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The New Fiduciary Rule

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The New Fiduciary Rule

On April 6, 2016, the U.S. Department of Labor (DOL) issued its final rule expanding the "investment advice fiduciary" definition under the Employee Retirement Income Security Act of 1974 (ERISA), modifying the complex of prohibited transaction exemptions for investment activities in light of that expanded definition (the "Rule").[1]

This is the first major rewrite to the fiduciary definition since ERISA was enacted in 1974 and is a key part of the White House's "middle-class economics" initiative. The DOL's motivation for the Rule is to "level the playing field" and to ensure that investment advice given to investors is in their best interest. To do so, the DOL seeks to mitigate conflicts of interest that exist among firms, advisors, and their clients and to address concerns that firms and advisors are incentivized to recommend products or services that may not be in the best interest of the customer.[2]

Overall, the new rule impacts over $12 trillion in individual retirement accounts (IRAs) and 401(k) plans.[3] The Rule went into effect on June 7, 2016. The Applicability date is April 10, 2017.

Definition

ERISA defines a Fiduciary to a plan or IRA as: "person engage[d] in specified plan activities, including rendering "investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan . . . [.]" ERISA safeguards plan participants by imposing trust law standards of care and undivided loyalty on plan fiduciaries, and by holding fiduciaries accountable when they breach those obligations. In addition, fiduciaries to plans and IRAs are not permitted to engage in "prohibited transactions," which pose special dangers to the security of retirement, health, and other benefit plans because of fiduciaries' conflicts of interest with respect to the transactions. Under this regulatory structure, fiduciary status and responsibilities are central to protecting the public interest in the integrity of retirement and other important benefits, many of which are tax-favored."[4]

Intent

The movement to revise the standard definition is driven primarily by the changes in the industry and how Americans save for retirement since ERISA's enactment. Over the past 40 years, there has been a dramatic shift from employer-sponsored defined benefit plans to self-directed IRAs and 401(k)s, requiring customers to self-direct investments through the use of personal investment advisers and broker dealers rather than relying on institutional money managers with set investment return goals. While many investment advisers acted in their customers' best interests,

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[1] https://www.dol.gov/ebsa/regs/conflictsofinterest.html

[2] https://www.whitehouse.gov/the-press-office/2016/04/06/fact-sheet-middle-class-economics-strengthening-retirement-security

[3] https://www.whitehouse.gov/the-press-office/2016/04/06/fact-sheet-middle-class-economics-strengthening-retirement-security

[4] http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806

certain entities, such as broker dealers, were not legally obligated to do so. Consequently, compensation incentives were often misaligned with the best interests of an ERISA account customer, resulting in a lower overall return on the assets.[5]

The Rule broadens the application of the traditional fiduciary standard of acting in the customer's best interest to include the activities of broker-dealers, insurance agents, plan consultants and other intermediaries not previously covered as fiduciaries to ERISA plans and IRAs, thus potentially precluding the agent from receiving certain forms of compensation absent an exemption. This expansion is set forth in the definition of "Covered Investment Advice."

Covered Investment Advice

Covered Investment Advice is defined as a recommendation to a plan, plan fiduciary, plan participant and beneficiary or IRA owner for a fee or other compensation, direct or indirect, as to the advisability of buying, holding, selling or exchanging securities or other investment property, including recommendations as to the investment of securities or other property after the securities or other property are rolled over, transferred or distributed from a plan or IRA.

- Covered Investment Advice also includes recommendations as to the management of securities or other investment property, including, among other things, recommendations 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., brokerage versus advisory); or 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 fundamental threshold element in establishing the existence of fiduciary investment advice is whether a "recommendation" occurred. A "recommendation" is a communication

[5] Ibid. Analysis by the President's Council of Economic Advisers last year showed that:

Working and middle class families receiving conflicted advice earn returns roughly 1 percentage point lower each year (for example, conflicted advice reduces what would be a 6 percent annual return to a 5 percent return).

An estimated $1.7 trillion of IRA assets were invested in products that generally provide payments that generate conflicts of interest. Thus, CEA estimated that the aggregate annual cost of conflicted advice is about $17 billion each year.

A typical worker who receives conflicted advice when rolling over a 401(k) balance to an IRA at age 45 will lose an estimated 17 percent from her account by age 65. In other words, if a worker has $100,000 in retirement savings at age 45, without conflicted advice it would grow to an estimated $216,000 by age 65 adjusted for inflation, but if she receives conflicted advice it would grow to $179,000—a loss of $37,000 or 17 percent.

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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 advice recipient or recipients, the more likely the communication will be viewed as a recommendation.[6]

- The types of relationships that must exist for such recommendations to give rise to fiduciary investment advice responsibilities include recommendations made, either directly or indirectly (e.g., through or together with any affiliate), by a person who:
    - Represents or acknowledges that they are acting as a fiduciary within the meaning of ERISA or the Internal Revenue Code (Code);
    - Renders 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
    - Directs the advice to a specific recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.
    - In order for a recommendation to constitute fiduciary investment advice, it must be rendered for a "fee or other compensation." "Fee or other compensation, direct or indirect" means any explicit fee or compensation for the advice received by the person (or by an affiliate) from any source, and any other 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 including, though not limited to, such things as commissions, loads, finder's fees, and revenue sharing payments. A fee or compensation is paid "in connection with or as a result of" such transaction or service if the fee or compensation would not have been paid but for the transaction or service or if eligibility for or the amount of the fee or compensation is based in whole or in part on the transaction or service.[7]

What Is Not Covered Investment Advice Under the Rule?

Not all communications with financial advisers will be covered fiduciary investment advice. As a threshold issue, if the communications do not meet the definition of "recommendations" as described above, the communications will be considered non-fiduciary. The Rule also includes

[6] The Department has taken an approach to defining "recommendation" that is consistent with and based upon the approach taken by the Financial Industry Regulatory Authority (FINRA), the independent regulatory authority of the broker-dealer industry, subject to the oversight of the Securities and Exchange Commission (SEC). https://www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html

[7] https://www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html

some specific examples of other communications that would not constitute a fiduciary investment advice communications including:

- Education
- General Communications
- Platform Providers
- Transactions with Independent Plan Fiduciaries with Financial Expertise
- Swap and Security-Based Swap Transactions

The BICE Exception

The Department's Best Interest Contract Exemption (which some refer to as the BIC or BICE) ensures retirement investors receive advice that is in their best interest while also allowing advisers to continue receiving commission-based compensation. Under ERISA and the Code, individuals providing fiduciary investment advice to plan sponsors, plan participants, and IRA owners are not permitted to receive payments creating conflicts of interest without a prohibited transaction exemption (PTE). ERISA authorizes the Secretary of Labor to grant PTEs.

The BIC Exemption permits firms to continue to rely on many current compensation and fee practices, as long as they meet specific conditions intended to ensure that financial institutions mitigate conflicts of interest and that they, and their individual advisers, provide investment advice that is in the best interests of their customers. Specifically, in order to align the adviser's interests with those of the plan or IRA customer, the exemption requires the financial institution to acknowledge fiduciary status for itself and its advisers. The financial institution and advisers must adhere to basic standards of impartial conduct, including giving prudent advice that is in the customer's best interest, avoiding making misleading statements, and receiving no more than reasonable compensation. The financial institution also must have policies and procedures designed to mitigate harmful impacts of conflicts of interest and must disclose basic information about their conflicts of interest and the cost of their advice. Importantly, the financial institution may not give its advisers financial incentives to make recommendations that are not in the customer's best interest.[8]

Impact of Rule

The impact of the Rule will be felt by firms across the financial services industry. The Rule fundamentally expands who is deemed to be a fiduciary by widening the range of activities covered by the standard.

The Rule imposes significant operational, compliance and supervisory burdens for broker/dealers, wealth managers/RIAs, bank trust/wealth platforms, retirement services platforms, plan record-

[8] Ibid.

keepers, and plan administrators, and requires all institutions to begin to implement compliance structures around the new requirements.

Issues to Watch

- Court challenges from industry groups to try to derail the Rule are likely. An injunction could push the implementation date further down the road into the next administration, which would allow those new agency officials to decide the remaining details of the Rule's implementation.[9] [10]
- House Republicans have already passed congressional resolutions to kill the Rule, but President Barack Obama has pledged to stop those with a veto, and opponents don't appear to have sufficient support to override.
- Finally, the Rule is increasing the pressure on the SEC to approve a uniform fiduciary standard. SEC Chairwoman Mary Jo White has previously indicated she supports this modification.

[9] http://legalnewsline.com/stories/510719100-class-actions-will-test-dol-s-new-fiduciary-rule-attorney-says
[10] http://www.benefitspro.com/2016/07/25/the-key-question-in-nafas-lawsuit-against-the-dol

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Aileen Doherty is a Senior Compliance Consultant and Trainer affiliated with Bekker Compliance Consulting Partners, LLC (BCCP). Aileen also serves as an Independent Consultant, Executive Attorney, and Chief Compliance Officer with broad International and US Financial Services expertise. She has worked extensively with investment advisers and broker-dealers, as well as with retail, private, and investment banks. Aileen provides strategic counsel for nonprofit organizations and governmental entities.

Aileen's career experience has provided her with significant expertise in the following regulatory areas: The Investment Advisers Act of 1940, Investment Company Act of 1940, Dodd-Frank, and the Fiduciary Standard. She also has working knowledge of the Securities Act of 1933, Securities Exchange Act of 1934, Commodities Exchange Act, USA PATRIOT Act, and ERISA. Her current focus is on anti-money laundering and cyber-security.

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