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New Fiduciary Rule Applies Stricter Standard to Most Retirement Account Advisers

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In its long-awaited final fiduciary rule, the Department of Labor (DOL) establishes stricter fiduciary standards for investment advisers and consultants providing services to ERISA plans and IRAs. Intended to offer additional protection to ERISA plan participants and IRA owners, the final rule issued yesterday morning broadens the application of the ERISA fiduciary standard to many investment professionals, consultants, and advisers who previously had no obligation to adhere to ERISA's fiduciary standards or to the related prohibited transaction rules.

Final Fiduciary Rule Replaces Five-Part Test

Since 1975, ERISA and its implementing regulations have defined “fiduciary” and “investment advice” narrowly. Under ERISA Section 3(21)(A), a “fiduciary” is someone who has the authority and/or responsibility to provide investment advice under a retirement savings plan and is compensated for doing so. Investment advisers and consultants who are a fiduciary with respect to an ERISA plan or IRA engage in a prohibited transaction if they receive “conflicted compensation” (*e.g.,* commissions, trailing commissions, sales loads, 12b-1 fees, and revenue-sharing payments) from third parties with respect to the investments they recommend to these ERISA plans and IRAs.

In 1975, the DOL created a five-part test to identify an ERISA fiduciary. An adviser or consultant who does not acknowledge his or her fiduciary status with respect to a plan will nonetheless be a fiduciary with respect to the plan if the adviser enters into an *agreement* to *regularly* provide *individualized* investment advice that will serve as the *primary basis* upon which the advice recipient will make *investment* decisions (the “five-part test”).

Believing that the retirement landscape has changed significantly since 1975, including the prevalence of participant-directed 401(k) plans and the extensive use of individual retirement accounts (IRAs), in 2010, the DOL proposed to broaden the definition of investment advice. The DOL subsequently withdrew the 2010 proposed rule in response to significant push back from various stakeholders. In 2015, a new proposed rule was published that eliminated the five-part test and extended fiduciary status to those advisers who provide advice that is individualized or specifically directed to the advice recipient. In response to the wide range of comments it received on the 2015 proposed rule, the DOL made significant changes to the final fiduciary rule, but kept much of the expansive nature of the 2015 proposed rule.

General Structure of the Final Fiduciary Rule

In today's marketplace, many investment professionals, consultants, and advisers have no obligation to adhere to ERISA's higher fiduciary standards or to the prohibited transaction rules because they do not satisfy each prong of the five-part test. The DOL expects that broader application of the fiduciary standard under the final fiduciary rule will more closely align the advisers' interests with those of their customers, while reducing conflicts of interest, disloyalty, and imprudence.

Under the final rule, an investment adviser or consultant that makes a “recommendation” to a plan or IRA for a fee or other compensation that is customized for or specifically directed at the plan or IRA may be a fiduciary. For purposes of the final fiduciary rule, a “recommendation” includes providing advice with respect to:

- buying, holding, selling, exchanging, or rolling over securities or other investment property; or
- management of securities or other investment property, investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or services, selection of investment account arrangements, and recommendations with respect to rollovers, distributions, or transfers from a plan or IRA.

Accordingly, an investment adviser or consultant who makes an investment recommendation (as defined above) and receives conflicted compensation in connection with the advice provided to the plan or IRA will engage in a prohibited transaction unless one of the enumerated carve-outs from the rule applies or the adviser/consultant complies with the “Best Interest Contract Exemption” requirement.

Key Carve-Outs

Notwithstanding the apparent breadth of the final fiduciary rule, the final rule contains a number of carve-outs that identify common situations in which an adviser will not be considered a fiduciary. These include:

- Providing a plan or IRA with an investment platform, provided that the recordkeeper or platform provider notifies the plan or IRA that it is not providing investment advice or serving as a fiduciary.
- Identifying investment options that satisfy the pre-established investment criteria of an independent plan fiduciary (e.g., expense ratios, size of fund, type of asset, etc.) and/or providing benchmarking information to the independent plan fiduciary.
- Providing general investment communications that under the circumstances a reasonable person would not view as investment advice (e.g., newsletters, public presentations and broadcasts).
- Providing investment education, including plan information and general financial, investment, and retirement information.
- Selling investments to a fiduciary who has the requisite investment background and who is properly informed that the broker is not undertaking to impartially advise the plan. This carve-out generally only applies to larger retirement plans with at least $50 million in assets.

- Marketing for purposes of retaining business, or recommending that an individual hire the adviser for advisory or asset management services. Although, once hired, the adviser would no longer be subject to the carve-out.

Best Interest Contract Exemption

The final rule also provides a means whereby an adviser who falls within the definition of a fiduciary may continue to receive conflicted compensation by satisfying certain requirements. The so-called “Best Interest Contract Exemption” provides relief from prohibited transaction restrictions on conflicted compensation received by fiduciaries as a result of the purchase, sale, or holding by a plan or IRA of certain investments. Generally, the exemption requires the adviser fiduciary to abide by the basic standards of impartial conduct, including giving advice that is in the client's best interest, avoiding misleading statements, and receiving reasonable compensation.
Importantly, the final rule liberalizes the requirements of the Best Interest Contract Exemption set forth in the proposed rule. The final rule no longer requires that the adviser have a written agreement with an ERISA plan and the final rule allows an agreement with an IRA owner to be entered into at the time of purchase of an investment (instead of at the time the advice is given, as required in the proposed rule).

Investor Protection

The fiduciary standard requires that advisers act with the care, skill, prudence, and diligence that a prudent person would exercise in the current circumstances. This offers significantly more protection to investors as opposed to the suitability standard that generally applies to non-fiduciary advisers whereby the non-fiduciary need only have a reasonable basis to believe that a recommended transaction or investment strategy is suitable for the customer, based on information obtained through reasonable diligence. Investors may take action against an adviser who breaches his or her fiduciary duty.

What You Need to Know

Plans, their affected financial advisers, and other service providers have until April 10, 2017 to prepare for any change from non-fiduciary to fiduciary status. Notably, there are also two exceptions to the effective date, which will provide more time for certain service providers to adapt to the new standards. In particular, the Best Interest Contract Exemption and rules regulating advice with respect to the advisers proprietary funds will have a transition period during which fewer conditions apply, from April 2017 to January 1, 2018, at which time the rule will be fully implemented.

ERISA plans should begin now to review their relationship with their current investment adviser/consultant. Some things plans should consider include:

- Determine if an adviser or consultant is currently a fiduciary under the new fiduciary rule.

- Determine if one of the rule carve-outs applies to the services provided by adviser or consultant.
- Discuss the Best Interest Contract Exemption with any adviser that is a fiduciary and determine the best way to document and comply with that exemption.

In conducting this review, plans should interpret the general fiduciary rule broadly and interpret any of the enumerated carve-outs narrowly. Fiduciaries should expect that advisers will provide written documentation of their role and their satisfaction of any carve-out. Plans should require advisers to indemnify the plan from any prohibited transaction that arises as a result of its failure to comply with any carve-out or exemption.

If you have any questions about this new rule, please contact the authors at rhudson@hollandhart.com, bfbusacker@hollandhart.com, or mchobbs@hollandhart.com, or any other member of the Benefits Law Group.