Client Alert | Employment, Compensation & Benefits

DOL issues final fiduciary rule defining "investment advice" under erisa and the code

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Authors: Henrik Patel, Victoria Rosamond, Robin Heszkel

New Rule Introduces Significant Changes to Fiduciary Advice Definition, Revises Existing Prohibited Transaction Exemptions, and Creates New Prohibited Transaction Exemptions.

Introduction

On April 6, 2016, the U.S. Department of Labor ("DOL") issued its long-awaited *final rule*[1] that re-defines "investment advice" for purposes of determining who is a "fiduciary" of employee benefit plans (such as retirement plans and health savings accounts) and individual retirement accounts ("IRAs") under ERISA and the U.S. Tax Code. The final rule, which will become effective in April 2017, comes almost six years after the DOL's first proposed new rule[2] on this topic in October 2010, and a year after the DOL re-proposed[3] the rule in 2015; it largely adopts the general structure of the 2015 proposal, but with certain modifications (as described in a helpful chart[4] on the DOL website) made in response to numerous commentator requests for changes or clarification.

The result of the final rule is, as expected, that many more professionals who make investment-related recommendations to employee benefit plans and IRAs may now be considered fiduciaries of such plans requiring them to adhere to ERISA's fiduciary standards, including the duties of prudence and loyalty, and prohibited transaction exemption requirements (non-fiduciary advisers are generally held to a 'suitability' standard meaning that they can sell products that suit an investor's needs and risk tolerance without disclosing any conflicts of interest). Investment professionals will need to consider (i) whether their dealings with employee benefit plans and IRAs make them a fiduciary for purposes of the final rule and, if so whether an exception applies, and (ii) if fiduciary status cannot be avoided, whether a prohibited transaction exemption ("PTE") is available such that they may continue to sell their services to such plans (after taking any necessary steps in order to avail themselves of the applicable PTE).

1 Final 2016 Regulations
2 2010 regulations
3 2015 regulations
4 DOL Comparison Chart

What are the Key Features of New Fiduciary Rule?

Expanded Fiduciary Status - All those who make "Recommendations"

The existing five-part test[5] that formed the basis for determining when a person should be treated as a fiduciary investment adviser has been replaced and only the final prong of the old test regarding the provision of "individualized" advice remains a part of the new analysis.

Under the new rule, fiduciary investment advisor status will occur if a person makes certain "recommendations" (as described below) for a fee and (A) represents or acknowledges that they are acting as a fiduciary within the meaning of ERISA or the Code, (B) renders advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the recipient, or (C) 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 employee benefit plan or IRA.

What are Recommendations?

A recommendation is a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the recipient of the advice engage in or refrain from taking a particular course of action and includes:

- A recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property.
- 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.
- A recommendation 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, distributions, or transfers 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 determination of whether a recommendation has been made is an objective rather than subjective inquiry and 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. A series of actions, directly or indirectly (e.g., through or together with any affiliate), that may not constitute recommendations when viewed individually may be considered recommendations when taken together as a whole.

Are there any Exceptions to the Definition of "Recommendation" under the Final Rule?

The final rule sets out a number of exceptions from the definition of recommendation. In determining whether or not the exception applies, it is important to remember the DOL's mantra "content, context, and presentation," which could turn one of the following exceptions into a "recommendation".

- General Communications: Making general communications and commentary on investment products (such as television, radio, and public media talk show commentary, remarks in widely attended speeches and conferences, and financial newsletters), marketing or making available a menu of investment alternatives that a plan fiduciary could choose from, and identifying investment alternatives that meet objective criteria specified by a plan fiduciary.

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5 The old test required that a person: (i) render advice as to the value of, or make recommendations as to the advisability of investing in, purchasing, or selling securities or other property; (ii) on a regular basis; (iii) pursuant to a mutual agreement, arrangement, or understanding with the plan or a plan fiduciary; that (iv) the advice serve as a primary basis for investment decisions; and (v) the advice be individualized based on the particular needs of the plan or IRA.

- Investment Education: The final rule excludes from the definition of "recommendation" investment education, including asset allocation models and interactive investment materials that reference specific investment alternatives (if presented as a hypothetical example and not as an investment recommendation). Note, the rule does not create a similar safe harbor from fiduciary status for such "hypothetical" examples in the IRA context (as there is no independent plan fiduciary to review and select investment options).

- Platform Providers and Selection and Monitoring Assistance: Service providers, such as record keepers and third-party administrators, will not be considered to make "recommendations" simply by making available (without regard to the individualized needs of the plan or its participants and beneficiaries) a platform of investment vehicles from which plan participants may direct the investment of assets in their individual accounts. However, the plan fiduciary must be independent of the person who markets or makes available the investment alternatives and the service provider must disclose in writing to the plan fiduciary that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

- "Hire Me" Exception: The final rule clarifies that an adviser can recommend that a customer hire them to provide advisory or asset management services without becoming a fiduciary. However, when a recommendation to "hire me" includes a recommendation on how to invest or manage plan or IRA assets (e.g., whether to roll assets into an IRA or plan or how to invest assets if rolled over), that recommendation would need to be evaluated separately under the provisions in the final rule.

Are there any Other Exceptions to Investment Advice Fiduciary Status?

The final rule exempts certain recommendations from conferring fiduciary status, provided that the person conducting the activity has not acknowledged that they are a fiduciary with respect to the recommendation. Again, consideration must be given to the "content, context, and presentation," of the recommendation, which could turn one of the following exceptions into investment advice and confer fiduciary status on an advisor:

- Transactions with Independent Fiduciaries with Financial Expertise: Advice provided to an independent fiduciary of the adviser in the context of arm's length transactions will not result in fiduciary status for the adviser if the independent fiduciary is (i) a licensed financial professional (e.g. a broker-dealer, registered investment adviser, bank, insurance company), or (ii) a plan fiduciary that has at least $50 million under management. The adviser must fairly inform the independent plan fiduciary that they are not providing impartial investment advice, not giving advice in a fiduciary capacity, and that they have a financial interest in the applicable transaction. The adviser must also know or reasonably believe that the independent fiduciary of the employee benefit plan or IRA is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies. The final rule expressly provides that the adviser may rely on written representations from the plan or independent fiduciary to satisfy this condition.

- Swap and Security-Based Swap Transactions: Persons acting as swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants do not become investment advice fiduciaries as a result of communications and activities conducted during the course of swap or security-based swap transactions.

- Employees of Plan Sponsors, Plans, or Plan Fiduciaries: A person is not an investment advice fiduciary if, in their capacity as an employee, they provide advice to a plan fiduciary, or to an employee (other than in his or her capacity as a participant or beneficiary of a plan) or independent contractor of a plan sponsor, affiliate of the plan sponsor, or employee benefit plan, so long as the person does not receive a fee or other compensation in connection with the advice beyond the employee's normal employment compensation.

If No Exception Applies and One is an Investment Advice Fiduciary, can One Continue to Provide Services to Plans or IRAs in Exchange for Fees?

The DOL has separately published final versions of two new PTEs: (i) the Best Interest Contract ("BIC") exemption ,and (ii) the Principal Transactions ("PT") exemption, as well as certain amendments to existing class exemptions that are intended to preserve the ability of certain investment advisers to continue to receive common forms of compensation that would otherwise be prohibited as conflicts of interest, so long as such advisers are willing to adhere to a new "best interest" standard of care.

The exemptions generally require the acknowledgement of fiduciary status, the adoption of policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest, and the disclosure of basic information about conflicts of interest and the cost of advice. If advice is provided to an IRA investor or a non-ERISA plan, the financial institution will also be required to set forth the standards of fiduciary conduct and fair dealing in an enforceable contract with the investor. The BIC only applies to certain asset types such as mutual funds, insurance and annuity products, as well as individual equity securities. Transactions in alternative investment products such as real estate, non-publicly traded securities, hedge funds or private equity funds are not eligible for the BIC and the PT exemption offers no additional relief in this regard.

What is the Expected Impact of the Final Rule?

The final rule can be expected to have a significant impact on the practices of financial/investment advisers who will now need to consider changing their business practices when dealing with employee benefit plans and IRAs including (i) whether and how to comply with the terms and conditions of BIC and/or (ii) altering their fee arrangements and contracts to satisfy the another exception or PTE.

In particular, fund sponsors will need to consider carefully the applicability of the new rules in relation to investments by IRAs. While it seems likely that the transactions with independent fiduciaries with financial expertise exception will provide relief from investment advice fiduciary status for such funds with respect to ERISA plan investments, this exception is unlikely to provide relief with respect to investments by IRAs. Fund sponsors will, therefore, need to consider whether any other exception would apply to such investments (e.g. the “general communications” exception) or whether IRAs should be excluded from the offering.

White & Case LLP
1155 Avenue of the Americas
New York, New York 10036-2787
United States

T +1 212 819 8200