to fees and other provisions.

In Closing

Controversy over the final rule and related exemptions will undoubtedly persist among some stakeholders in the financial services industry and elsewhere. As noted, it will likely be a while until these become settled in practice and not subject to some challenge. For plan sponsors, however, the DOL appears to have addressed many key concerns.

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