

Employer Action Required Following Issuance of Final Rule

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On April 8, 2016, the Department of Labor (DOL) released the much anticipated final regulation to broaden the scope of fiduciary status under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986, as amended (Code). While the final rule will become officially effective on June 7, 2016, its requirements are not applicable until April 10, 2017. The DOL explained that the purpose in making the rule officially effective right away and yet not applicable until next year was to provide certainty that the rule is indeed final and not subject to modification without additional public notice and comment. Thus, parties affected by the final rule may therefore begin planning for compliance with assurance of the provisions.

The final rule replaces a long-standing regulatory interpretation of the term “fiduciary” as it relates to the provision of investment advice for employee benefit plans and other tax-advantaged accounts, such as individual retirement accounts and health savings accounts (collectively referred to herein as IRAs). Since the issuance of the prior interpretation, there has been significant utilization of participant-directed plans, more rollovers of retirement plan assets, and increased sophistication of financial products. Due to these changes in the marketplace, the DOL concluded that the final rule was necessary, particularly, to protect the interests of participants, beneficiaries, IRA owners, and small plan sponsors (collectively referred to herein as retail investors). The results of the final rule are far reaching. Traditional investment advisors, as well as broker-dealers, insurance brokers, banks, and employers, will be interested in how this rule affects them, and the guidance will undoubtedly continue to develop over the coming months.

This news alert is intended to provide you a general summary of the final rule. Additional news alerts will be distributed to address each component of the final rule and applicable exemptions in detail.

Background of Current Law

Under current law, ERISA imposes standards of care that the United States Supreme Court characterizes as the “highest known to the law.” Fiduciaries that violate these standards of care are personally liable for losses to the applicable plan. Additionally, ERISA prohibits fiduciaries from engaging, directly or indirectly, in prohibited transactions, including self-dealing transactions where conflicts of interest may be present. While similar prohibited transaction rules are prescribed under the Code (and would apply to IRAs, for instance), there is no fiduciary standard of care imposed under the Code with respect to these accounts. Violations of the prohibited transaction rules under either ERISA or the Code can result in significant excise taxes (of up to 100% of the amount involved) being imposed upon the parties and payable to the IRS; however, there is no right on the part of retail investors to pursue any action against an investment advisor for breach of fiduciary duty.

For purposes of ERISA and the Code, the term “fiduciary” is defined on a functional basis to include any person, to the extent, he has or exercises certain discretionary authority, responsibility, or control with respect to plan assets and administration. The final rule does not change the fiduciary status of such persons. For example, administrative committees of plans, investment managers with discretionary authority to manage plan assets and, to some extent, plan sponsors, will continue to be fiduciaries following the release of this rule.

In addition, however, a person is a fiduciary under ERISA and the Code to the extent he renders investment advice for a fee or other compensation (whether direct or indirect) with respect to plan assets, or has any authority or responsibility to do so. Notwithstanding the expansive statutory language describing this latter group, the DOL issued a regulatory interpretation in 1975 that greatly constricted the scope of the definition of “fiduciary” for investment advisors. Several conditions had to be met under this interpretation in order for the advisor to be considered a fiduciary with respect to such advice. Specifically, the advice had to be provided on a *regular basis* to the plan, there had to be a *mutual understanding* of the parties that the advice would serve as the *primary basis* for investment decisions with respect to plan assets, and the advice had to be *individualized* based on the particular needs of the plan.

If any factor of this regulatory test was not satisfied, the person rendering the advice would not be considered a fiduciary by virtue of providing such advice. Under this rule, persons who provided one-time advice, like recommendations for a

rollover from a qualified plan or investment of a rollover into an insurance or annuity product, were not fiduciaries. Noteworthy, the regulatory interpretation included exceptions for the execution of transactions for the purchase or sale of securities on behalf of a plan in the ordinary course of business if certain conditions are met. This regulatory exception remains largely intact under the final rule, except for some clarifying changes.

New Definition of “Fiduciary”

Under the final rule, a person is considered a fiduciary by virtue of rendering investment advice (and is referred to herein as a fiduciary investment advisor) with respect to ERISA plan assets or IRA assets if the person provides to a plan, plan fiduciary, plan participant or beneficiary, or IRA or IRA owner, for a *fee or other compensation*:

1. a *recommendation* about the advisability of acquiring, holding, disposing of or exchanging securities or other investment property, or a *recommendation* as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA; or
2. a *recommendation* as to the management of securities or other investment property, including a *recommendation* on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g. commission-based brokerage v. fee-based advisory), and *recommendations* with respect to rollovers, transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer or distribution should be made.

The final rule does not cover the issuance of an appraisal, fairness opinion or similar statement concerning the value of securities or other investment property. Instead, the DOL intends to issue separate guidance with respect to these activities.

In order to be treated as a fiduciary investment advisor, the *recommendation* must be made directly or indirectly by a person who:

1. Represents or acknowledges that it is acting as a fiduciary within the meaning of ERISA or the Code,
2. Renders the advice pursuant to a *written or verbal agreement, arrangement or understanding* that the advice is based on the particular investment needs of the advice recipient; or
3. Directs the advice to a specific advice recipient(s) regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.

For these purposes, an investment advice fiduciary is not limited to a person registered under the Investment Advisers Act of 1940. On the other hand, not all persons who provide investment advice will be considered fiduciaries under the final rule. Rather, the person must satisfy each of the requirements prescribed in the final rule in order to be considered a fiduciary investment advisor and, further, not be covered by an applicable exception to the rule (as described below).

At the crux of the analysis is whether the advice involves a *recommendation*. The final rule defines “recommendation” 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. Certain activities, however, do not rise to the level of a recommendation. The final rule includes a non-exhaustive list of examples, including certain activities related to the offering of an investment platform for participant-directed plans; the provision of investment education information and materials to plan participants or IRA owners, including asset allocation models and interactive investment materials for plan participants; and general or public communications, provided, in each instance, that certain conditions are met.

Absent the advisor’s receipt of a fee or other compensation, however, the fact that the advisor makes a recommendation will not, by itself, result in the advisor being a fiduciary. Satisfaction of this condition is not limited to a direct payment of fees by the recipient of the advice. Rather, it includes the advisor’s receipt of any fee or compensation received from any source in connection with or as a result of the recommended purchase or sale of a security or the provision of investment advice services. Meaning, the compensation could be paid, among others, as commissions, loads, finder’s fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, underwriting compensation, payments to brokerage firms in return for shelf space, recruitment compensation, gifts and gratuities, and expense reimbursements. Consequently, an advisor will not escape fiduciary status merely because it has not directly charged the recipient for the recommendation.

Even if the advisor receives a fee or other compensation in connection with the recommendation, it will not be a fiduciary investment advisor if any one of three regulatory exceptions applies. The first regulatory exception covers certain transactions, such as sales pitches, that are part of an arm's length transaction with a sophisticated plan fiduciary where neither side assumes that the counterparty to the plan is acting as an impartial or trusted advisor. The second regulatory exception is for certain communications and activities conducted during the course of swap or security-based swap transactions. The third regulatory exception is for certain advice provided by employees of the plan sponsor (or an affiliate).

With the expanded definition of "fiduciary", new groups of persons will now find themselves being regarded as fiduciaries under ERISA and/or the Code. Advisors often receive compensation for advice through a variety of arrangements that may implicate the prohibited transaction rules prescribed under ERISA and the Code. Further, if the person provides advice to an ERISA-governed plan, it will become subject to the standards of care prescribed under ERISA and can be held personally liable for failures to act prudently and solely in the interests of plan participants.

To address this former concern, the DOL, simultaneously with the publication of the final rule, issued a new prohibited transaction exemption referred to as the "**Best Interest Contract Exemption**." The Best Interest Contract Exemption is specifically designed to address the conflicts of interest that exist as a result of various compensation arrangements utilized by fiduciary investment advisors in connection with advice provided to retail investors. In addition, a new "**Principal Transactions Exemption**" has been issued to permit fiduciary investment advisors to sell or purchase certain debt securities and other investments out of their own inventories to or from plans and IRAs. These exemptions require, among other things, that the advisors contractually agree to adhere to certain impartial conduct standards, which include fundamental obligations of fair dealing and fiduciary conduct such as obligations to act in the customer's best interest, avoid misleading statements, and receive no more than reasonable compensation. The DOL also amended existing prohibited transaction exemptions to ensure uniform application of the impartial conduct standards. *The incorporation of these standards into the prohibited transaction exemptions effectively provide IRA owners a contractual right to protections similar to those prescribed under the fiduciary responsibility rules of ERISA.*

The new and amended exemptions supplement existing statutory exemptions and previously adopted class exemptions, as well as previously issued guidance in the form of advisory opinions. Fiduciary investment advisors may continue to rely on these existing exemptions and guidance to avoid a prohibited transaction. In short, reliance on the Best Interest Contract Exemption is not the sole method for avoiding a prohibited transaction with respect to compensation received in connection with the provision of investment advice.

What does this mean for employers who sponsor ERISA-governed plans?

To the extent an employer (including an authorized delegate) is already exercising fiduciary authority or retains fiduciary responsibility with respect to the administration or management of its retirement plan or assets, nothing in this final rule changes that status or the duty to comply with fiduciary standards of care under ERISA and avoid prohibited transactions under ERISA and the Code. As such duty relates to the engagement of investment advisors, employers remain obligated under ERISA to carefully select and monitor all (fiduciary and non-fiduciary) service providers and to pay no more than reasonable compensation to such advisors.

Some advisors engaged by the employer may now be considered fiduciary investment advisors under the final rule. For example, some advisors may select investment alternatives based on the specific needs of the plan and will be treated as having made a recommendation under the final rule. Similarly, some advisors may continue to provide model investment allocations based on actual investment alternatives under the plan, which is also considered a recommendation under the final rule unless certain conditions are satisfied.

Assuming that the selection and ongoing engagement of the advisor satisfies the applicable standard of care under ERISA, the designation of an advisor as a fiduciary does not adversely affect the plan. For example, the employer may continue to rely on the protections of ERISA Section 404(c) for participant-directed investments, where applicable, and will not be liable for losses that are the direct and necessary result of the participants' directions. However, where the fiduciary investment advisor acts imprudently or in violation of the prohibited transaction rules in providing advice to the participants, the ongoing engagement by the employer of that advisor may give rise to co-fiduciary liability under ERISA.

Employers should review applicable service agreements with their advisors, paying particular attention to provisions governing limitations of liability, insurance requirements and indemnification. Employers should also expect that advisors may want to renegotiate their service arrangements for various reasons, such as:

1. To change the scope of investment advice or education provided to the plan or its participants,
2. To revise compensation arrangements to ensure that no prohibited transaction occurs by virtue of the receipt of such compensation,
3. To provide necessary disclosures or acknowledgments to ensure the arrangement fits within an applicable exception to the final rule, and
4. To incorporate required provisions under the newly issued Best Interest Contract Exemption or other applicable prohibited transaction exemptions and advisory opinions to avoid exposure to possible excise taxes.

Noteworthy, the DOL explained that many administrative functions performed by employers will not implicate the final rule. For example, employees of the plan sponsor who routinely develop reports and recommendations for the employer and other fiduciaries of the plan will not generally become fiduciary investment advisors as a result of these activities. Furthermore, the provision of general retirement and investment education by employees of the plan sponsor, including an explanation of required distributions under the plan, is not generally considered investment advice under the final rule. Nonetheless, communications between the employer (or its authorized employees) and the plan participants continue to be subject to general fiduciary duties under ERISA and misrepresentations can result in fiduciary liability to the employer.

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