DOL's final rule designed to resolve conflict of interest problems in retirement advice

By Pamela Wolf, J.D.

The Labor Department has finalized its controversial rule addressing conflicts of interest in retirement advice and defining the term "fiduciary" for ERISA purposes. The so-called "conflicts of interest" or "fiduciary" rule underwent substantial modification in light of comments submitted from the public before reaching its final form, according to the DOL. Still, the final rule, slated for publication in the *Federal Register* on April 8, will likely continue to draw controversy because of the great waves of change it will bring to the many industries and businesses that will be impacted by its new requirements. And, there remains a substantial question about how well it will dovetail with the SEC's anticipated rulemaking that would cover some of the same territory.

Proposed vs. final rule. The DOL has been working on a final rule since 2009. It published two separate proposals for public comment in 2010 and 2015. It also held multi-day public hearings on both proposals, hundreds of individual meetings with a wide range of stakeholders, and published the public comments and hearing transcripts on its website. Thousands of comments and petitions came from consumer groups, plan sponsors, financial services companies, academics, elected government officials, trade and industry associations, and others, both in support of and in opposition to the proposals. The changes between the 2015 proposed rule and the final rule are mapped out in this DOL-prepared chart.

After careful consideration of the issues raised, the DOL adopted a final rule and related exemptions. The final rule defines exactly who is a fiduciary investment adviser, while at the same time, accompanying prohibited transaction class exemptions permit certain broker-dealers, insurance agents, and others who act as investment advice fiduciaries to continue to receive various common forms of compensation *so long as* they adhere to standards intended to ensure that their advice is impartial and in the best interest of their customers.

The rulemaking package, the DOL noted, also includes a regulatory impact analysis, which demonstrates the monetary harm caused to retirement investors from conflicted advice and the gains that will result from the rule. In addition, the Labor Department has posted a set of FAQs about the rulemaking on its website.

Conflict of interest problem. The major feature of the final rule is its focus on conflicts of interest. The DOL noted that currently, although many advisers act in accord with their customers' best interest, not everyone is legally obligated to do so. "Many investment professionals, consultants, brokers, insurance agents, and other advisers operate within compensation structures that are misaligned with their customers' interests and often create strong incentives to steer customers into particular investment products," according to a DOL fact sheet. Notably, under current regulations, these conflicts of interest are not always subject to disclosure.

At the same time, advisers enjoy only limited liability under federal pension law for the harms that may result from advice they give to plan sponsors and retirement investors—harms that include the loss of billions of dollars a year for retirement investors in the form of eroded plan and IRA investment results, often after rollovers out of ERISA-protected plans and into IRAs.

Protecting investors. How will the final conflict of interest rule protect investors? By requiring all who provide retirement investment advice to plans and IRAs to abide by a "fiduciary" standard that puts their clients' best interest before their own profits, according to the DOL. Under the final rule, those who provide investment advice to plans, plan sponsors, fiduciaries, plan participants, beneficiaries, and IRAs and IRA owners must either avoid payments that create conflicts of interest or comply with the protective terms of an exemption.

Under the new exemptions, firms are obligated to acknowledge their status and the status of their individual advisers as "fiduciaries." Firms and advisers are required to make prudent investment recommendations without regard to their own interests or the interests of anyone other than the customer. Firms and advisors are also required to charge only reasonable compensation and to make no misrepresentations to their customers about recommended investments.

Covered investment advice. The rule sets out the sort of communications that would amount to investment advice and then describes the types of relationships in which those communications would give rise to fiduciary investment advice responsibilities. Covered investment advice is defined as "a recommendation to a plan, plan fiduciary, plan participant and beneficiary and IRA owner for a fee or other compensation, direct or indirect, as to the advisability of buying, holding, selling or exchanging securities or other investment property, including recommendations as to the investment of securities or other property after the securities or other property are rolled over or distributed from a plan or IRA," the DOL explained.

In addition, covered investment advice includes recommendations as to the management of securities or other investment property, including recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, and selection of investment account arrangements (*e.g.*, brokerage versus advisory). It also includes 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 a rollover, transfer, or distribution should be made.

Did a recommendation occur? The DOL said that the threshold element in establishing the existence of fiduciary investment advice is whether a "recommendation" has occurred. A "recommendation" under the final rule is 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 more tailored the communication to a specific advice recipient or recipients, the more likely the communication will be considered a recommendation. The DOL said that its approach to defining "recommendation" is consistent with and based on the approach taken by the Financial Industry Regulatory Authority, the independent regulatory authority of the broker-dealer industry subject to the oversight of the SEC.

Relationships that count. The Labor Department spelled out the types of relationships that must exist before recommendations will give rise to fiduciary investment advice responsibilities. These include recommendations made either directly or indirectly (*e.g.* through or together with any affiliate) by a person who:

- Represents or acknowledges that they are acting as a fiduciary within the meaning of ERISA or the Internal Revenue Code.

- Renders 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.
- Directs the advice to a specific 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.

For fee or compensation. For the recommendation to give rise to fiduciary investment advice responsibilities under the final rule, the recommendation must be provided in exchange for a "fee or other compensation." The DOL explained that the phrase "fee or other compensation, direct or indirect" means "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 recommended purchase or sale of a security or the provision of investment advice services including, though not limited to, such things as commissions, loads, finder's fees, and revenue sharing payments." A fee or compensation is paid "in connection with or as a result of" such transaction or service where "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."

What advice is not covered under the rule? The DOL noted that not all communications with financial advisers are considered covered fiduciary investment advice under the final rule. At the threshold, if the communication does not meet the definition of "recommendations" under the rule, it's considered non-fiduciary. The final rule includes some specific examples of communications that would *not* rise to the level of a recommendation and thus would not amount to a fiduciary investment advice communication. A number of these provisions reflect changes and clarifications in response to public comments.

Education. Education as defined in the final rule does not amount to advice, regardless of who provides the educational information, the frequency with which the information is shared, or the form in which the information and materials are provided.

In the plan context, the education provision permits specific investment alternatives to be included as examples in presenting hypothetical asset allocation models or in interactive investment materials intended to educate participants and beneficiaries as to what investment options are available under the plan, as long as they are designated investment alternatives selected or monitored by an independent plan fiduciary and other conditions are met.

However, because there is no similar independent fiduciary in the IRA context, the investment education provision in the final rule does not treat asset allocation models and interactive investment materials with references to specific investment alternatives as merely "education."

General communications. Also not considered recommendations are general communications that a reasonable person would not view as an investment recommendation, including general circulation newsletters; commentary in publicly broadcast talk shows; remarks and presentations in widely attended speeches and conferences; research or news reports prepared for general distribution; general marketing materials, and general market data including data on market performance, market indices, or trading volumes, price quotes, performance reports, or prospectuses.

Platform providers. Simply making available a platform of investment alternatives without regard to the individualized needs of the plan, its participants, or beneficiaries, *if* the plan fiduciary is independent of such service provider does *not* amount to communications that would be considered recommendations under the final rule, *provided that* such provider also represents in writing to the plan fiduciary that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

Transactions with independent plan fiduciaries. The final rule does not impose fiduciary obligations on advisers when communicating with independent plan fiduciaries when the adviser knows or reasonably believes that the independent fiduciary is a licensed and regulated provider of financial services (banks, insurance companies, registered investment advisers, broker-dealers) or those that have responsibility for the management of $50 million in assets, and other conditions are met. The conditions are aimed at making sure the exclusion is limited to true arm's length transactions between advisers and investment professionals or large asset managers who do not have a legitimate expectation that they are in a relationship where they can rely on the other adviser for impartial advice.

Swap and security-based swap transactions. Communications and activities made by advisers to ERISA-covered employee benefit plans in swap or security-based swap transactions also do not result in the advisers becoming investment advice fiduciaries to the plan where certain conditions are met. This provision has been coordinated with both the SEC and the Commodity Futures Trading Commission, the DOL noted, to ensure that there is no conflict with the swap and security-based swap rules promulgated by those agencies under the Dodd–Frank Wall Street Reform and Consumer Protection Act.

Certain employees. Employees working in a company's payroll, accounting, HR, and financial departments who routinely develop reports and recommendations for the company and other named fiduciaries of the sponsors' plans are not considered investment advice fiduciaries under the final rule so long as the employees receive no fee or other compensation in connection with any such recommendations beyond their normal compensation for work performed for their employer.

This exclusion in addition covers communications between employees, such as HR department staff who communicate information to other employees about the plan and distribution options in the plan, as long as they meet certain conditions. Those conditions include that they are not registered or licensed advisers under securities or insurance laws and receive only their normal compensation for work performed by the employer.

Best Interest Contract Exemption. In a move aimed at ensuring that retirement investors receive advice that is in their best interest while at the same time permitting advisers to continue receiving commission-based compensation, the DOL issued the "Best Interest Contract Exemption" (BICE). Under ERISA and the Code, individuals providing fiduciary investment advice to plan sponsors, plan participants, and IRA owners are not permitted to receive payments creating conflicts of interest without a prohibited transaction exemption (PTE). The Labor Secretary is authorized under ERISA to grant PTEs.

Fiduciary status. The BICE permits firms to continue to rely on many current compensation and fee practices, *provided* they meet specific conditions designed to ensure that financial institutions mitigate conflicts of interest and that they, and their individual advisers, provide investment

advice that's in the best interests of their customers. Under the exemption, the financial institution must acknowledge fiduciary status for itself and its advisers, and the financial institution and advisers must adhere to basic standards of impartial conduct, including giving prudent advice that is in the customer's best interest, avoiding making misleading statements, and receiving no more than reasonable compensation. The financial institution also must have policies and procedures in place that are designed to mitigate harmful impacts of conflicts of interest and must disclose basic information about their conflicts of interest and the cost of their advice.

Disclosure. Disclosure requirements in the BICE include descriptions of material conflicts of interest, fees or charges paid by the retirement investor and a statement of the types of compensation the firm expects to receive from third parties in connection with recommended investments. Investors also have the right to request and obtain specific disclosure of costs, fees, and other compensation. Moreover, a website must be maintained and updated regularly that includes information about the financial institution's business model and associated material conflicts of interest, a written description of the financial institution's policies and procedures that mitigate conflicts of interest, and disclosure of compensation and incentive arrangements with advisers. Individualized information on a particular adviser's compensation is not required to be posted on the website.

Enforcement. The BICE provides for enforcement of the standards it establishes. The DOL explained that when providing advice to an IRA owner, the financial institution must commit to these protective conditions as part of an enforceable contract. However, ERISA plan investors will be able to rely on their advisers' fiduciary acknowledgement to assert their rights under ERISA. If advisers and financial institutions do not adhere to the standards established in the exemption, retirement investors will be able to hold them accountable either through a breach of contract claim (for IRAs and other non-ERISA plans) or ERISA's protective provisions.

The DOL pointed out that investors will not be able to use the enforcement mechanism just because they did not like investment results. Under long-existing ERISA jurisprudence, advisers can usually prove they have acted in their clients' best interest by documenting the use of a reasonable process and adherence to professional standards in deciding to make the recommendation and determining it was in the customer's best interest, and by documenting compliance with the financial institution's policies and procedures required by the BICE. "This helps retirement savers get best interest financial advice while leaving the adviser and financial institution the flexibility and discretion necessary to determine how best to satisfy the exemption's standards in light of the unique attributes of their business," the DOL wrote.

Additional relief through exemptions. The Labor Department is issuing additional exemptions that are detailed in the fact sheet, including a Principal Transactions Exemption, and an amendment to PTE 84-24, which provides relief for insurance agents and brokers, and insurance companies, to receive compensation for recommending fixed rate annuity contracts to plans and IRAs.

Compliance dates. Compliance with the final rule's new requirements will begin in April 2017, one year after the final rule is published in the *Federal Register*. The exemptions will generally become available on the applicability date of the rule. However, the DOL has adopted a phased implementation for the BICE and the Principal Transactions Exemption. Both exemptions provide for a transition period from the April 2017 applicability date to January 1, 2018, under

which fewer conditions will apply. During this period, firms and advisers must adhere to the impartial conduct standards, provide a notice to retirement investors that, among other things, acknowledges their fiduciary status and describes their material conflicts of interest, and designate a person responsible for addressing material conflicts of interest and monitoring advisers' adherence to the impartial conduct standards. Full compliance with the exemption will be required on January 1, 2018.

Skeptical reactions. Although it will take some time to analyze the final rule and identify any purported problems that it may create or fail to address, many remain skeptical about the DOL's judgment in making appropriate revisions to the proposed version of the rule. House Education and the Workforce Committee Chairman John Kline (R-Minn.), Health, Employment, Labor, and Pensions Subcommittee Chairman Phil Roe (R-Tenn.), House Ways and Means Committee Chairman Kevin Brady (R-Tex.), and Oversight Subcommittee Chairman Peter Roskam (R-Ill.) issued a statement stressing what they called "serious concerns" that the final rule "will make it harder for low- and middle-income families to receive basic education about retirement savings and will create new hurdles for small business owners who want to offer their workers retirement options. These are consequences working families and job creators cannot afford."

Senate labor committee Chairman Lamar Alexander (R-Tenn.) similarly expressed his intention to scrutinize the final rule "to ensure that it is nothing like the proposed rule, which would have crippled low- and middle-income Americans' access to affordable retirement advice—ensuring good retirement advice is only available to the rich. I want to be sure this rule does nothing to make it harder and more expensive for hard-working Tennesseans to plan for their retirement and will continue oversight in the Senate labor committee on this issue."