

DOL Rule Re-Defining Investment Advice Fiduciary Status

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Executive Summary

- April 20, 2015-US Department of Labor (DOL) published a re-proposed regulation that would dramatically alter the definition of fiduciary investment advice set forth in the existing regulation that has been in effect for 40 years
- The DOL provided a comment period on the proposed regulation ending in July of 2015, and held hearings the week of August 10, 2015
- April 8, 2016-Final regulation was issued
- June 7, 2016-"Official" effective date of the final revised definition of fiduciary investment advice and the date on which related new and revised exemptions are considered issued.
- DOL rule applies to all plans subject to ERISA as well to retirement savings plans and accounts subject to Section 4975 of the Internal Revenue Code (IRC), most significantly, IRAs
- Rule materially expands the range of activities that would result in Investment Advisor fiduciary status under ERISA. It also modifies the definition of investment education which has been relied on by the financial services industry for almost two decades
- April 10, 2017-Final rule fully applicable , exemptive relief available
- January 1, 2018-Final rule and all related new or revised exemptions and requirements are applicable
- April 10, 2017-January 1, 2018-Best Interest Contract exemption relief available with limited applicable conditions

Prior Rule-Fiduciary Investment Advice

- Five-part test provides that if, and only if, **all five requirements listed below** are satisfied and a direct or indirect fee received he or she will be considered to be a fiduciary under ERISA:
 - the **advice is rendered** as to the value of securities or other property, investment recommendations, or purchasing or selling securities or other property
 - on a **regular basis**
 - pursuant to a **mutual agreement**
 - to be used as the **primary basis for investment decisions** and
 - was **individualized** to the needs of the advice recipient
- The final rule significantly expands the circumstances under which service providers and financial advisors may become Investment Advice fiduciaries under ERISA as certain key components of the five-part test would no longer apply
 - Advice no longer needs to be provided on a ***regular basis***; a one-time investment recommendation is sufficient
 - The parties would no longer need to have a ***mutual understanding*** that investment advice is being provided
 - Investment recommendations would no longer need to serve as ***the primary basis*** for investment decisions

Final Rule-Fiduciary Investment Advice

- A person will become a fiduciary under ERISA and IRC Section 4975 if one of each of the **Advice Services and Advisor Status** requirements are satisfied for a fee (direct or indirect)

Advice Services: a person or legal entity will satisfy the **advice service** category if any one of the following is provided to a plan, plan sponsor, plan participant, beneficiary, IRA, or IRA owner:

- Investment recommendations as to the advisability of acquiring holding, disposing of, exchanging securities or other investment properties; **or**
- Management recommendations, including persons to provide investment advice or management services, selection of investment account arrangements, recommendations with respect to rollovers, transfers, distributions involving retirement accounts; **or**
- Recommendations as to how securities or other investment property should be invested

Advisor Status: a person will satisfy the **advice status** category in they:

- Represents that he or she is acting as an ERISA fiduciary regarding assets for which an investment recommendation was provided; **or**
- Provides advice pursuant to a written or verbal agreement, arrangement; **or** understanding that the advice is based on the particular needs of the advice recipient; **or**
- Directs the advice to a specific recipient regarding the advisability of a particular investment or management decision with respect to ERISA plan or IRA securities or other investment property

Investment or Management “Recommendation” Defined

- Recommendation- 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 a particular course of action

- Activities that do not constitute a “recommendation” under the final rule:
 - **“Platform Marketing”**-marketing a platform of investment alternatives to plan sponsors of participant-directed plans
 - **“Selection and Marketing Assistance”** – based on ERISA plan fiduciary specifications including RFP responses
 - **“General Investment Marketing Information”**-investment performance information may be provided to plan sponsors based on objective standards
 - **“Investment Education”**-providing investment education information as redefined under the DOL rule
 - **“Investment Order Taking”**-mere execution of investment instructions will not constitute investment advice

Activities Not Constituting Fiduciary Investment Advice

- Unless an individual has acknowledged fiduciary status, even if service and the status requirements are satisfied, individual will not become a fiduciary if any one of the following applies:
 - **“Seller’s Transactions”**-investment recommendations provided to fiduciaries with financial expertise, or an investment manager with at least \$50M in assets under management, and in an arms length transaction
 - **“Swap Transactions”**-offers or recommendations concerning swaps at plan level
 - **“Employee Communications”**-investment advice from employee of the plan sponsor to ERISA plan fiduciary, as long as no additional compensation is received by the employee

“Best Interests Contract” Exemption

- The major new exemption adopted by the DOL is the “Best Interest Contract” (BIC) Exemption-applies to advice provided to ERISA plans, participants, beneficiaries, IRA owners and small ERISA plans
 - Requires recommendation to be in the “best interest” of the advice recipient without consideration of financial interests of the advisor or its affiliates
 - Compensation must be “reasonable”
 - Advice provided by an employee or agent of a Financial Institution
 - Written contract between the Financial Institution and the advice recipient in place prior to or at the time advice services provided (does not need to be a separate agreement)
 - Comply with an “Impartial Conduct Standard” and disclose any conflicts of interest
 - Warrant adoption of policies and procedures designed to reduce the impact of conflicts of interest
 - Additional disclosures required-public webpage and detailed fee information upon request
 - Notify DOL in intention to rely on BIC Exemption
 - Subject to DOL audit, class action lawsuits, and state contract law claims
- Distinguishes requirements for flat fee versus variable fee arrangements

Final Revision of Existing PTEs 84-24 and 86-128

- Significant modifications to PTEs that have served as the basis for current product and fee structure provided by broker-dealers and financial institutions
- PTE 84-24 provides relief for commissioned sales of insurance, annuity, and mutual fund products to ERISA plans and IRAs. Modifications include:
 - No longer applicable to variable or fixed index annuity products or registered annuity products
 - No longer applicable to IRA recommendations
 - “**Impartial Conduct Standards**” imposed requiring the best interests of an investor to govern the recommendation on an investment advice provider but no contract required
 - Limits compensation for insurance and annuities to commissions for initial purchase, contract renewal, and trail commissions
- PTE 86-128 –allows payment of commissions for execution of securities transactions by a fiduciary and for agency cross-transactions. Modifications include:
 - No longer applicable to IRA transactions
 - Fee disclosure under ERISA section 408(b)(2) may be required
 - Commission in the form of a brokerage commission or sales load only
 - Incorporates “**Impartial Conduct Standards**” that require the adviser to act without consideration of its own financial interests but no written contract required
 - Does not require contract

Fiduciary Investment Advice Analysis

IF:

- Fee received (directly or indirectly) **and**
- Acknowledges status as a fiduciary with respect to investments in question; **or**
- Provides investment advice “recommendation” as defined under new rule; **and**
- Not Excluded as “recommendation” as defined under the new rule:
 - Education
 - Selection and Monitoring
 - Platform Marketing
 - Investment Marketing Activities

 - Not Excluded as “fiduciary investment advice” as defined under new rule:
 - Sellers Transactions
 - Swap Transactions
 - Employee Conversations

THEN:

- New advice arrangements on or after April 10, 2017-must satisfy prohibited transaction exemption, statutory provision, or guidance from the DOL, allowing for provision of such fiduciary investment advice to an advice recipient
- Existing advice arrangements -negative consent of best interest contract terms available

Potential Penalties and Liability for Breach of Fiduciary Responsibility

- To the extent investment advice is provided to a plan sponsor, participant, beneficiary, or IRA owner, it must be provided in accordance with a prohibited transaction exemption, or guidance from the DOL.
 - If not, the advisor will breach its fiduciary duty to the advice recipient and be liable for engaging in a prohibited transaction under ERISA Section 408(b) and/or IRC Section 4975
 - If reliance on BIC Exemption-potential state contract law liability and class action lawsuits (BIC contract may exclude punitive damages claim)
- ERISA requires that a fiduciary be held to the highest standard of conduct:
 - Duty of Loyalty and Prudence-Fiduciary may not engage in self dealing and must act in the sole interest of the plan, participant or beneficiary in a manner that a prudent expert would under similar circumstances
- Correction of a prohibited transaction requires a fiduciary to restore plan, participant, beneficiary, or IRA owner to:
 - At least the position they would have been in had the breach not occurred
 - This would likely result in disgorgement of any amounts earned and profits realized on such amounts that were involved in the prohibited transaction

Potential Penalties and Liability for Breach of Fiduciary Responsibility (cont'd)

- Fiduciary breach involving ERISA plan assets-If fiduciary breach involves assets held in an ERISA plan, then the fiduciary could be subject to the following:
 - Civil Penalties-The DOL may assess a penalty of up to 20% of settlement amount agreed to by a fiduciary, or as ordered by court
 - Criminal Penalties-Criminal penalties and punishments, while rarely imposed in the past, may also be applicable in the case of a violation of ERISA that is particularly egregious or fraudulent:
 - Individuals may be fined up to \$100,000 and jailed up to 10 years or face fines of up to \$10,000 per individual that was affected by the fraudulent acts of fiduciary
 - Companies may face up to \$500,000 in fines for ERISA violations
- Fiduciary breach involving ERISA plan or IRA assets subject to IRC Section 4975-IRA assets must be restored as if the prohibited transaction did not occur, and IRC Section 4975 excise tax liability applicable.