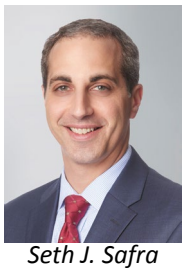

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Expert Interview – The DOL's 2016 Final Fiduciary Rule

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Seth J. Safra of Proskauer Rose LLP discusses the Department of Labor's (DOL's) final regulation concerning fiduciaries and conflicts of interest, published in the Federal Register on April 8, 2016, under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (Code). (In this interview, the term ERISA refers to both Title I of ERISA and the prohibited transaction provisions of section 4975(c) of the Code, unless the context indicates otherwise.) The DOL's *2016 regulatory package* addresses the definition of fiduciary investment advice and certain prohibited transaction class exemptions (PTEs), including two new PTEs — the Best Interest Contract exemption (discussed by Safra below) and a PTE for principal transactions.

The regulatory package aims to protect plans and participants (as well as owners of individual retirement accounts (IRAs) and health savings accounts (HSAs)) against a situation in which an adviser provides investment advice that is conflicted or adversely affected by the adviser's self-interest. This interview explores the objectives and implications of the new rule and Best Interest Contract exemption, as well as some key practical applications.

For a summary of the new rule and Best Interest Contract exemption, and general information on ERISA fiduciaries, fiduciary duties, and prohibited transaction rules, see *Fundamentals of ERISA Fiduciary Duties*. Additional analysis on the implications of the DOL's new fiduciary rule is available on Proskauer's *ERISA Practice Center Blog*.

1. What key issues did the DOL intend to address in the new fiduciary rule?

The new rule was intended to achieve two principal objectives:

- **Expand the types of interactions that are subject to the fiduciary standard.** In the DOL's view, the definition of "investment advice" under regulations issued in 1975 was too easy to contract around. For example, a service provider who was making recommendations that might be perceived as advice could avoid fiduciary responsibility by saying that the recommendation was not intended to serve as the "primary basis" for investment decisions, or that the service provider did not render advice "on a regular basis." In contrast, the new rule generally picks up any investment-related communication that "would reasonably be viewed as a suggestion [to] engage in or refrain from taking a particular course of action" — even if the communicator does not intend to give definitive advice (whether on a primary basis, or otherwise). The new rule also picks up one-time recommendations (e.g., a recommendation to make a particular investment or to roll over from one arrangement to another arrangement), which generally would not have been treated as investment advice under the 1975 definition.

- **Reduce the potential for conflicts of interest.** In particular, the DOL was concerned about service providers taking advantage of a trusting relationship to make recommendations that affect their compensation. For example, the DOL was concerned about service providers guiding their clients toward investment products that generate commissions or other revenue — potentially elevating the service provider's interest in generating a commission above the investor's interest.

In conjunction with the new rule, the DOL issued a new PTE, called the Best Interest Contract exemption, that is designed to achieve both objectives. The stated purpose of the exemption is to offer a principles-based way forward for broker-dealers and other service providers to continue existing compensation arrangements. As one might expect, the exemption includes a host of conditions that are designed to mitigate potential harm from conflicts of interest. But more importantly, the exemption expands the reach of ERISA enforcement by requiring anyone who is deemed to provide investment advice for tax-favored arrangements that are not subject to Title I of ERISA (e.g., IRAs and HSAs) to sign on to a contractual enforcement regime that mirrors the one for ERISA fiduciaries. This means that advisers to arrangements that are not subject to Title I of ERISA can now be subject to state lawsuits that are comparable

to ERISA actions for breach of fiduciary duty — but only if they rely on the Best Interest Contract exemption. This point is discussed in more detail in the answer to question 3, below.

2. What are some of the unexpected effects of the new rule on sponsors of large ERISA plans?

The new rule will have very little direct effect on sponsors of large ERISA plans, most of whom already are ERISA fiduciaries. One effect that might surprise some plan sponsors, though, is that the new rule has a number of carve-outs that allow their service providers to avoid fiduciary responsibility. The DOL's rationale for creating the carve-outs was that the plan sponsor or another fiduciary has oversight responsibility that adequately protects the plan and participants.

The following three carve-outs are premised on the expectation that the plan sponsor, or a fiduciary who is appointed by the plan sponsor (and is not a participant or beneficiary under the plan), retains responsibility:

- **Seller's exception.** The DOL rejected requests for a "buyer beware"-type exception to allow marketing of investment opportunities without fiduciary responsibility, but the final rule includes a seller's exception for advice provided to "qualified" fiduciaries that are assumed to have a requisite level of sophistication, including fiduciaries of plans having at least $50 million in assets. (Note that the seller's exception is much narrower than an exception under the 2010 proposed rule (withdrawn by the DOL) for cases where the recipient of advice knows or should know that the advice is being provided by a purchaser or seller that has an adverse interest.) The seller's exception provides relief for the seller, but it does not relieve the qualified fiduciary of its duty to review the transaction on behalf of the plan. So, for example, suppose that a large ERISA plan invests in a fund, and during the negotiation process the fund manager makes representations about the quality of the fund. The seller's exception might protect the fund manager from fiduciary responsibility for its comments during the negotiation process, but the exception would not relieve the plan's fiduciaries from their independent fiduciary responsibility to evaluate the fund prudently.

- **Platform provider exception.** A "platform provider" exception allows record-keepers and other administrators to avoid fiduciary responsibility based on providing investment menus to 401(k) and other participant-directed plans. The exception assumes that a plan fiduciary (typically the sponsor or a consultant) evaluates and monitors each investment option, and the preamble to the final rule reiterates the plan fiduciary's review and monitoring responsibilities.

- **Investment education exception.** Consistent with existing law, the new rule distinguishes between advice (which is subject to the fiduciary standard) and education (which is not subject to the fiduciary standard). As in past guidance, the new rule emphasizes that even if the education materials are not subject to the fiduciary standard, ERISA's fiduciary obligations apply to the selection and monitoring of the education provider. This means that if the educational materials are defective in some way (for example, they are misleading or gloss over an important principle), the service provider will be exempt from fiduciary responsibility but the fiduciary appointing the service provider will not be off the hook. An important example is asset allocation models that identify investment alternatives available under the plan. Fiduciaries (i.e., plan sponsors or fiduciaries appointed by the sponsor) should evaluate the risk that plan participants might inappropriately rely on the models as if they were vetted recommendations.

In short, plan sponsors and other named fiduciaries need to be diligent when engaging service providers who do not acknowledge and accept fiduciary responsibility. Any responsibility that the service provider does not take could ultimately come back to the plan sponsor or fiduciary who hired the service provider or who was responsible for monitoring the service provider.

3. What practical implications does the new rule have on service providers who did not previously take on fiduciary status?

At least in the "retail" context, which generally refers to IRAs, HSAs, and arrangements that are not subject to Title I of ERISA, as well as small plans, service providers will need to assume that they are subject to ERISA's fiduciary standards. There are limited exceptions, but providing services without fiduciary responsibility will generally require hyper-technical and fact-specific justifications, which would be difficult (if not impossible) to achieve in practice.

The most significant change arising from having fiduciary status will be having to revise compensation arrangements to comply with ERISA's self-dealing rules (ERISA § 406(b) and Code § 4975(c)(1)(E)-(F)). Even for the most loyal and prudent investment adviser, ERISA's self-dealing rules prohibit compensation arrangements where the service provider's compensation can be affected by the service provider's advice or other action (unless a specific exemption applies). For example, except to the extent a specific exemption applies, ERISA prohibits commissions, revenue sharing, and similar arrangements where a fiduciary adviser's compensation is affected by the plan's investments. This is so because the plan's investments are (or at least can be) affected by the adviser's advice.

As previously noted, service providers can use the new Best Interest Contract exemption to continue existing commission, revenue sharing, and similar arrangements. On its face, the Best Interest Contract exemption is attractive because it provides a road map for maintaining the status quo, and it stands for a logical rule that if something is in the client's best interest it should not be prohibited by technical rules.

In practice, though, many service providers will find the Best Interest Contract exemption to be unattractive — at least for IRA, HSA, and other arrangements that are not subject to Title I of ERISA. This is because the exemption's requirements are burdensome and, most importantly, it requires providers to non-ERISA arrangements to give their clients the right to a private ERISA-like cause of action that otherwise would not exist.

Here's what I mean: absent the Best Interest Contract exemption, investment advice fiduciaries of arrangements that are not subject to Title I of ERISA must comply with the prohibited transaction rules under the Code (similar to those under Title I of ERISA), but ERISA's fiduciary duties of prudence and loyalty do not apply. Neither the DOL nor individual investors can bring an ERISA cause of action for a fiduciary breach against such advisers. In contrast, one of the requirements for the Best Interest Contract exemption is to commit contractually to a standard of care that mimics ERISA's duties of prudence and loyalty — giving clients a right to bring a contract-based claim for breach of the ERISA standard of care.

Service providers who find the Best Interest Contract exemption unattractive will want to consider less burdensome PTEs. One approach is to move to level-fee arrangements, under which the service provider's compensation is not affected by the advice provided or the client's investment choices. For example, the fee can be a reasonable fixed dollar amount or fixed percentage of assets under management. (Even with level-fee arrangements, a streamlined version of the Best Interest Contract exemption—without the new ERISA-like cause of action—will be required in some cases, such as marketing an investment opportunity to a new client or recommending that a new client roll over assets to a new IRA. The streamlined version is discussed in question 5, below.)

In any event, service providers will want to review the fiduciary standards of prudence and loyalty, and update policies and procedures to improve compliance. Regardless of what legal standard applies, aspiring to live up to ERISA's prudence and loyalty standards — that is, to give good advice and to watch out for your clients' interests — will be good for business.

4. What existing adviser/service provider relationships will not likely be impacted by the final rule?

The final rule probably will not affect traditional investment advisers and managers — that is, those who regularly provide investment advice or are discretionary managers of pools of assets. Those advisers are already fiduciaries and should have fee arrangements that are designed to qualify for a PTE.

Also, record-keepers for large plans (assets equal or exceed $50 million) and attorneys, actuaries, and other consultants who do not advise on investments generally will not be affected by the final rule. Nevertheless, all service providers should review the broad new definition of investment advice, and develop policies that prohibit discussing investments and distributions in a way that could reasonably be interpreted as investment advice under the new rule.

Finally, the new rule should have little practical impact on service providers to non-ERISA arrangements (e.g., IRAs and HSAs) who are paid a direct fee for the services they provide. Many of those providers will now be fiduciaries, but their only responsibility will be to avoid prohibited transactions — which should not be difficult if their only compensation is through level-fee arrangements. (Discretionary investment advisers will also need to avoid transactions with parties in interest, often relying on PTEs like the qualified plan asset manager (QPAM) exemption or ERISA's service provider exemption. But that is not new under the final rules.)

5. What are some ways in which certain transactions that have been accepted in the past raise issues under the new rule?

Common marketing practices raise issues because the new rule does not have an exemption for retail sales activities. (There is a "hire me" exception for investment advisers to pitch their services, but that exception does not cover specific recommendations.) For example, the new rule raises issues for single-product sales, any pitch to roll over assets from one arrangement to another, selection of investment options (or a menu) for IRAs, HSAs, and small plans, and recommendations to restructure a provider's compensation arrangement.

- **Single-product sales.** Under the new rule, the fiduciary standard will apply for any recommendation related to investment management if the recommendation is directed to a particular individual. The rule carves out general marketing materials and marketing of one's own investment management and advisory services (a "hire me" carve-out), but the DOL states that the fiduciary standard applies if you recommend a particular investment or customize the marketing materials to suggest that a particular investment or strategy is good for a particular client.

- **Rollovers.** As with single-product sales, the carve-outs for marketing do not apply for a recommendation to roll over funds from an employer plan or another tax-favored vehicle to an IRA with a new provider.

- **Selecting an investment menu.** Under the new rule, narrowing the universe of available investment options to a select list (sometimes called an investment platform) is generally subject to the fiduciary standard. The final rule has a platform provider exception, but it is available only for ERISA plans (not IRAs, HSAs, and other non-ERISA arrangements), and only if another fiduciary is responsible for reviewing and selecting funds from the list.

- **Compensation arrangement restructuring.** The DOL states in the preamble to the Best Interest Contract exemption that a recommendation to switch from a commission-based account to a level-fee arrangement can itself be subject to the fiduciary standard: "the prohibited transaction rules could be implicated by a recommendation to switch from a low activity commission-based account to an account that charges a fixed percentage of assets under management on an ongoing basis."

The DOL introduced a streamlined version of the Best Interest Contract exemption to accommodate these common practices where the adviser receives a level fee. Although the streamlined version still requires a written statement of fiduciary status, impartial prudence, and certain other detail (in some circumstances), the streamlined version does not require giving the client a right to sue for breach of the ERISA-like standard of care.

6. What are some practical implications of the new rule on service providers to benefit plans and arrangements?

Service providers to ERISA plans, IRAs, and other tax-favored savings vehicles should review the final rule's impact on their businesses and operations. The impact will vary by provider, depending on things like who the client is (large ERISA plan versus small plan versus IRA), what the service provider offers (non-investment services or broad-based investment services versus single-product sales), and how the service provider markets its services (general marketing materials versus pitches to individuals).

- **Marketing considerations.** Service providers should review their practices and evaluate whether they fall on the fiduciary side of the line. Providers that do not want fiduciary responsibility might need to make adjustments and, either way, they will need to establish policies and train staffs accordingly. Providers who want to avoid fiduciary status will want policies and training on what they can and cannot say. Providers who accept fiduciary responsibility will need to educate their staffs on factors that go into the best interest determination, and they might need to update agreements and compensation structures to qualify for the Best Interest Contract or another exemption.

- **Ongoing business considerations.** A threshold question for every provider that accepts fiduciary status will be how to structure their compensation arrangements. We expect that many fiduciaries, particularly in the non-ERISA space, will prefer level-fee arrangements over commissions and revenue sharing because of the onerous requirements for the Best Interest Contract exemption. In any event, providers will want to adapt their existing policies and training programs to the new rule.

7. What types of materials might be considered investment advice that were previously considered investment education?

In general, the final regulation codifies existing principles for distinguishing between investment education and investment advice, as set forth in DOL Interpretive Bulletin 96-1 — with an important exception for model asset allocations and interactive investment materials:

- Providing a model asset allocation or interactive investment material that includes or identifies specific investments available under the recipient's plan, IRA, or other arrangement will ordinarily be treated as investment advice.

- This treatment does not apply, however, in the case of an ERISA plan for which the investment options were selected by a plan fiduciary who (1) is independent of the service provider, and (2) retains responsibility for monitoring the investment options. In other words, service providers to ERISA plans can continue to provide plan-specific model asset allocations and interactive investment materials without accepting fiduciary responsibility.

The principle here is that models and other material that refer to specific investments can easily be perceived as investment advice (or at least be misused as if they provided investment advice). Even if the model and other material include appropriate disclaimers, participants who are looking for answers tend to behave as if the models were put together with a standard of care appropriate for a fiduciary.

The final regulation provides an exception from fiduciary status for advice to ERISA plans that are subject to fiduciary oversight (the seller's exception discussed in the answers to questions 2 and 8), on the theory that plan fiduciaries can (and should) adequately assess the potential for confusion before engaging the service provider. But buyer beware: although the carve-out protects service providers from fiduciary liability for their models and interactive material, it does not have a safe harbor for the plan fiduciaries who select the providers (or make ultimate investment decisions). Plan fiduciaries engaging service providers should review carefully whether the providers intend to accept fiduciary responsibility, and if they don't accept fiduciary responsibility, the fiduciaries should assess the risk that the "education" being provided might cause more harm than good.

8. Which potential fiduciaries will use (a) the seller's exception, (b) the Best Interest Contract exemption, and (c) the Pension Protection Act exemption for investment advice?

Seller's exception. This exception will be important for parties that deal with large plans in principal transactions, as buyers or sellers. The seller's exception will be particularly important for parties that want to market particular investment funds. A key condition for the seller's exception is that the seller has to deal with a qualified plan fiduciary: the exception is not available, for example, for sales and marketing to small plans or IRA account holders.

Best Interest Contract exemption. This exemption will be used primarily by broker-dealers and other service providers who are compensated by commissions, revenue-sharing, and other indirect arrangements. The streamlined version of the exemption will be used by providers who are compensated through level-fee arrangements to facilitate pre-engagement marketing that is not covered by an exception—for example, suggesting to a client to roll over to an IRA or marketing a particular fund.

Pension Protection Act exemption for investment advice. The Pension Protection Act exemption for investment advice (under ERISA § 408(b)(14) and Code § 4975(d)(17)) will be used primarily by investment advisers where the advice is provided by a computer program and the provider receives commissions, revenue sharing, or other compensation that is affected by particular investments.

9. How will the new rule affect ERISA plan service provider agreements and requests for proposals (RFPs)?

Service provider agreements will inevitably be getting longer. For starters, service providers will need to take a position on whether they are acting in a fiduciary capacity, and they will usually need to state that position in the agreements. (This is already required for most arrangements with ERISA pension plans, but it will now apply for other arrangements.) Depending on which side of the line they are on, service provider agreements will likely include more disclaimers (if the provider does not intend to be a fiduciary), disclosures (fees, information about conflicts of interest, etc.), acknowledgments (reasonableness of fees), and references to outside sources (other documents, websites, etc.) than in the past.

Providers responding to RFPs will want to be careful to avoid falling into the net of fiduciary investment advice. Any response that includes information about investments (such as a sample investment line-up or hypothetical scenarios) should state clearly that the responder is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity. Many responders will choose to avoid specific examples altogether. Responders to RFPs also will need to identify potential conflicts of interest and address them.

10. To what extent do you believe the new rule resolves the issues they were intended to address?

On paper, the new rule seems to address effectively the concern that certain providers have been able to guide their clients' investment decisions in a particular direction without regard to conflicts of interest or the quality of the advice.

For large plans and large individual accounts, the new rule will have very little effect. Those investors typically already pay for level-fee fiduciary advice or at least have access to it.

The jury is still out on whether the final rule will be a net positive for middle class investors. For small plans and individual accounts (i.e., arrangements that cater to middle class investors), the new rule will chill many providers' willingness to provide "free" advice. Of course, free advice isn't worth the price if it is unduly influenced by conflicts of interest and generally not reliable. The question is whether the benefits from the fiduciary standard will be sufficient to justify the added costs that come from a higher compliance burden. Only time will tell.

11. What are the effective and applicability dates for the new regulation and the various PTEs? What is the purpose of the transition period?

The new regulation has a stated effective date of June 7, 2016, but the old "investment advice" standard will continue to apply until April 10, 2017. The effective date for several requirements of the Best Interest Contract exemption is delayed until January 1, 2018. The transition period is intended to give service providers sufficient time to review the new requirements, develop compliance strategies, and update their document and procedures accordingly.

There is a lot of work to be done between now and April 10, 2017. Simply digesting the new rule and evaluating its impact will take most service providers several months. Settling on a compliance strategy and implementing it will take several more, and training staff will take more time after that.