Who's a Fiduciary Now?

Understanding the Department of Labor's New Definition

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The sky isn't falling, but in a very real sense the retirement world is changing. After months of angst from many in the industry and boisterous posturing by members of Congress, on April 8, 2016, the Department of Labor released a final regulation that more broadly defines who is an "investment-advice" fiduciary for purposes of ERISA and the Internal Revenue Code. Along with related prohibited transaction exemptions issued at the same time, the DOL's new regulatory regime will dramatically expand the scope of its enforcement authority and, in the process, change the way that many service providers interact with plan sponsors.

Investment consultants, recordkeepers, and other service providers will be most affected by the new rules. Conversations and transactions that previously were untouched by ERISA – such as distributions and rollovers from retirement plans, conversations with call center representatives, and advice about IRA investments – now will be measured against "best interest" standards. And although these rules may not *directly* affect employers and plan-level fiduciaries, those fiduciaries nevertheless have a duty to understand the new regulatory regime so that they can protect retirees and participants and mitigate their own co-fiduciary liability.

Key Issues for Employers	Key Issues for Advisors
• Understand the new rules and how they affect relationships with service providers • Ask service providers about their compliance strategies • Educate plan-level fiduciaries (investment and administrative committees, HR personnel) about the new regulatory regime • Determine how to deal with new service-provider disclosures and agreements • Monitor the rollover process more closely	• Understand your fiduciary (or non-fiduciary) status • Audit your services and revenue streams and map out compliance strategies • Prepare for BIC Exemption compliance • Create required disclosures and agreements

The Regulation in a Nutshell

- The regulation replaces 40-year-old guidance that determines when a person becomes a "fiduciary" under ERISA and the Internal Revenue Code by providing "investment advice for a fee or other compensation." (The regulation does not affect the other ways in which a person can become a fiduciary.)

- Under the new definition, a person or entity is an investment-advice *fiduciary* if he or she receives *compensation* (directly or indirectly) in connection with a *recommendation* provided to a *covered party* concerning the advisability of a particular *investment or management decision* with respect to a plan or IRA, if such person either (1) *acknowledges fiduciary status*, (2) gives the advice pursuant to an *understanding that it is individualized* for the recipient, or (3) directs the advice to a *specific recipient* concerning a particular investment or management decision.

- A new prohibited transaction exemption (the "*Best Interest Contract Exemption*" or "BIC Exemption") will allow the expanded group of fiduciary advisors to receive compensation that would otherwise be prohibited (such as commissions, revenue sharing, and 12b-1 fees) if the advisor acknowledges fiduciary status, commits to an impartial conduct standard, adopts policies to minimize conflicts, makes certain disclosures, and (in some cases) enters into an enforceable "best interest" contract with the advice recipient. (Other prohibited transaction exemptions also were modified to reflect the new fiduciary definition.)

What's Changed?	What Hasn't Changed?
• New definition of "investment-advice" fiduciary • New (and more) fiduciary relationships • Expanded DOL enforcement authority • New ways of regulating "conflicted" investment-advice relationships • New regulation of plan distributions and IRAs	• Those who were fiduciaries before issuance of the regulation are still fiduciaries • ERISA's standards and duties for fiduciaries • Code and ERISA prohibited transaction rules (but exemptions have changed) • Personal and co-fiduciary liability

Effective and Applicability Dates

The final regulation contains both an "effective date" and a separate "applicability date." The regulation is final and formally "effective" on June 7, 2016 (60 days after its publication in the Federal Register). This near-term date is intended to assure plan investors and service providers that the regulation is legally binding and not subject to further amendment after that date.

In order to give service providers more implementation time, however, the new definition, and several conditions of the BIC Exemption, will first become “applicable” on April 10, 2017. In the meantime, an interim rule that mirrors the current investment-advice fiduciary definition will apply. Other conditions of the BIC Exemption (*e.g.*, the written contract requirement and certain representations and warranties regarding conflicts of interest) become effective even later, on January 1, 2018.

Statutory Background

At the core of ERISA’s regulatory regime is the concept of a “fiduciary.” The prudent expert standard, exclusive benefit rule, and other duties imposed under ERISA, as well as the prohibited transaction rules set forth both in ERISA and the Internal Revenue Code, apply to fiduciaries. Congress borrowed from the common law of trusts when defining the term “fiduciary” for these purposes, but it expanded that definition.

As is the case under the common law, a fiduciary for ERISA purposes includes a person or entity that is specifically identified or named as such in the governing plan documents. These fiduciaries are known as “named fiduciaries” under ERISA (or “trustees” under the common law of trusts).

Unlike the common-law definition, however, ERISA and the Tax Code also include as fiduciaries individuals who perform certain *functions*, even if they are not specifically identified as fiduciaries in the plan documents. Section 3(21)(A)(ii) of ERISA and Section 4975(e)(3)(B) of the Code define these “functional fiduciaries” to include a person who “renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property” of a plan. These individuals are commonly referred to as “investment-advice fiduciaries.” The recently released final regulation addresses this subset of the functional fiduciary definition.

The Rationale for Change

Shortly after ERISA was enacted, the DOL issued guidance that was intended to clarify when an individual provides “investment advice for a fee or other compensation,” and thus becomes a fiduciary. This 1975 regulation employed a five-part test which required, among other things, that the advice be provided on a “regular basis” and pursuant to a “mutual understanding” between the advice provider and the advice recipient that the advice would form the primary basis for the investment decision. According to the DOL, the “regular basis” and “mutual understanding” requirements allowed some advisors to dodge fiduciary status – and thus avoid the requirement that they act in the best interests of the plan and its participants – by offering advice on only a sporadic basis or by expressly disclaiming (often in a service agreement or marketing disclosure) that the advice recipient should rely on the advice (thus defeating the “mutual understanding” requirement). That is a result with which the DOL has become increasingly dissatisfied.

The 1975 rule has not kept pace with the rapidly evolving retirement industry. It was adopted prior to the existence of participant-directed 401(k) and 403(b) plans, the widespread use of IRAs, and the now common practice of rolling assets of ERISA plans into non-ERISA IRAs. The DOL cited these and other factors in the preamble to the new regulation to justify the expanded definition of investment-advice fiduciary:

> Today, as a result of the five-part test, many investment professionals, consultants, and advisers have no obligation to adhere to ERISA's fiduciary standards or to the prohibited transaction rules, despite the critical role they plan in guiding plan and IRA investments. . . . Non-fiduciaries may give imprudent and disloyal advice; steer plans and IRA owners to investments based on their own, rather than their customers' financial interests; and act on conflicts of interest in ways that would be prohibited if the same persons were fiduciaries.[1]

The Department therefore engaged in a lengthy process to replace the five-part test with one that more accurately reflects the current state of the industry. This process began in 2010 with the issuance of the first of two proposed regulations. That proposal (summarized in our November 18, 2010, article) met with substantial resistance from industry lobbyists, and was subsequently withdrawn in 2011.

A new proposed change to the 1975 regulation was announced on April 20, 2015. The 2015 proposed regulation made many changes to the 2010 proposal, but still generated substantial comments, requests for change, and outright opposition. The DOL ultimately took many of those comments and requests for change into account, releasing the substantially revised final regulation and a series of prohibited transaction exemptions on April 6, 2016.[2]

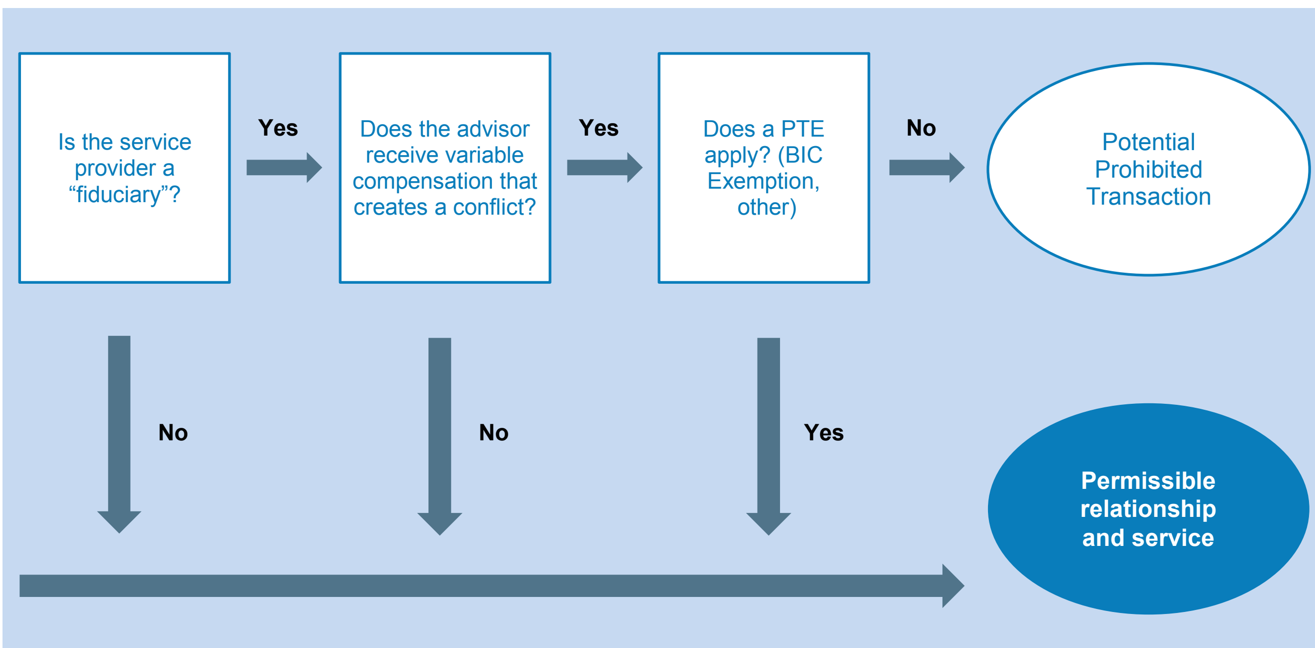
The New Regulatory Framework

The new investment-advice fiduciary definition will work in tandem with the contemporaneously issued complex of prohibited transaction exemptions. Together, the definition and exemptions will regulate a substantial number of relationships and transactions that were previously outside the DOL's regulatory authority.

[1] Preamble to Final Rule, 81 Fed. Reg. 20946 (April 8, 2016).

[2] The final rule was published in the Federal Register on April 8, 2016.

Broadly speaking, the final regulation expands the number of investment-advice relationships that create fiduciary status. Those relationships – which now will involve fiduciaries – will become subject to the prohibited transaction rules. Many of those relationships will be impermissible under the new rules because they enable the investment advisor (who is now a fiduciary) to increase his or her compensation by steering investors to investments that pay the advisor a higher fee or commission, thus creating a conflict of interest. (This is especially true for rollovers and IRA investments.) The accompanying package of new and revised prohibited transaction *exemptions* then will make some of those relationships permissible again, but only if the advisor complies with conditions imposed under the exemptions that are designed to protect retirement-plan and IRA investors.



For ERISA plans, the new regulation simply means that more advisors will be subject to ERISA’s prudence and exclusive benefit rules. Those rules do not apply, however, to non-ERISA arrangements like IRAs, Roth IRAs, and health savings accounts. But even those non-ERISA arrangements are subject to the separate (but nearly identical) prohibited transaction rules set forth in the Tax Code. The new regulatory framework reaches those arrangements by imposing “ERISA-like” requirements as conditions of the prohibited transaction exemptions, over which the DOL has regulatory authority.[3] Thus, the scope of the new regulatory framework is extremely broad, reaching not only ERISA plans (including both defined benefit and defined contribution arrangements and Section 403(b) plans that are subject to ERISA), but also non-ERISA arrangements that are subject to the Tax Code’s prohibited transaction rules, such as traditional IRAs, Roth IRAs, health savings accounts, Archer medical savings accounts, and Coverdell education savings accounts.

Investment-Advice Fiduciary – the New Definition

The revised definition of an investment-advice fiduciary in the final regulation replaces the old five-part test. The new definition describes the kinds of *communications* that constitute investment advice, and then describes the types of *relationships* in which such communications give rise to fiduciary obligations. Under the new rule, a person becomes a fiduciary with respect to advice if he or she:

Covered Communications	• Makes *a recommendation* • To a *plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner* • For *compensation* (directly or indirectly) • Concerning: – The acquisition, holding, disposing, or exchange of *securities or investment property*, or concerning how such property should be invested after a rollover or distribution from a plan or IRA; or – The *management of securities* or other investment property, including *investment policies or strategies*, portfolio composition, the *selection of investment advisors, and whether and how to take a transfer, distribution, or rollover from* a plan or IRA

[3] The authority of the Secretary of the Treasury to issue regulations and exemptions governing the Tax Code’s prohibited transaction rules was transferred to the Secretary of Labor in 1978 in order to ensure that the parallel prohibited transaction rules under ERISA and the Code are administered uniformly. It is this transfer of authority (technically known as Reorganization Plan No. 4 of 1978) that permits the DOL to regulate non-ERISA arrangements like IRAs, through the prohibited transaction rules and exemptions.

Covered Relationships	• If the person providing the advice either: – *Acknowledges* his or her fiduciary status; – Gives the advice pursuant to a written or verbal agreement, arrangement, or *understanding* that the *advice is individualized* for the recipient; or – Directs the advice to a specific investor concerning a particular investment or management decision

Is there a "Recommendation"?

The initial step in determining whether a fiduciary investment-advice relationship has been established is to decide whether there has been a "recommendation." A recommendation 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."[4] This is an objective, as opposed to subjective, determination. In general, the more individually tailored the advice is to a specific recipient, the more likely it will be considered a recommendation.

What is *Not* a Recommendation?

The regulation also describes some common communications that generally do *not* constitute "recommendations," and thus do not create a fiduciary relationship.[5] This non-exhaustive list of non-fiduciary communications includes:

- *Platform Provider Communications.* Marketing and making available investment platforms to independent fiduciaries of ERISA plans, without regard to individualized plan or participant needs, so long as the platform provider makes appropriate disclosures (note that this exclusion does *not* apply to IRA investments);

- *RFP Responses.* Providing objective financial data and benchmark comparisons, offering information in response to a request for proposals, and identifying investment alternatives that satisfy objective criteria established by the plan fiduciary, so long as appropriate disclosures are made (note that this exclusion does *not* apply to IRAs);

[4] 29 C.F.R. § 2510.3-21(b)(1).

[5] The DOL referred to these as "carve-outs" in the 2015 Proposed Regulation. In the final regulation, however, these communications are described as "examples of communications that are non-fiduciary because they fall short of constituting 'recommendations.'" Preamble to Final Regulation, 81 Fed. Reg. 20946, 20948 (April 8, 2016).

- *General Communications.* Furnishing general marketing communications and commentaries on investment products, such as financial newsletters, that a reasonable person would not view as investment recommendations; and

- *Investment Education.* Providing investment education (as opposed to investment *advice*) to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner.

Communications like these generally are not customized for a specific recipient.

Platform Provider Communications. The platform provider exclusion is directed to service providers, such as recordkeepers and third-party administrators that offer a “platform” or selection of investment alternatives from which ERISA plan fiduciaries may choose when creating the plan’s menu of investment options. Under the rule, such persons would not be considered to make “recommendations” simply by making the platform available, so long as the platform is constructed without regard to the individualized needs of the plan or its participants. Moreover, simply responding to a request for proposals (“RFP”) or providing objective financial data regarding available alternatives would not constitute a recommendation. In both cases, however, the service provider must disclose in writing to the plan fiduciaries that the provider is not attempting to provide impartial investment advice.

Investment Education. The final regulation retains the DOL’s prior guidance (contained in Interpretive Bulletin 96-1) concerning the distinction between non-fiduciary investment *education* and fiduciary investment *advice*, but with some minor modifications. It does so by including investment education as an example of communications that do not constitute a recommendation. Significantly, however, the rule differentiates between education provided to ERISA plans and their participants and education provided to IRAs and IRA owners.

Generally, the following kinds of investment information and materials will not be treated as recommendations:

- *Plan information* – such as descriptions of plan investment options, the objectives and philosophies (*i.e.,* risk/return characteristics) of those options, fees, historical returns, and distribution options;

- *General investment information* – such as retirement-related risks (longevity, market/interest rates, inflation, health care), diversification, risk and return, and general methods of managing assets in retirement, so long as the advisor does not recommend a specific investment or investment strategy;

- *Asset allocation models* – hypothetical ways that an investor might allocate his or her account among various asset classes; these asset allocations may identify investment alternatives offered under the plan (but not an IRA) if the investment is a designated investment alternative (*i.e.*, a “core” fund) that is subject to oversight by a plan fiduciary, so long as the person who develops or markets the model identifies all of the other investment options available under the plan with similar risk/return characteristics to the option included in the hypothetical model, and also informs participants where they can obtain information on those similar options; and

- *Interactive investment materials* – such as questionnaires, worksheets, and software programs that enable users to estimate future retirement needs.

The regulation notes that there may be other examples of information, materials, and educational services that would not constitute investment advice or recommendations.

Educational material provided directly by employers generally will not give rise to investment advice under the rule, because employers do not typically receive compensation in connection with such material. However, the preamble to the final rule emphasizes that plan-level fiduciaries already have a fiduciary duty to prudently select and monitor all plan service providers, including those that merely provide non-fiduciary investment education. Moreover, the DOL refused to adopt a modification to the proposed regulation that was championed by service providers and employers which would have relieved plan sponsors from having to address complaints from participants and IRA owners about imprudent or conflicted advice they receive from advisors. The clear implication is that plan sponsors continue to have fiduciary oversight responsibilities over – and potential liability for – advice and education providers.

Other Exceptions. Finally, the regulation exempts certain transactions and communications from classification as “fiduciary investment advice,” even if they would otherwise constitute recommendations. These include:

- *“Sophisticated fiduciary” transactions* – arms-length transactions between service providers (“sellers”) and independent plan fiduciaries who have financial expertise (including fiduciaries who hold or manage at least $50 million in assets), so long as the “seller” makes appropriate disclosures to the independent fiduciary and does not receive compensation directly from the plan, plan participant, or IRA;

- *“Swap” transactions* – specified securities-based swap transactions with ERISA plans; and

- *Employee communications* – advice provided by an employee of a plan sponsor to a plan participant or plan fiduciary (such as the plan's investment committee), so long as the employee is not a licensed investment professional and receives only his or her normal compensation for the work performed.

Regulating Through the Back Door: Prohibited Transaction Exemptions

The final regulation will cause some investment advisors who had previously avoided fiduciary status to become fiduciaries. Those "new fiduciaries" who advise non-ERISA arrangements such as IRAs will become subject to the Tax Code's prohibited transaction rules. New fiduciaries who advise ERISA plans and their participants will become subject to ERISA's fiduciary standards of conduct *and* its prohibited transaction rules. Thus, all of those fiduciaries will have to avoid engaging in conduct that creates a prohibited transaction – such as receiving compensation that creates a conflict of interest – *unless* that conduct falls within a prohibited transaction *exemption*.

New Exemptions. The DOL issued two new prohibited transaction exemptions (and modified several others) in order to permit – and better regulate – certain common industry practices. These include the Best Interest Contract ("BIC") Exemption and the Principal Transactions Exemption. The BIC Exemption permits financial institutions and their advisors to receive compensation related to investment advice that would otherwise create a conflict of interest, such as commissions, revenue sharing payments, and 12b-1 fees from investment products they recommend.

The Principal Transactions Exemption permits investment-advice fiduciaries to buy or sell certain recommended debt securities and other investments out of their own inventories to or from plans or IRAs. Many of the prerequisites for reliance on the BIC Exemption also apply to the Principal Transactions Exemption.

Significantly, some investment advisors and advice transactions will not need to rely on the BIC Exemption at all. Any prohibited transaction *exemption* – including the BIC Exemption – becomes relevant *only* if there is a prohibited transaction in the first place. Many independent, fee-based investment advisors (*e.g.,* registered investment advisors) have structured their businesses such that they do not receive commissions, revenue sharing payments, 12b-1 fees, or other "variable compensation" that might create a conflict of interest. Those advisors need not rely on the BIC Exemption to "bless" their compensation arrangements.[6] Thus, for some plan sponsors and advisors, the BIC Exemption will largely be irrelevant, at least with respect to plan-related advice.

[6] Advice provided under other fee-neutral models, such as "eligible investment advice arrangements" under Section 408(g) of ERISA and managed account models based on the DOL's "SunAmerica" Opinion (Advisory Opinion 2001-09A), also need not rely on the BIC Exemption.

The BIC Exemption. Financial institutions and their advisors who are fiduciaries and who receive compensation (directly or indirectly) that could vary based on the advice they give (*e.g.,* commissions, revenue sharing, 12b-1 payments, finders' fees, and loads) will need to comply with the BIC Exemption in order to continue serving ERISA plans, plan participants and beneficiaries, and plan fiduciaries. Moreover, complying with the BIC Exemption is the *only* way for a financial institution or advisor who receives variable compensation to provide rollover and other assistance to IRA owners.

The BIC Exemption is available only to "financial institutions" and their advisors. A "financial institution" generally includes a bank, registered investment advisor, insurance company, or broker/dealer. The Exemption applies to advice given to "retirement investors," which includes plan participants and beneficiaries, IRA owners, and plan or IRA fiduciaries who are not eligible for the sophisticated fiduciary exception described in the final regulation. All financial institutions relying on the BIC Exemption must follow basic standards of impartiality, including providing investment advice that is in the "best interest" of the investor (a standard similar to ERISA's fiduciary duty standard), avoiding misleading statements, and refraining from recommending transactions that will generate unreasonable compensation.

For advice involving IRAs and non-ERISA plans, the BIC Exemption requires the financial institution to enter into an enforceable, written contract with the retirement plan investor. The contract must be available through the financial institution's website, acknowledge the financial institution's fiduciary status, commit the institution to impartial conduct standards, and contain certain warranties regarding conflicts of interest. This "best interest contract" will give IRA owners and non-ERISA plans a private cause of action against the financial institution to enforce the terms of this agreement.[7]

Like the final regulation, the BIC Exemption, Principal Transactions Exemption, and changes to other prohibited transaction exemptions are generally applicable to transactions occurring on or after April 10, 2017. There is an additional transition period – from April 10, 2017, through December 31, 2017 – during which the BIC Exemption will be available, but subject to eased compliance conditions. During that transition period, the written contract requirement does not apply, but the best-interest and other standards of the Exemption do. For transactions occurring on or after January 1, 2018, the BIC Exemption is available only if all of its conditions are satisfied.

[7] The final regulatory package modified the proposed rule by eliminating the BIC Exemption's written contract requirement for advice given to ERISA plans and their participants and fiduciaries. The DOL reasoned that those parties already have a remedy under ERISA against advisors who do not adhere to the Exemption's conditions. Non-ERISA plans and IRA owners would not have such a remedy absent the written contract.

What Does it All Mean?

While it affects only one component of one subsection of ERISA and the Tax Code, the final investment-advice fiduciary regulation represents a sea change for the retirement plan industry. A vast number of relationships, products, and services will be subjected to a new regulatory regime under the watchful eye of the Secretary of Labor. Disruption like this can drive innovation and create new markets, products, and services.

Faced with this new scrutiny, however, some advisors may choose to avoid retirement plans and retirement investors altogether, and some investment products may no longer be offered. For others – especially those independent advisors who long ago embraced the fiduciary standard and operated on a fee-for-service basis – the new rules will present more of an opportunity than an operational challenge.

Investment advisors, investment platform providers, recordkeepers, and other vendors will feel the impact of the new rules most directly. Employers and plan-level fiduciaries (such as investment committees) will be affected only indirectly, but nevertheless should closely monitor whether and how their service providers change the way they provide services. Newly created fiduciary relationships with investment advisors and service providers may increase co-fiduciary liability risk for employers and plan-level fiduciaries, and new prohibited transaction rules increase the risk that they will be drawn into non-exempt prohibited transactions. As the tangible effects of the new rules become apparent over the coming months – in the form of new disclosures from advisors and service providers, new or revised service agreements, and/or new services – plan sponsors would be well advised to read the fine print carefully and proceed cautiously.

About the Author:

As the leader of the firm's Employee Benefits Practice Group, Greg Ash helps his clients maximize the value and minimize the risks inherent in their benefit plans. With more than 20 years of experience, Greg translates complicated legal issues under ERISA and the Internal Revenue Code into meaningful decision points for employers. He forecasts risk and identifies opportunities to help his clients meet their business objectives.

Greg uses his substantive knowledge of ERISA and the Tax Code to create unique litigation avoidance strategies and, when necessary, winning defense arguments. He recently served as a panel presenter at the American Conference Institute's National ERISA Litigation Conferences in New York City and Chicago.

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