April 29, 2016

CLIENT ALERT

Final Department of Labor Fiduciary Rules

The Department of Labor ("DOL") issued a final rule and regulations ("Rule")[*] expanding the definition of "fiduciary" as a result of giving investment advice to pension plans covered by the Employment Retirement Income Security Act of 1974, as amended ("ERISA") and individual retirement accounts ("IRAs"). This long-awaited Rule "treats persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of a plan or IRA as fiduciaries in a wider array of advice relationships." The Rule creates a new, stricter standard than current regulations, which only require that brokers recommend products that are "suitable" to investors, even if they are not the investor's best options. The Rule is designed to provide a new layer of protection to investors by improving disclosures and reducing conflicts of interest. The aim of the Rule is to require advisers to give advice that is in the "best interest" of their customers, without prohibiting common compensation arrangements by allowing such arrangements under conditions designed to ensure the adviser is acting in accordance with fiduciary norms and basic standards of fair dealing.

Definition of "Fiduciary"

Under ERISA, a person is a fiduciary to a plan or IRA to the extent that the person engages in specified plan activities, including rendering "investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan …[.]" ERISA protects plan participants by imposing trust law standards of care and undivided loyalty on plan fiduciaries, and by holding fiduciaries accountable when they breach those obligations. In addition, fiduciaries to plans and IRAs are not permitted to engage in "prohibited transactions," which pose special dangers to the security of retirement, health, and other benefit plans because of fiduciaries' conflicts of interest with respect to the transactions.

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[*] The Rule is available at http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806

Regulations adopted in 1975 (prior to the existence of participant – directed 401(k) plans) narrowed the breadth of the statutory definition of fiduciary investment advice such that many investment professionals had no obligation to adhere to ERISA's fiduciary standards or to the prohibited transaction rules. Since these investment professionals were not fiduciaries, they were able to operate with conflicts of interest that they need not have disclosed and had limited liability under federal pension laws for any harm resulting from the advice they provided. Non-fiduciaries may give imprudent and disloyal advice; steer plans and IRA owners to investments based on their own, rather than their customers' financial interests; and act on conflicts of interest in ways that would be prohibited if the same persons were fiduciaries.

In light of the intent of ERISA, the DOL issued the Rule, which amends the regulatory definition of fiduciary investment advice to better reflect the broad scope of the statutory text and purposes and to better protect plans, participants, beneficiaries and IRA owners from conflicts of interest, imprudence and disloyalty. The Rule first describes the kinds of communications that would constitute investment advice and then describes the types of relationships in which such communications give rise to fiduciary investment advice responsibilities.

Specifically, the Rule provides that persons render investment advice if they provide for a fee or other compensation, direct or indirect, certain categories or types of advice. The listed types of advice are:

- recommendations as to the advisability of acquiring, holding, disposing of, or exchanging securities or other investment properties, or recommendations as to how securities or other investment properties should be invested after the securities are rolled over, transferred, or distributed from the plan or IRA.

- recommendations as to the management of securities or other investment properties, 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 investment account arrangements (e.g., brokerage versus advisory), or recommendations with respect to rollovers, distributions, or transfers from a plan or IRA.

The Rule then establishes the types of relationships that must exist for such recommendations to give rise to fiduciary investment advice responsibilities. The Rule covers:

- recommendations by persons who represent or acknowledge that they are acting as a fiduciary;

- advice rendered pursuant to a written or verbal agreement that the advice is based on the particular investment needs of the advice recipient; and

- recommendations directed to a specific advice recipient regarding the advisability of a particular investment or management decision with respect to securities of the plan or IRA.

What Constitutes a "Recommendation?"

A communication constitutes a recommendation when, based on its content, context and presentation, it reasonably would be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action. The determination as to whether a recommendation has been made is an objective rather than a subjective inquiry.

Interestingly, it makes no difference whether the communication was initiated by a person or a computer software program.

"Carve-Outs" and Exemptions

The Rule provides certain "carve-outs" from the definition of fiduciary investment advice - better described as examples of communications that are non-fiduciary investment advice - because they fall short of constituting a recommendation, including carve-outs for general communications, investment or retirement education, and directing execution of a securities transactions by broker-dealers.

Among other things, the Rule includes a new exemption – the "Best Interest Contract Exemption" or "BIC" that is designed to provide conditional relief for common compensation arrangements, such as commissions and revenue sharing that an adviser might receive in connection with investment advice to retail retirement investors. For purposes of this exemption, retail investors include individual plan participants and beneficiaries, IRA owners, and certain plan fiduciaries that are not banks, insurance carriers, registered investment advisers, broker-dealers, or independent fiduciaries that hold, manage or control $50 million or more.

To avail itself of this exemption, the financial adviser must adhere to basic standards of impartial conduct and (a) give prudent advice that is in the customer's "best interest," avoid misleading statements, and receive no more than "reasonable" compensation; (b) adopt policies and procedures designed to mitigate conflicts of interest; (c) disclose basic information about its conflicts of interest and the cost of its advice; and (d) if dealing with an IRA investor or a non-ERISA plan, enter into a contract that sets forth the standards of fiduciary conduct and fair dealing. This gives the IRA investor a mechanism to enforce its rights and ensures it will have a remedy for advice that does not honor its best interests.

Concerns with the Rule

The Rule, although a long time in the making, raises certain concerns and portends several possible court and legislative challenges. One of the concerns is that it has the potential effectively to end the commission business of brokers. However, the counter-veiling view is that the Rule would not end commission business, but rather, that it simply would require brokers to explain why they are recommending a particular product. Another concern is that brokers would try to move clients from commission based accounts to fee-based accounts, which already are subject to fiduciary standards, and in doing so, would raise costs affecting, in particular, smaller investors and investors who trade only infrequently.

One possible court challenge to the Rule is that the DOL's definition of "fiduciary" is overly broad and seeks to include brokers – a group specifically excluded from the definition of investment adviser under the Investment Advisers Act of 1940, as amended. Another possible court challenge is that the DOL lacks authority to promulgate a rule that affects brokers; and may be viewed as an "end-run" around the SEC, which has not yet proposed a "fiduciary" standard rule. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank"), the SEC was directed to study the need for establishing a new, uniform, federal fiduciary standard of care for brokers and investment advisers. Dodd Frank authorized the SEC to establish such a standard if it saw fit. The SEC has been working on various rulemaking initiatives that would address the fiduciary standard applicable to brokers and investment advisers. Proposed rules are due in October 2016. It will be interesting to see how fiduciary standard rules to be proposed by the SEC will interact with the Rule just issued by the DOL.

As of this writing, the House of Representatives – strictly along party lines – voted to strike down the Rule. The White House has signaled that President Obama would veto the resolution.

We continue to monitor the situation.

Effective Date

The effective date of the Rule is June 7, 2016, but financial advisers will have until April 10, 2017 to adjust to the basic change from non-fiduciary to fiduciary status. Certain other requirements of exemptions under the Rule will not become effective until January 1, 2018.

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We are continuing to monitor the effect of the DOL's Rule and we continue to await the SEC's rule proposals in this regard. Please call Meryl Wiener, any of the undersigned or your regular Warshaw Burstein attorney for any questions you may have about fiduciary standards of care.

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