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Beyond the Soundbite: Why the New DOL Fiduciary Rule Means More Than Acting in a Client's Best Interest

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On April 6, 2016, the U.S. Department of Labor issued a significant rule that will greatly expand the coverage of ERISA's fiduciary requirements. Rhetoric around the new rule has focused on a financial adviser to a retirement plan's obligation to act in that plan's "best interest." This article explores the limits of that position. ERISA's prohibited transaction restrictions, particularly the fiduciary self-dealing prohibitions in ERISA Section 406(b), may prevent a fiduciary from acting at all, regardless of the client's best interest, unless an exemption applies. The "Best Interest Contract Exemption" may be available but has compliance burdens. A new fiduciary should also consider other options, including the statutory exemption for investment advice in ERISA Section 408(b)(14).

On April 6, 2016, the U.S. Department of Labor (DOL) issued its final rule on the "Definition of the Term 'Fiduciary'" (the Fiduciary Rule).[1] The Fiduciary Rule rewrites the previously long-standing rule (issued in 1975)[2] on when a person is deemed to be a

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fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 (Code)[3] by reason of providing investment advice to retirement plans. After April 10, 2017, when the Fiduciary Rule becomes applicable, many more people will find themselves subject to ERISA's fiduciary responsibilities and rules.

The proposal to change the fiduciary definition caused an uproar among market participants, generating thousands of comments from both supporters and opponents. But if the Fiduciary Rule is only about making sure that "retirement savers get investment advice in their best interest,"[4] then why the controversy?

Under ERISA Section 3(21), a person is a fiduciary with respect to a plan to the extent (1) he or she exercises any discretionary authority or control respecting management of the plan or its assets or has any discretionary authority or responsibility in the administration of a plan, or (2) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so. The Fiduciary Rule focuses on this second way to become a fiduciary, through the provision of nondiscretionary investment advice. The 1975 rule that the Fiduciary Rule is replacing defined fiduciary investment advice as having five required elements:

(1) Advice as to the value of securities or other property or recommendations as to the advisability of investing in, purchasing, or selling securities or other property;

(2) Rendered on a regular basis;

(3) Pursuant to a mutual agreement, arrangement, or understanding with the plan or a plan fiduciary;

(4) That the advice will serve as a primary basis for investment decisions with respect to plan assets; and

(5) The advice will be individualized based on the particular needs of the plan.

The lack of any of these elements resulted in the advice provider not being deemed a fiduciary. Over the years, DOL grew concerned that the five-part test had narrowed the breadth of the statutory definition of fiduciary investment advice too much, resulting in investment professionals that provide advisory services to plans "operat[ing] with conflicts of interest that they need not disclose and hav[ing] limited liability under federal pension law for any harms resulting from the advice they provide."[5] Several of the elements from the five-part test

seemed too easy to eliminate, allowing such professionals to avoid fiduciary status by, for example, providing only one-time advice (eliminating the regular basis element) or by disclaiming the existence of a "mutual agreement" that the advice served as a "primary basis for investment decisions." The Fiduciary Rule notably eliminates the regular basis, primary basis, and mutuality requirements, which the DOL viewed as particularly problematic elements.

Instead of the five-part test, under the Fiduciary Rule advice to a plan, plan fiduciary, plan participant or beneficiary, individual retirement account (IRA), or IRA owner for a fee or other compensation, direct or indirect, is fiduciary investment advice if the advice is a "recommendation" regarding acquiring, holding, disposing of, or exchanging, securities or other investment property, or regarding the management of investment property, the selection of other persons to provide investment advice or management services, or the selection of investment account arrangements. These categories include recommendations about transferring assets or how property should be invested after a rollover. In addition, unless the advice provider acknowledges its fiduciary status (in which case the advice provider is a fiduciary), the advice provider must render the advice pursuant to an 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 regarding the advisability of a particular investment or management decision regarding plan assets.

A "recommendation" is broadly defined to mean "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."[6] The Fiduciary Rule also contains examples of communications that do not rise to the level of recommendation, such as general communications that are not specifically directed to individuals, as well as certain exceptions from coverage, including a distinction between advice to "institutional" versus "retail" retirement plans and fiduciaries.

Many news articles, after the proposed rule change was announced included soundbites such as "Brokers and other investment professionals who are not fiduciaries don't have to act in a client's best interests."[7] And President Obama promoted the rule as protecting retirement investors from financial advisers "bilking" clients and selling "snake oil."[8] The "best interest" soundbite is hard to argue with—shouldn't advisers to retirement plans act in the best interest of their clients? However, ERISA fiduciary status confers more responsibilities than just acting in a client's best interest—in fact, to the extent such action involves a prohibited transaction (as discussed later), an ERISA fiduciary may actually be *prevented* from acting at all, whether such action is in a client's best interest or not.

ERISA fiduciary duties have been called the "highest duties known to law."[9] According to ERISA's legislative history, ERISA's fiduciary principles were intended to codify trust law principles[10] but always "bearing in mind the special nature and purpose of employee benefit plans."[11] Thus, while these fiduciary duties evolved from common trust law principles, they go beyond the traditional law of trusts. "After all, ERISA's standards and procedural protections partly reflect a congressional determination that the common law of trusts did not offer completely satisfactory protection."[12] This resulted in two sets of fiduciary standards under ERISA, one based closely on general trust principles,[13] such as the duties of prudence and loyalty, and the second a list of *per se* prohibited transactions[14] that apply unless the prohibited activity is subject to an exemption.

It is this second set of fiduciary standards, the prohibited transaction restrictions, that seem to cause the most consternation when dealing with plan assets. And it is avoiding dealing with this very technical scheme that seems to prohibit practically everything, unless a specific exemption applies, that has led many service providers to plans to do everything they can to avoid fiduciary status.

PROHIBITED TRANSACTION RESTRICTIONS

The prohibited transaction restrictions fall into two categories, the "party in interest"[15] prohibitions in ERISA Section 406(a) and the fiduciary "self-dealing" prohibitions in ERISA Section 406(b). Section 406(a) prohibits certain transactions between a plan and a party in interest, specifically the sale, exchange, or leasing of property;[16] the lending of money or other extension of credit;[17] the furnishing of goods, services, or facilities;[18] and the transfer by a fiduciary of plan assets to, or the use of plan assets by or for the benefit of, a party in interest.[19]

This article, and the effect of the Fiduciary Rule, is focused more on the next category of prohibitions, ERISA Section 406(b), which prohibits certain transactions involving fiduciary self-dealing and conflicts of interest. A fiduciary cannot deal with the assets of the plan in its own interest or for its own account,[20] act in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries,[21] or receive any consideration for its own personal account from a party dealing with a plan in connection with a transaction involving plan assets.[22] DOL regulations state that a fiduciary violates Section 406(b) if the fiduciary uses any of the authority, responsibility, or control that makes it a fiduciary to cause a plan (or a third party) to pay an additional fee to the fiduciary or to a person in which the fiduciary has an interest that may affect its best judgment as a fiduciary (such as an

affiliate of the fiduciary).[23] The breadth of these prohibitions means that most fiduciary actions involving conflicts are simply not allowed unless a specific exemption applies. Without such an exemption, a plan fiduciary would not be able to use its fiduciary authority to affect the level of its own compensation, for example, by recommending a product that pays the fiduciary more than another product or recommending a product with a sales charge that is paid to the fiduciary, without engaging in a prohibited transaction. As one can see, this result causes a lot of concern in a transaction-fee based business, such as that of a broker being compensated on commission.

In advocating for the change in fiduciary definition, Labor Secretary Thomas Perez unfavorably compared the level of obligation a nonfiduciary financial adviser has to the fiduciary obligations of other professionals. "Lawyers and doctors have an obligation to look out for what is best for you," he said.[24] ERISA Section 406(b) prohibited transactions make a big difference, however, in the effect fiduciary status has on an ERISA fiduciary versus another professional fiduciary, such as a doctor. A doctor also has conflicts tied to compensation incentives that may be misaligned with those of his or her patients. For example, a doctor can make a great deal of money prescribing expensive medications or procedures, but a doctor is expected to manage these inherent conflicts while still acting in the patient's best interest. Without an exemption, the same type of conflict over compensation causes an ERISA fiduciary to be unable to act at all, regardless of the client's best interest.

DOL attempted to change the fiduciary definition once before, in 2010.[25] That proposal was withdrawn after heated criticism from the financial services industry and Congress. A major part of the criticism involved the lack of any prohibited transaction exemption to allow new fiduciaries to continue operating their business while using traditional variable compensation models. DOL learned from its mistake, and in 2016 the Fiduciary Rule is accompanied by the "Best Interest Contract Exemption" (BIC Exemption). The BIC Exemption allows the receipt of "[c]ertain types of fees and compensation common in the retail market, such as brokerage or insurance commissions, 12b-1 fees, and revenue sharing payments,…that in the absence of an exemption, would not be permitted under ERISA and the Code."[26] It remains to be seen how able companies will be to use the BIC Exemption to receive these types of variable compensation.

While containing some more favorable terms than originally proposed,[27] the final BIC Exemption still contains substantial requirements that must be met in order to obtain relief. Further, many of those requirements are subjective, which may make it difficult for institutions to be comfortable they are satisfactorily complying with all conditions, particularly because the burden of demonstrating compliance falls upon the party claiming the exemption.[28] Further,

while the BIC Exemption allows financial institutions and their affiliates to receive variable compensation, the individual adviser (such as the registered representative of a broker-dealer) may only receive differential compensation to the extent such compensation is not "misaligned" with the interests of retirement investors (such as if the compensation is based on neutral factors like the difference in time it took the adviser to analyze and provide the advice with respect to different types of investments). Therefore, if two investments take equivalent time and analysis, it seems it would be difficult for the adviser to receive different compensation in connection with recommending each of those investments without being out of compliance with the BIC Exemption. In addition, the BIC Exemption requires substantial representations, warranties, and disclosures, the adoption of policies and procedures, and special conditions that apply if recommendations are limited, in whole or in part, to proprietary investments or investments that generate payments from third parties. Financial institutions are required to sign a contract with IRAs and other non-ERISA plans[29] under the BIC Exemption, which also creates a private right of action for the owners or participants of such plans to sue the fiduciary under state law for a contractual breach.[30]

New fiduciaries under the Fiduciary Rule may also consider other established alternatives to avoiding or addressing prohibited transactions. These include the independent financial expert approach described in DOL Advisory Opinion 2001-09A, known as the "SunAmerica Letter"; the complete offset method described in DOL Advisory Opinion 97-15A, known as the "Frost Letter"; and the statutory exemption for investment advice to plan participants found in ERISA Section 408(b)(14) and Section 408(g), as implemented by DOL Regulation Section 2550.408g-1 & 2[31] (the Statutory Exemption).

The Statutory Exemption in particular may be worth a second look. The Statutory Exemption allows the provision of investment advice to a plan participant or beneficiary under a "fee leveling" "eligible investment advice arrangement."[32] Under this arrangement, compensation to the "fiduciary adviser" (such as a broker-dealer) and any of its employees (such as a registered representative) actually providing the investment advice cannot vary depending on the basis of any particular investment selected. However, affiliates of that fiduciary adviser entity may receive a variable fee.[33] The Statutory Exemption also requires a number of disclosures and, perhaps most significantly, an annual compliance audit. While the Statutory Exemption also imposes some structural and compliance burdens, a financial institution should evaluate whether it is better able to comply with those conditions than the BIC Exemption.

What is clear is that when the Fiduciary Rule becomes applicable on April 10, 2017, anyone providing investment "recommendations"

to plans needs to already have a strategy in place to avoid engaging in nonexempt prohibited transactions.

NOTES

1. Published in the *Federal Register* on April 8, 2016, 81 *Fed. Reg.* 20946 (Apr. 8, 2016).

2. 29 C.F.R. § 2510.3-21(c).

3. Any reference to ERISA herein should be read to include the parallel provisions of the Code, as applicable.

4. Statement by Jeffrey Zients, Director of the National Economic Council and Assistant to the President for Economic Policy, at the Press Conference announcing the final Fiduciary Rule, April 6, 2016.

5. 81 *Fed.Reg.* at 20946.

6. The Fiduciary Rule further attempts to clarify that: "[t]he determination of whether a 'recommendation' has been made is an objective rather than subjective inquiry. In addition, the more individually tailored the communication is to a specific advice recipient or recipients about, for example, a security, investment property, or investment strategy, the more likely the communication will be viewed as a recommendation. Providing a selective list of securities to a particular advice recipient as appropriate for that investor would be a recommendation as to the advisability of acquiring securities even if no recommendation is made with respect to any one security. Furthermore, a series of actions, directly or indirectly (e.g., through or together with any affiliate), that may not constitute a recommendation when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program."

7. Michelle Singletary, "Is your adviser truly protecting your retirement?", *The Washington Post,* Sept. 12, 2015, available at *https://www.washingtonpost.com/business/get-there/is-your-adviser-truly-protecting-your-retirement/2015/09/10/9a66a2fe-564d-11e5-8bb1-b488d231bba2_story.html,* last accessed May 10, 2016.

8. Kathleen Hennessey, "Obama proposes tougher rules for retirement fund advice," *Los Angeles Times*, Feb. 23, 2015, available at *http://www.latimes.com/business/la-fi-obama-retirement-funds-20150224-story.html,* last accessed May 10, 2016.

9. For example, *Donovan v. Bierwirth*, 754 F.2d 1049 (2d Cir. 1985).

10. H.R. Rep. No. 93-533, 93d Cong., 1st Sess. 11–12 (1973).

11. H.R. Conf. Rep. No. 93-1280, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5083.

12. *Varity v. Howe*, 516 U.S. 489, 497 (1996).

13. ERISA Sec. 404(a).

14. ERISA Sec. 406. Although the Code contains prohibited transactions parallel to ERISA Sec. 406, it does not contain principles that parallel ERISA Sec. 404(a).

15. Parties in interest include, among others, plan fiduciaries, persons providing services to the plan, and the employer whose employees are covered by the plan. Parties in interest also include persons having certain relationships to the foregoing persons,

including, among others, 10 percent or more shareholders of fiduciary service providers. ERISA Sec. 3(14).

16. ERISA Sec. 406(a)(1)(A).

17. ERISA Sec. 406(a)(1)(B).

18. ERISA Sec. 406(a)(1)(C).

19. ERISA Sec. 406(a)(1)(D).

20. ERISA Sec. 406(b)(1).

21. ERISA Sec. 406(b)(2).

22. ERISA Sec. 406(b)(3).

23. 29 C.F.R. § 2550.408b-2(e)(1).

24. Quoted in Lisa Shidler, "As President Obama takes the gloves off, pro-broker groups throw up 'sledgehammer' response," RIABiz, Feb. 24, 2015, available at *http://www.riabiz.com/a/5015648866402304/as-president-obama-takes-the-gloves-off-pro-broker-groups-throw-up-sledgehammer-response,* last accessed May 10, 2016.

25. *See* 75 *Fed. Reg.* 65263 (Oct. 22, 2010).

26. Best Interest Contract Exemption, 81 *Fed. Reg.* 21002, 21002 (April 8, 2016).

27. Proposed Best Interest Contract Exemption, 80 *Fed. Reg.* 21960 (April 20, 2015). For example, the proposal required that a written contract be entered into between the financial institution, the individual advisers, and retirement investors prior to any advice being provided to the retirement investor. The final BIC Exemption requires a written contract only with IRAs and other non-ERISA plans (ERISA plans may receive a written disclosure form instead), requires only the financial institution and retirement investor sign the contract (not the individual adviser), allows the contract to be entered into prior or at the same time as the execution of the transaction, and allows the financial institution to use negative consent to enter into contracts with existing investors.

28. *See* 81 *Fed. Reg.* at 21033.

29. This condition becomes applicable January 1, 2018.

30. Under the BIC Exemption, the contracts may require arbitration for individual claims but cannot restrict the right to bring a class action. Financial institutions may contractually limit damages to "make whole" amounts, however. Interestingly, allowing (and even encouraging) these types of state law claims to enforce the BIC Exemption seems to fly in the face of Congress's rational for ERISA's state law preemption. In the legislative history, Congress indicated that it believed state law preemption "essential to provide for a uniform source of law … for evaluation of fiduciary conduct." H.R. Rep. No. 93-533, 93d Cong., 1st Sess. 17 (1973).

31. 76 *Fed. Reg.* 66136 (Oct. 25, 2011).

32. The Statutory Exemption also allows for eligible investment advice arrangements that use computer models. This article does not discuss the computer model option.

33. 76 *Fed.Reg.* at 66139.

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