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U.S. Department of Labor Finalizes Fiduciary Definition and Conflict of Interest Rule

April 19, 2016

On April 6, 2016, the U.S. Department of Labor (Department) issued its highly anticipated final rule addressing when a person is considered to be a fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (Code) as a result of providing investment advice to a plan (including an individual retirement account (IRA)) or its participants or beneficiaries. As discussed below, the final rule (available here) offers a definition of fiduciary investment advice that expands the group of people who would be considered fiduciaries.

The Department also finalized a new Best Interest Contract Exemption (BICE) and amended other prohibited transaction class exemptions (PTCEs) applicable to fiduciaries that would allow certain broker-dealers, insurance agents and others who provide investment advice to continue to engage in certain transactions and to receive common forms of compensation that otherwise would be prohibited as conflicts of interest. The BICE and amendments to the PTCEs will be addressed in separate forthcoming Client Alerts.

Background

ERISA provides that "a person is a fiduciary with respect to a plan to the extent . . . he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so." ERISA § 3(21)(A)(ii). Pursuant to a 1975 regulation, in order for a person to be held to ERISA's fiduciary standards with respect to investment advice for a fee, such person must: (i) make recommendations as to investing in, purchasing or selling securities or other property, or give advice as to their value, (ii) on a regular basis, (iii) pursuant to a mutual understanding that the advice, (iv) will serve as a primary basis for investment decisions with respect to plan assets, and (v) will be individualized to the particular needs of the plan.

The Department first published a new proposed rule on October 2010. In doing so, the Department stated its belief that the existing regulatory scheme no longer adequately protected plans, participants and beneficiaries. Facing immense pressure, on September 2011, the Department stated that the proposal would be withdrawn and that a new proposal would be issued at a later date.

In April 2015, the Department proposed a new set of rules on the belief that the new proposal was necessary to adequately protects plans, participants, beneficiaries, and, in particular, IRA owners (to which ERISA's current fiduciary rules regarding prudence and loyalty do not apply) from conflicts of interest, imprudence and disloyalty. The Department explained that under current law many investment professionals are not subject to ERISA's fiduciary standards and thus, in its view, have the ability to operate with undisclosed conflicts of interest. Addressing concerns raised over the past several years, the Department stated that it has consulted with other federal regulators, including the Securities Exchange Commission (SEC), concerning whether the proposal would subject investment professionals who provide investment advice to requirements that are overly burdensome or conflict with their obligations under other federal laws.

Since then, lobbyists on both sides of the issue have been voicing their concerns and views about the Department's proposal. The Department stated that it received over 3,000 comments and held four days of hearings (collectively, referred to herein as "comments"). Now, the final rule has been published and will apply as of April 10, 2017.

The Final Rule

The final rule first describes the kinds of communications or categories of advice that constitute "investment advice." It then describes the types of relationships and circumstances that give rise to fiduciary investment advice and thus subjecting the advice provider to fiduciary standards and certain prohibited transaction rules intended to address conflicts of interest and those types in which they do not. Below are summaries of these two parts of the final rule, along with observations on the differences between the final rule and the proposed rule.

(a) *Investment Advice*

The final rule describes the types of advice communications provided to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner, which, when provided for a fee or other compensation, directly or indirectly, and given under certain circumstances (discussed below), would be "investment advice."

(1)(i) *Investment Recommendations.* *"A recommendation as to 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."*

The Department modified the proposal rule to make it clear that the adviser must make a recommendation with respect to the advisability of acquiring, holding, disposing or exchanging securities or other investment property to fall within this section of the rule. Accordingly, recommendations to purchase group health, disability, term life or similar insurance policies that do not have an investment component are not covered. The final rule creates an important distinction between investment advice and investment education (discussed below).

(1)(ii) *Investment Management Recommendations.* *"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, 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."*

In response to comments that the term "management" should be clarified, the final rule adds examples (stated in the italicized text above) to clarify the scope of the definition. The revisions also are intended to make clear that advice providers cannot avoid fiduciary responsibility for recommendations to roll over plan or IRA assets (*e.g.*, to a mutual fund provider) by not including in that recommendation any advice on how to invest the assets after they are rolled over. To that end, the final rule supersedes the Department's position in Advisory Opinion 2005-23A (Dec. 7, 2005).

In addition, this provision was amended to include recommendations regarding the "selection of other persons to provide investment advice or investment management services," which was contained in a separate provision in the proposed rule. This was done to better reflect that recommendations of persons to perform investment management services for plans or IRAs are examples of recommendations on investment management.

The Department also provided its view on a number of comments to the proposed rule in the summary of the final rule:

- ???A special rule for sales and marketing of proprietary products was unnecessary.

- ???The fact that an organization is exempt from tax under the Code or that it has an educational or charitable mission does not provide a basis for excluding investment advice provided to plan or IRA investors by those organizations from fiduciary regulation.

- ???Actuaries, accountants, and attorneys – who historically have not been treated as ERISA fiduciaries for plan clients – would not become fiduciaries investment advisers by reason of providing actuarial, accounting, or legal services.

- ???The final rule does not alter ERISA Interpretive Bulletin 75-8, D-2 at 29 C.F.R. § 2509.75-8 (1975), which explains that a plan sponsor's human resources personnel or plan service providers who have no power to make decisions as to plan policy, interpretations, practices, or procedures, but who perform purely administrative functions for an employee benefit plan, within a framework of policies, interpretations, rules, practices and procedures made by other persons, are not thereby investment fiduciaries with respect to the plan.

- ???ERISA § 404(c) would not provide any relief from liability for a fiduciary investment adviser for investment advice provided to a participant or beneficiary.

- ???Merely advising a participant or IRA owner that certain minimum distributions are required by tax law would not constitute investment advice.

- ???The Department did not believe special clarification was needed with respect to foreign exchange transactions, the internal operation of stable value funds, and

options trading. The Department noted that recommendations on foreign exchange transactions and options trading clearly can involve recommendations on investment policies or strategies and portfolio composition.

- A person or firm can tout the quality of his, her or its advisory or investment management services and recommend that a plan or IRA investor enter into an advisory relationship with the adviser without triggering fiduciary obligations. However, when a recommendation to "hire me" effectively 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 could trigger fiduciary obligations.

- The final rule does not carry forward a provision in the proposed rule covering appraisals and valuations as investment advice and appraisals and valuations will instead be addressed in a separate project.

Fee Or Other Compensation

Fiduciary status under ERISA requires that the investment advice be provided for a "fee or other compensation, direct or indirect." The final rule defines this phrase to mean *"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 purchase or sale of a security or the provision of investment advice services, including though not limited to, 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 paid in connection with transfers of accounts to a registered representative's new broker-dealer firm, gifts and gratuities, and expense reimbursements. 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."*

(a)(2) *The Circumstances Under Which Advice Is Provided*

A person would be considered a fiduciary investment adviser in connection with a recommendation, if the recommendation is made either directly or indirectly (*e.g.*, through or together with any affiliate) by a person who:

(i) Represents or acknowledges that he or she is acting as a fiduciary within the meaning of ERISA or the Code with respect to the advice described in Section (a)(1);

(ii) 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

(iii) Directs the advice to a specific advice 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.

Advisers who claim fiduciary status may not later argue that their advice was not fiduciary in nature. The final rule does not require a meeting of the minds as to the extent to which the recipient will actually rely on the advice, but the parties must agree or understand that the advice is individualized or specifically directed to the particular advice recipient for consideration in making investment decisions. There is no requirement that the advice be specific to the needs of the plan, participant or beneficiary or IRA owner; rather, the advice only needs to be specifically directed to such recipient. There is no requirement that the advice be provided on a regular basis.

(b) *Definition of Recommendation*

In response to comments expressing concern or confusion regarding several of the "carve-outs" from the definition of recommendation identified in the proposed rule, the Department determined that the carve-out approach was not the best way – structurally or definitionally – to delineate the scope of investment advice. Instead, the final rule uses an alternative approach (discussed below) for describing the scope of what constitutes a "recommendation."

The final rule clarifies and reclassifies the "carve-outs" in the proposed rule as either (i) examples of communications and activities that are not recommendations (and thus not fiduciary investment advice), or (ii) communications that might constitute recommendations but nevertheless do not constitute fiduciary investment advice.

(b)(1) *Communications and Activities That Constitute "Recommendations"*

A "recommendation" means *"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. The determination of whether a 'recommendation' has been made is an objective, rather than subjective inquiry. In addition, the more individually tailored the communication is to a specific advice recipient or recipients about, for example, a security, investment property, or investment strategy, the more likely the communication will be viewed as a recommendation. Providing a selective list of securities to a particular advice recipient as appropriate for that investor would be a recommendation as to the advisability of acquiring securities even if no recommendation is made with respect to any one security. Furthermore, a series of actions, directly or indirectly (e.g., through or together with any affiliate), that may not constitute a recommendation when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program."*

(b)(2) *Communications and Activities That Do Not Constitute "Recommendations"*

(i) Platform Providers

This provision is intended to cover service providers, such as record-keepers and third-party administrators, that offer a "platform" or selection of investment vehicles to participant-directed individual account ERISA plans, but not to plan participants and beneficiaries, and IRAs. The final rule makes clear that persons would not be providing investment advice by marketing or making available to a plan specific investment alternatives to be made available to participants, without regard to the individualized needs of the plan or its participants and beneficiaries, as long as the plan fiduciary is independent of the person who markets or makes available the investment alternatives and the platform provider discloses in writing that it is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

(ii) Selection and Monitoring Assistance

The final rule provides that certain common activities that platform providers may carry out to assist plan fiduciaries in selecting and monitoring investment alternatives that they offer to participants are not recommendations, such as (a) identifying investment alternatives meeting objective criteria specified by the plan fiduciary (*e.g.*, expense ratios, fund size, or asset type or credit quality), (b) in response to a request, identifying a limited or sample set of investment alternatives based on only the size of the plan or employer, the current designated investment alternatives, or both, or (c) providing objective financial data regarding available alternatives to the plan fiduciary. With respect to the first two examples, the person identifying the investment alternatives must disclose in writing whether the person has a financial interest in any of the identified investment alternatives and, if so, the precise nature of that interest.

(iii) General Communications

A recommendation does not include the furnishing of "general communications" that a reasonable person would not view as an investment recommendation, including general circulation newsletters, television, radio, and public media talk show commentary, and remarks in widely attended speeches and conferences; research reports prepared for general distribution, general marketing materials, general market data, including data on market performance, market indices, or trading volumes, price quotes, performance reports, or prospectuses.

(iv) Investment Education

Furnishing or making available educational information and materials to a plan, plan fiduciary, participant, beneficiary or IRA owner will not constitute the provision of investment advice, regardless of who provides the information (*e.g.*, plan sponsor, fiduciary or service provider), the frequency with which the information is shared, the form in which it is provided (*e.g.*, on an individual or group basis, in writing or orally, via a call center, or by way of video or computer software), and whether an identified category of information and materials is provided or made available alone or in combination with other categories identified, or the type of plan or IRA involved.

The final rule incorporated much of Interpretive Bulletin 96-1 (IB 96-1). The categories of investment education information and materials include, but are not limited, to certain: (a) plan information that, for example, describes the terms or operation of a plan or IRA; (b) general financial, investment and retirement information (such as effects of inflation and historic differences in rates of return between different asset classes); (c) asset allocation models; and (d) interactive investment materials (that, for example, provide a means to estimate future retirement income).

In response to comments to the proposed rule, the Department made several adjustments and the final rule provides that asset allocation models and interactive investment materials can identify a specific investment product or specific alternative available under plans and be considered education (and not a fiduciary investment recommendation) if: (1) the alternative is a designated investment alternative under an employee benefit plan; (2) the alternative is subject to fiduciary oversight by a plan fiduciary independent of the person who developed or markets the investment alternative or distribution option; (3) the asset allocation models and interactive investment materials identify all the other designated investment alternatives available under the plan that have similar risk and return characteristics, if any; and (4) the asset allocation models and interactive investment materials are accompanied by a statement that identifies where information on those investment alternatives may be obtained. The final rule does not, however, deem such communications "education" and not fiduciary investment recommendations when made to IRA owners.

(c) *Persons Not Deemed Investment Advice Fiduciaries*

The final rule provides that certain communications and activities shall not be deemed to be fiduciary investment advice, including counterparty transactions, swap transactions, and certain employee communications.

(1) Transactions with Independent Plan Fiduciaries with Financial Expertise

Fiduciary status does not attach to advice and recommendations made to an expert plan fiduciary (including a fiduciary of an entity that holds plan assets) in an arm's-length sale, purchase, loan, exchange, or other transaction related to the investment of securities or other property where there is generally no expectation of fiduciary investment advice, provided several conditions are satisfied. A person shall not be deemed to be a fiduciary solely because of the provision of any advice to an independent fiduciary of a plan or IRA with respect to an arm's length sale, purchase, loan, exchange, or other transaction involving the investment of securities or other property, if, prior to entering the transaction the person providing the advice satisfies the following requirements:

1. The person knows or reasonably believes that the independent fiduciary of the plan or IRA is: (A) certain regulated and supervised banks; (B) an insurance carrier which is qualified under the laws of more than one state to perform the services of managing, acquiring or disposing of assets of a plan; (C) a registered investment adviser; (D) a registered broker-dealer; or (E) any other person acting as an independent fiduciary that holds, or has under management or control, total assets of at least $50 million. The person may rely on written representations from the plan or independent fiduciary to satisfy this condition.

   The $50 million threshold is a change from the proposed rule, which would have required $100 million in assets for the exclusion to apply. The final rule reflects the Department's desire to ensure that it appropriately distinguishes between incidental advice as part of an arm's-length transaction, with no expectation of trust or acting in the customer's best interest, from those instances where a customer may be expecting unbiased investment advice that is in its best interest.

2. The person knows or reasonably believes that the independent fiduciary of the plan or IRA is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies. The person may rely on written representations from the plan or independent fiduciary to satisfy this condition.

3. The person fairly informs the independent plan fiduciary that the person is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with the transaction and must fairly inform the independent plan fiduciary of the existence and nature of the person's financial interests in the transaction.

4. The person knows or reasonably believes that the independent fiduciary is a fiduciary under ERISA or the Code, or both, with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction. The person may rely on written representations from the plan or independent fiduciary to satisfy this requirement.

5. The person does not receive a fee or other compensation directly from the plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner for the provision of investment advice (as opposed to other services) in connection with the transaction.

The counterparty exclusion does not apply to recommendations to retail investors, including small plan fiduciaries, IRA owners and plan participants and beneficiaries. The Department believes that recommendations to retail investors and small plan providers generally are not "arm's-length" and are presented routinely as advice, consulting, or financial planning services.

(2) 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 regulated under the Dodd-Frank Act provisions in the Commodity Exchange Act or the Securities Exchange Act of 1934 and applicable CFTC and SEC implementing rules and regulations if certain conditions are met. The following conditions must be satisfied for this provision to apply:

1. In the case of a swap dealer or security based swap dealer, the person is not acting as an adviser to the plan (within the meaning of Section 4s(h) of the Commodity Exchange Act or Section 15f(h) of the Securities Exchange Act of 1934) in connection with the transaction;

2. The employee benefit plan must be represented in the transaction by an ERISA fiduciary independent of the person;

3. The person does not receive a fee or other compensation directly from the plan or plan fiduciary for the provision of investment advice (as opposed to other services) in connection with the transaction; and

4. In advance of providing any recommendations with respect to the transaction, the person obtains a written representation from the independent plan fiduciary that the independent fiduciary understands that the person is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with the transaction and that the independent plan fiduciary is exercising independent judgment in evaluating the recommendation.

(3) Employees

A person is not an investment advice fiduciary if, in his or her capacity as an employee of a plan sponsor of an ERISA plan, employees of an affiliate of such plan sponsor, employees of an employee benefit plan, employees of an employee organization, and employees of a plan fiduciary, the person provides 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 to an independent contractor of a plan sponsor, affiliate and plan, provided the person receives no fee other compensation, direct or indirect, in connection with the advice beyond their normal compensation for work performed for the employer.

This rule protects internal employees, such as human resources professionals, who routinely may develop reports and recommendations for investment committees and other named fiduciaries of sponsors' plans. The final rule was revised from the proposed rule to clarify that it covers employees even if they are not the persons ultimately communicating directly with the plan fiduciary (*e.g.*, employees in financial departments that prepare reports for the CFO who then communicates directly with a named fiduciary of the plan).

Similarly, the exclusion also covers communications between employees (*e.g.*, human resources department staff) communicating information to other employees about the plan and distribution options in the plan subject to certain conditions. Specifically, the exclusion covers circumstances where an employee of the plan sponsor of a plan, or as an employee of an affiliate of such plan sponsor, provides advice to another employee of the plan sponsor in his or her capacity as a participant or beneficiary of the plan, provided the person's job responsibilities do not involve the provision of investment advice or investment recommendations, the person is not registered or licensed under federal or state securities or insurance laws, the advice they provide does not require the person to be registered or licensed under federal or state securities or insurance laws, and the person receives no fee or other compensation, direct or indirect, in connection with the advice beyond the employee's normal compensation for work performed for the employer.

(d) *Scope of Fiduciary Duty – Investment Advice*

A person who is a fiduciary with respect to a plan or IRA by reason of rendering investment advice for a fee or other compensation, direct or indirect, with respect to any securities or other investment property of such plan or IRA, or having any authority or responsibility to do so, shall not be deemed to be a fiduciary regarding any assets of the plan or IRA with respect to which such person does not have such authority, control or responsibility. However, the absence of such authority, control or responsibility does not exempt such person from the provisions of Section 405(a) of ERISA, or exclude such persons from the definition of the term "party in interest" under ERISA or "disqualified person" under the Code with respect to any assets of the employee benefit plan or IRA.

(e) *Execution of Securities Transactions*

(1) A person who is a broker or dealer registered under the Exchange Act, a reporting dealer who makes primary markets in securities of the United States Government or of an agency of the United States Government and reports daily to the Federal Reserve Bank of New York its positions with respect to such securities and borrowings thereon, or a bank supervised by the United States or a State, shall not be deemed to be a fiduciary with respect to a plan or IRA solely because such person executes transactions for the purchase or sale of securities on behalf of such plan in the ordinary course of its business as a broker, dealer, or bank, pursuant to instructions of a fiduciary with respect to such plan or IRA, if:

1. Neither the fiduciary nor any affiliate of such fiduciary is such broker, dealer, or bank; and

2. The instructions specify:
   (A) The security to be purchased or sold;
   (B) A price range within which such security is to be purchased or sold, or, if such security is issued by an open-end investment company registered under the Investment Company Act of 1940, a price which is determined in accordance with Rule 22c1 under the Investment Company Act of 1940;
   (C) A time span during which such security may be purchased or sold (not to exceed five business days); and
   (D) The minimum or maximum quantity of such security which may be purchased or sold within such price range, or, in the case of a security issued by an open-end investment company registered under the Investment Company Act of 1940, the minimum or maximum quantity of such security which may be purchased or sold, or the value of such security in dollar amount which may be purchased or sold, at the price referred to above.

(2) A person who is a broker-dealer, reporting dealer, or bank which is a fiduciary with respect to a plan or IRA solely by reason of the possession or exercise of discretionary authority or discretionary control in the management of the plan or IRA, or the management or disposition of plan or IRA assets in connection with the execution of a transaction or transactions for the purchase or sale of securities on behalf of such plan or IRA which fails to comply with the provisions of paragraph (e)(1) of this section, shall not be deemed to be a fiduciary regarding any assets of the plan or IRA with respect to which such broker-dealer, reporting dealer or bank does not have or exercise any discretionary authority, discretionary control or discretionary responsibility, does not render investment advice for a fee or other compensation, and does not have any authority or responsibility to render such investment advice. However, the absence of such authority, control or responsibility does not exempt such person from the provisions of Section 405(a) of ERISA, or exclude such persons from the definition of the term “party in interest” under ERISA or “disqualified person” under the Code with respect to any assets of the employee benefit plan or IRA.

Applicability Date

The final rule applies April 10, 2017.

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