The DOL's fiduciary regulation

In the final regulation released on April 6, 2016, the Department of Labor (DOL) has streamlined the rules and exemptions that were proposed in April 2015. The final rule has reduced the compliance burden on firms while maintaining an enforceable best interest standard to protect consumers. Specifically, there are changes to the time frame, exemptions to the definition of fiduciary advice, and updates to the Best Interest Contract (BIC) exemption.

The DOL's fiduciary regulation seeks to require more retirement investment advisers to put their client's best interest first, by expanding the types of retirement investment advice covered by fiduciary protections. Discussions about plan distributions, IRA rollovers, and other matters that were commonly considered sales conversations fall into the realm of regulated fiduciary advice. The regulation also provides significant guidance on how investment professionals working with plans and IRAs should comply with this general expansion of fiduciary liability.

Time Frame

The DOL has increased the time to comply with the finalized rule to one year after the publication of the final rules (April 2017). As of that date, an advisor may rely on the BIC exemption, but the full set of conditions for that exemption does not take effect until January 1, 2018.

Fiduciary Status

Under the regulation, any person providing covered advice would be doing so as an ERISA fiduciary if the individual represents or acknowledges that he or she is acting in a fiduciary capacity. Short of that, a person who is not a fiduciary per se would nevertheless be subject to fiduciary status under the functional test outlined in the regulation.

Under the functional test, individuals are deemed fiduciaries if they either:

- Render 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**
- Direct 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.

This standard replaces the five-part test that has been applicable for decades.

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Covered Advice

The key issue for determining whether one is an advice fiduciary under the new regulation is whether covered advice is being provided. A person will be deemed to render investment advice if such person provides directly to a plan fiduciary, plan participant, beneficiary, IRA or IRA holder, the following types of advice in exchange for a fee or other compensation, direct or indirect:

- 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 a 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 investments account arrangements (brokerage vs. advisory); or recommendations with respect to rollovers, transfers, or distributions from a plan or an IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer, or distribution should be made

In short, a recommendation to maintain, change, sell, or reallocate existing retirement plan assets or a recommendation as to how to invest assets that originated from a plan or IRA would be covered advice. Furthermore, the recommendation of policies, strategies, composition, or entity responsible for the investment selection or management of assets originating from a plan or IRA would be deemed covered advice.

The final rule also clarifies the definition of a 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." In its press materials concerning the final rule, the DOL explained that its intent was to create a definition of recommendation consistent with the definition used by FINRA. However, it declined to agree that the definition of recommendation would be governed by current and future FINRA guidance.

The definition of covered advice expands the current understanding of what constitutes ERISA investment advice in two key ways. First, it adds advice concerning taking a distribution of benefits or rolling over from a plan to an IRA. Second, it adds any recommendation of an investment advisor. Unlike in the DOL's initial proposal, appraisals will not be treated as covered advice; the DOL has reserved the right to issue regulations on appraisals at a later date.

Carve Outs and Exemptions

While the DOL's proposed drafts included specific language about carve outs, the actual regulation sets aside that term altogether. The final rule does, however, list items exempted from the definition of covered fiduciary advice, including:

- **Self promotion:** Financial intermediaries do not act as a fiduciary merely by recommending that a customer retain them to render advisory or asset management services.
- **Platform providers:** Making available a platform of funds to an employee benefits plan will not constitute investment advice if it is not individualized towards the plan and if certain written disclosures are made. But the platform provider may not provide advice on the selection of funds from those available on the platform.
- **Proposals:** Proposals or responses to requests for information may include sample fund lineups, provided the lineup is created based solely on the size of the plan in comparison to the plan's current investment lineup, or both.
- **Selection and monitoring assistance:** If a plan sponsor provides specific objective criteria against which the sponsor wants funds evaluated, identifying funds that best satisfy those criteria will not be covered advice.

- **Investment education:** The proposal allows for general participant investment education similar to that previously allowed under Interpretive Bulletin 96-1. The final rule does allow an asset allocation model presented to a plan participant (but not an IRA owner) to identify specific investments in the asset class, with some limitations.
- **Communications:**
  - General circulation newsletters
  - Television
  - Radio
  - Media talk show commentary
  - Speeches
  - Conferences
  - Research reports for general circulation
  - General marketing materials
  - General marketing data
- **Communications with expert fiduciaries:** Communications with a plan fiduciary that you know or reasonably believe to be a registered financial professional or who is responsible for the management of at least $50 million in assets will not constitute advice.
- **Plan sponsor employee:** The employee of a plan sponsor that provides investment advice to the plan fiduciary will not be covered if any fee or compensation is rendered.
- **Swap transactions:** Advice to a plan (but not an IRA) by a counterparty in a swap transaction will not be covered advice provided certain conditions are met.

The DOL also modified several prohibited transaction exemptions (PTEs) and created two new PTEs. The most important PTE is the new BIC exemption, which covers investment advice given to individual plan participants, beneficiaries, IRA holders, and the fiduciaries of small plans. Meeting the requirements of this exemption would allow fiduciary investment advisors to receive certain types of compensation that would otherwise be prohibited by ERISA. Consistent with its name, the exemption requires the advisor to enter into a contract with the recipient of the advice in which the advisor does the following:

- Acknowledges fiduciary status
- Agrees to provide advice in best interest of investor
- Agrees to receive no more than reasonable compensation
- Agrees to avoid misleading statements
- Makes various warranties

The final rule maintained the general nature of the BIC exemption, but it did streamline its administration in many ways:

- The BIC is available for advice provided to the plan fiduciary of a small 401(k) plan, as well as to individual plan participants and IRA owners.
- The contract requirement is only between the firm and the client. In situations like a call center where a customer speaks to multiple advisers at a firm, there does not have to be a new contract for each interaction with a different employee of the same firm.
- There is more flexibility on when the contract can be executed—for example, at the time of account opening rather than at the initial meeting.
- The transaction disclosure requiring one-, five-, and 10-year projections have been revised. The transaction disclosure is simplified to focus on the firms’ conflicts of interest, and website disclosures were designed to enable third parties to help customers evaluate different firms’ practices. The annual disclosure is eliminated entirely.

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- Firms have to retain only the records that show they complied with the law, as they would in other situations.
- A new special provision clarifies how the BIC can be used for the recommendation of proprietary products.
- If you are relying on the BIC for advice provided to ERISA plan sponsors and their participants and beneficiaries, there does not need to be a separately executed contract.
- The level fee provision enables advisers and firms that receive a level fee for the advice they provide to rely on the exemption without entering into a contract; they must, however, pay special attention and maintain documentation to show that certain specific recommendations are in the customer's best interest. Specific to this provision is the recommendation to rollover assets from an employer plan to an IRA.
- A grandfathering provision allows for additional compensation from previously acquired assets. The provision includes recommendations to hold existing assets, as well as systematic purchase agreements, but requires that additional advice satisfy essential best interest and reasonable compensation requirements.
- The BIC can now cover any asset class, rather than the limited list included in the original proposal.

An advisor who fails to live up to these contract terms becomes susceptible to a lawsuit for breach of contract. Importantly, the contract may contain an arbitration clause (with limits) but may not preclude a class action. The BIC also comes with onerous disclosure requirements. Fortunately, the final regulation does simplify the process of administering the best interest contract as it was originally proposed; rather than requiring a three-party contract between the individual, the advisor, and the manufacturer of the investment product executed before the advice is provided, the final regulation allows the best interest contract to be at the time of account opening.

Of the amendments to various PTEs made as part of the initiative, the most important are the changes to PTE 84-24, which allows the payment of commissions in connection with the sale of insurance and annuity contracts and interests in mutual fund shares to plans and IRAs. First, PTE 84-24 is no longer available for sales of any annuities to IRAs or plans, except for fixed annuities. Second, if the person receiving the commission is a fiduciary advisor to the plan, the advisor must comply with a best interest standard.

Lastly, the DOL created a new PTE for principal transactions between a plan and a fiduciary advisor, and made relatively minor amendments to existing PTEs 75-1, 77-4, 83-1, and 86-128.

John Hancock Retirement Plan Services will continue to review these regulations and will keep you informed as additional information and analysis become available.

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