

Executive Summary

Definition of the Term ‘Fiduciary’ U.S. Department of Labor ‘Conflict of Interest Rule’¹

April 15, 2016

I. Introduction.

Background. The U.S. Department of Labor (the “Department” or “DOL”) on April 6, 2016, released the final rule (the “Rule”) [updating the definition of a fiduciary](#) under the Employee Retirement Income Security Act of 1974 (“ERISA”). The Rule is the culmination of six years of effort by the DOL to broaden the definition of “fiduciary” advice to ERISA plans and extend it to include advice on individual accounts including IRAs. The debate over the rulemaking has been contentious and the subject of intense scrutiny. For the most part the Rule retains the basic framework of the 2015 proposal (the “Proposal”) and responds to various comments by streamlining and clarifying parts of the rule and extending the overall compliance dates.

The original proposal was introduced in 2010 and withdrawn the following year in response to strong industry opposition and bipartisan concerns expressed in Congress. Following an unexpected hiatus of five years, the 2010 proposal was formally withdrawn with the introduction of the final proposal on April 14, 2015, which first introduced the new three-part test of fiduciary advice, the extension of a fiduciary standard of care for individual accounts, and a number of prohibited transaction exemptions, most notably the [Best Interest Contract Exemption](#) (“BICE” or “BIC Exemption”).

fi360’s initial review of the final Rule concludes that the Rule does indeed retain the key components from the Proposal and reduces many of the requirements that industry opponents considered onerous. However, the original purpose of the rulemaking, which was to update a four decades-old rule and respond by aligning current market conduct standards for retirement advice with ERISA’s longstanding fiduciary standard, has survived largely intact. According to an April 6, 2016, [White House fact sheet](#) the final

¹ This executive summary is a regulatory overview and should not be relied upon as a legal authority or advice for compliance purposes. Although most of the material requirements are covered, readers are advised to review the rule for specific details, some of which are omitted in this condensed summary.

rule and related exemptions will “ensure that retirement savers get investment advice in their best interest.”

II. Overview.

Consistent with the 2015 Proposal, the final Rule broadens the definition of “fiduciary” for firms and financial advisors providing investment advice to ERISA plans and IRAs, and extends fiduciary coverage to rollover advice and distributions. The Rule also retains the BIC Exemption, the most controversial feature of the 2015 Proposal. The BIC Exemption is designed to allow brokers and their firms to receive commissions and other third-party compensation while subject to regulatory constraints that preserve robust duties of loyalty and care under ERISA’s prudence standard. New streamlining concessions of the exemption will ostensibly improve its utility with a phased-in approach for compliance that begins April 10, 2017. Full compliance is required Jan. 1, 2018. The original proposal anticipated eight months for compliance.

One other new prohibited transaction exemption (“PTE”), the Principal Transactions Exemption, permits the sale of certain fixed-income securities from a financial service firm’s inventory in ERISA plans and IRA accounts. Up to 18 months would be permitted for full compliance by firms wishing to use the safe harbor, or Jan. 1, 2018. The PTE is somewhat similar to a safe harbor under the Investment Advisers Act of 1940 for dually registered broker-dealers placing high-grade bonds into advisory accounts. One of the most significant differences between the two laws is broker recommendations to plan participants and IRA accounts under the Rule would be subject to a much stronger prudence standard compared to the implied duty of suitability under the Investment Advisers Act of 1940 (“Advisers Act”).

The final Rule also retains other PTEs with modifications generally consistent with the 2015 Proposal. Among other things, exclusions from the fiduciary definition attempt to distinguish between investment advice and education when an advisor or service provider is acting in a non-fiduciary capacity.

Status. In response to industry criticism and partisan congressional pressure to add more time to the implementation deadline, the Department has extended the eight-month period under the Proposal to a much longer “phased” implementation in the final Rule.

- A. The revised definition of a fiduciary takes effect April 10, 2017.
- B. The BIC and Principal Transaction exemptions go into partial effect on this same date. Firms relying on the safe harbors for these two PTEs have to comply with a limited set of conditions initially. For the BIC Exemption, these limited conditions include acknowledging fiduciary status, adhering to a best interest standard, and making basic disclosures about conflicts. The remaining requirements under BICE

will go into full effect on Jan. 1, 2018, or approximately 18 months after the April 2016 date of publication.

III. Definition of a Fiduciary.

Current. The four decades-old five-part test for determining functional fiduciary status under ERISA is defined as a person who does not have discretionary authority over plan assets and who, for compensation

1. Renders advice as to the value of securities or other property;
2. On a regular basis;
3. Pursuant to a mutual agreement;
4. The advice serves as the primary basis for investment decisions; and
5. The advice is individualized.

All five prongs of the test must be met to be deemed an investment fiduciary.

New Definition. The proposed changes would essentially remove the “regular” and “primary basis” prongs (nos. 2 and 4) from the definition and thereby expand the advisory activities and persons subject to the fiduciary definition.

For purposes of the ERISA sec. 3(21) and Internal Revenue Code sec. 4975 (“the Code”) definition, a fiduciary is a person who, for compensation renders investment advice to a plan or IRA (including participants of a plan) through a recommendation as to

1. The advisability of investing in securities or other investment property, including advice on rollovers, transfer or distributions from a plan or IRA; and
2. The management of securities or other investment property, including recommendations on investment policies or strategies, portfolio composition, professional referrals for investing services, types of investment accounts (such as brokerage versus advisory) and rollover activities including the destination.

Holding Out. Persons who represent themselves as ERISA fiduciaries and who provide investment advice for compensation would be held to the fiduciary standard under ERISA.

Communications. The final Rule relies in part, but not explicitly, on FINRA guidance to brokers describing when a communication, based on its context, content, and presentation, would be viewed as a “recommendation,” or fiduciary activity. Essentially the Department views investment advice as a “call to action” to pursue an investment strategy or purchase a product. Put another way, a communication is a recommendation when the advice recipient reasonably views the communication as a suggestion to either engage in or refrain from taking a particular course of action.

Scope of application. The definition generally applies to investment advice provided to, among others, defined contribution plans, IRAs, health savings accounts (“HSAs”), certain 403(b) plans, Keoghs, Savings Incentive Match Plans for Employees (“SIMPLEs”), SIMPLE-IRAs, and Simplified Employee Pensions (“SEPs”).

Duty to monitor. The rule states that the ongoing obligation to monitor is “a function of the reasonable expectations, understandings, arrangements, or agreements of the parties.” Whether a duty to monitor exists is determined in part by the scope of the agreement in place. However, the DOL makes clear that consideration should be given to whether an investment can be prudently recommended at all without a mechanism for ongoing monitoring.

IV. Exemptions from the Fiduciary Definition.

Given the more expansive definition of a fiduciary, the final Rule retains most of the carve-outs from the 2015 Proposal. Subject to additional conditions, the carve-outs would cover six activities of persons who do not provide advice and who do not represent themselves as ERISA fiduciaries. Note that the DOL has dropped the use of the term “carve-out” in the final Rule to describe exemptions from the definition. The new term used in the Rule is “non-fiduciary communications.” The exemptions are listed below.

1. **Seller’s Exemption.** Advice to plan sponsors or IRAs with more than \$50 million in assets is exempt from the definition. Conditions for the exemption:
 - a. The service provider is a regulated bank, insurance company, registered investment adviser (“RIA”), or broker-dealer; or
 - b. the service provider
 - i. Reasonably believes the plan sponsor is capable of evaluating investment risks independently
 - ii. “Fairly informs” the plan that impartial advice is not being provided or given in a fiduciary capacity
 - iii. Reasonably believes the plan sponsor is a fiduciary under ERISA or the Code for IRAs and is responsible for exercising independent judgment in evaluating the transaction; and
 - iv. Does not receive a fee or other compensation for investment advice.
2. **Platform providers.** Marketing or making available to a plan, without regard to its individualized needs, an investment platform from which the plan fiduciary may select or monitor investment options,

including qualified default investment alternatives (“QDIAs”).

Conditions include

- a. Identifying investment alternatives meeting objective criteria specified by the plan fiduciary
- b. Responding to an RFP
- c. Providing objective financial data and comparisons with independent benchmarks

General communications such as marketing materials, research or news reports prepared for general distribution, widely attended speeches and remarks in publicly broadcast talk shows, among others, would not be deemed a recommendation.

3. **Investment education.** A person who provides information on investment options in a plan or IRA without making recommendations regarding specific investment products or IRA alternatives. Educational materials may include information on investment concepts such as risk and return, diversification and dollar-cost averaging, as well as objective questionnaires, worksheets and interactive software.

Reference to specific investment options. However, changes from the 2015 Proposal permit the identification of specific investment products or alternatives as designated investment alternatives in asset allocation models or interactive investment materials subject to oversight by a plan fiduciary independent from the person who developed or markets the investment alternative and the model. This option is not available for IRA advice.

4. **Swaps and security-based swap transactions.** Similar to the seller’s exemptions, a recommendation to a plan fiduciary to enter into a swap or securities-based swap regulated by the U.S. Securities and Exchange Commission or Commodity Futures Trading Commission would not be a fiduciary act. Certain conditions apply including the swap or securities-based dealer obtaining a written representation from the separate fiduciary to the plan that the dealer is not undertaking to provide impartial investment advice or to act as a fiduciary.
5. **Plan sponsor employees.** Internal staff of the company sponsoring the plan that provides advice and receives no compensation beyond the employee’s “normal compensation” for work performed.
6. **Appraisals.** The final Rule completely exempts all appraisals from meeting the definition of fiduciary. In the 2015 Proposal only appraisals of employee stock ownership plans were exempted. Interestingly, the DOL said that they may make this the subject of a future rulemaking and noted that they believe appraisers should be

fiduciaries due to the critical role their valuations serve for other fiduciaries in the due diligence process.

Scope of fiduciary duty. The person who is a fiduciary by providing investment advice to a plan or IRA is not deemed to be a fiduciary to other assets for which the person does not hold discretionary authority or provide advice.

Other service providers. The definition does not apply to attorneys, actuaries and accountants providing professional services to plans.

Self-directed transactions. “Mere execution” of a securities transaction at the direction of a plan or IRA owner would not be deemed a fiduciary act. Nor would it apply to order-taking where no advice is provided.

V. Prohibited Transaction Exemptions.

a. Best Interest Contract ‘PTE.’

The centerpiece of the Department’s exemptions from ERISA’s prohibited transaction rules is the so-called “Best Interest Contract Exemption,” a new PTE introduced in the 2015 Proposal. The BIC Exemption is designed to respond to critics expressing concerns that the 2010 proposal would have banned or *de facto* eliminated brokerage commissions and other indirect forms of compensation including 12b-1 fees, sales incentives, sales loads, trails and revenue-sharing. At the same time the DOL has attempted to preserve a ‘best interest’ standard protecting advice recipients.

Coverage. BICE would be available as a safe harbor to so-called small “retail” plan officers with less than \$50 million in assets, individual plan participants and beneficiaries, and IRA account owners. It covers all investment advice activities, including advice on all assets and proprietary products.

Contracts. Enforceable contracts would be required between the firm and the IRA holder or non-ERISA plans, but is not required for those covered by ERISA plans. New IRA or non-ERISA plan customers would be required to execute the best interest contract. Existing customers would be provided a negative consent process in lieu of a new contract.

Timing. In the preamble to the final Rule, the DOL clarified that the precise timing of contract execution is not critical to the exemption as long as it occurs prior to or at the same time as execution of the recommended transaction. As a result, advisors can discuss advisory services with prospective customers. However, recommendations made prior to contract execution must be covered under the contract’s terms.

Conditions. Brokerage and insurance firms would still be able to determine their own compensation practices with respect to plan or IRA advice as long as the compensation was ‘reasonable.’ In addition, a firm must commit in writing that it

- Acknowledges fiduciary status
- Adheres to impartial conduct standards that requires a firm and its advisors to
 - Provide prudent investment advice
 - Charge only reasonable compensation; and
 - Make no misleading statements about investments, compensation and conflicts of interest.
- Implement policies and procedures reasonably designed to prevent violations of the impartial conduct standards.
- Refrain from awarding financial incentives to advisors to act contrary to the customer’s best interest; and
- Fairly disclose fees, compensation and material conflicts of interest.
- Firms using BICE must notify the DOL in advance of doing so and retain certain records.

The disclosures and record-keeping in the 2015 Proposal have been greatly reduced in the final Rule. Note that even though a contract isn’t required for advice to plans and plan participants under BICE, written disclosures and acknowledgement of fiduciary status are still required.

Private right of action. ERISA plan participants already have a private right of action to sue for breach of fiduciary duty and other violations. The contract requirement for IRAs and non-ERISA plans allows retirement investors to sue or, if required by a binding arbitration provision in the customer agreement, go to arbitration in a legal forum.

Proprietary products. Firms offering a limited range of products must document the limitations they place on their advisors’ recommendations, and the conflicts associated with proprietary or third-party arrangements and the service provided.

Firms must reasonably conclude that the limitations will not cause them to receive excessive compensation.

Firms also must satisfy impartial conduct standards and “clearly and prominently inform in writing” so that the investor is “fully and fairly informed” of any conflict.

Reasonable compensation. The Rule refrains from offering a bright-line definition of what is reasonable compensation. Instead the Rule preamble notes that ERISA and the Code require that compensation not be excessive, as measured by the fair market value of the specific service that generated the compensation.

Grandfathering provision. Certain conditions are prescribed for receipt of compensation for pre-rule transactions in which a firm or advisor receives a continuing revenue stream for those products after the applicability date of the Rule. Among the conditions:

- Recommendations prior to the effective date of the Rule to exchange investments within a fund family or a variable annuity contract are permitted so long as the recommendation does not result in increased compensation to the firm or advisor.
- Prior transactions must have satisfied ERISA's reasonable compensation standard.
- Any advice provided on grandfathered products after the applicability date of the Rule must conform to BICE.

Exemptions from BICE.

Exemptions from BICE for firms and advisors otherwise in receipt of variable compensation for product transactions and advice include riskless principal transactions.

BICE is unavailable for advisors holding discretion with respect to the recommended transaction.

BICE is unavailable to robo-advisors receiving variable compensation; they are afforded a special safe harbor under ERISA sec. 408(g).

Level-fee fiduciary exemption for rollover advice. So-called level-fee advisors, including most robo-advisors, have a streamlined exemption available under BICE. Level-fee advisors are typically registered investment advisers that charge flat, hourly, or asset management fees. In particular, the exemption is expected to be used by RIAs providing rollover advice to new or existing customers in which the recommendation will increase their overall compensation, notwithstanding the fact that the basic fee arrangement is "level."

The conditions for meeting the level-fee exemption are:

- Written acknowledgement to the client of fiduciary status.
- Compliance with the impartial conduct standards.

- Documentation of the specific reasons why the final recommendation was considered to be in the best interest of the client.

b. 'Low-fee' PTE withdrawn.

Following industry opposition and lack of interest during the public comment period on the 2015 Proposal, the DOL determined not to include an alternative, streamlined exemption to BICE for variable compensation received in connection with so-called high-quality, low-fee investments in a given product class.

- c. Asset restriction lifted.** The definition of "Asset" under BICE has been removed in the final Rule. The 2015 Proposal had restricted investment advice under BICE to more traditional investment products such as bank deposits and CDs, exchange-traded REITs, ETFs, mutual funds, corporate bonds and Treasuries. No investment product is *per se* banned, but recommendations must conform to the impartial conduct (prudence) standard required under the exemption.

d. Principal transactions exemption.

Similar in concept to the SEC's principal transaction relief for dually registered broker-dealers and investment advisers selling higher-quality fixed-income securities out of inventory, the final Rule permits advisers to recommend similar products to plan participants and IRA accounts under a special PTE. The [Principal Transactions PTE](#) would be subject to a best interest standard similar to the prudence standard in the BIC Exemption as well as other unique recordkeeping requirements for principal transactions at the Jan. 1, 2018 applicability date.

In addition, the broker-adviser would have to obtain the best execution reasonably available under the circumstances.

If you have any questions about this executive summary or are interested in learning more about fi360's solutions for fiduciary excellence, please contact us at (844) 394-9960 or support@fi360.com.