DOL Fiduciary Rule: Impact and Action Steps

With the survival of the US Department of Labor's (DOL) new fiduciary rule (at least for now) and the applicability date (June 9, 2017) now behind us, plan sponsors who have not already begun to do so should take steps to ensure compliance in light of the changes resulting from the rule. Fortunately, the implementation of certain exemption conditions are phased-in to some extent (from June 9, 2017, to January 1, 2018), and the DOL has announced a temporary "non-enforcement policy" for those fiduciaries who are working diligently and in good faith to comply with the rule and exemptions.

This Legal Update is not a comprehensive discussion of the rule, but instead focuses on certain aspects of the rule that have implications for plan sponsors, plan committees and employees of plan sponsors who provide services for such plans and summarizes action steps that plan sponsors should consider taking now.

Background

On April 7, 2017, the DOL (i) extended the applicability date of the fiduciary rule by 60 days from April 10, 2017, to June 9, 2017, and (ii) extended to June 9 the applicability dates of the new BIC Exemption (described below), a second new exemption[1] and certain amendments to existing exemptions. The delay was a response to the US president's February 3, 2017, directive that the DOL conduct an examination of the new fiduciary rule to determine whether it adversely affects the ability of Americans to gain access to retirement and financial advice and otherwise furthers the policies of the new administration. The DOL explained that, while it is not expected to complete its re-evaluation of the rule until the end of the year, the 60-day delay is all that is needed because the more controversial aspects of the new rule are certain conditions under the new exemptions that will not be phased in until January 1, 2018.

On May 22, 2017, the DOL issued Field Assistance Bulletin 2017-02 announcing that during the phased implementation period ending on January 1, 2018, the DOL will not pursue claims against fiduciaries who are working diligently and in good faith to comply with the fiduciary rule and exemptions and will not treat those fiduciaries as being in violation of the fiduciary rule and exemptions. FAB 2017-02 further notes that to the extent that circumstances surrounding the applicability date of the fiduciary rule and exemptions give rise to the need for other temporary relief, the DOL will consider taking such additional steps as necessary.[2]

The DOL has also stated in Q&As issued in May that, pursuant to the president's February 3rd directive, the DOL is engaging in an ongoing analysis of the issues raised by the president and that it is possible that, based on the results of the examination, additional changes to the fiduciary rule will be proposed. On June 29, 2017, the DOL released a request for information (RFI) seeking comments on whether to further extend the January 1, 2018, date for compliance with certain conditions under the BIC Exemption (described below) and further information regarding a number of potential changes to the rule and the best interest contract exemption under consideration. Responses to the RFI are generally due on or before August 7, 2017; however, comments on the question of extending the BIC Exempton applicability date are due by July 21, 2017. The questions presented in the RFI may provide some insight into amendments under consideration by the DOL. For example, the DOL is seeking input on whether:

- recommendations to make or increase contributions to a plan or IRA should be expressly carved out from the definition of investment advice;
- the carve-out for communications with independent fiduciaries with financial expertise should be expanded;
- (if the SEC promulgates its own fiduciary standards for broker-dealers that provide advice to retail investors) the DOL should develop a new streamlined exemption for brokers that comply with the SEC standards; and
- the written contract requirements under the BIC Exempton should be eliminated.

Definitions and Central Concepts

Revised "Fiduciary" Definition. In general, the new rule significantly expands the definition of a person deemed to render investment advice (and thus to be a "fiduciary") to include persons who make *recommendations* for a fee or other compensation (direct or indirect) to a plan fiduciary or participant or IRA owner with respect to: (i) the acquisition, sale or holding of securities or other property; (ii) distributions from a plan or IRA or decisions to roll over a plan account to an IRA; (iii) general investment management decisions; or (iv) the selection of investment managers or advisors for the plan or IRA. Fiduciary status is triggered if the advisor represents or acknowledges its fiduciary status, enters into an oral or written agreement or understanding that the advice is based on the particular investment needs of the plan or IRA, or merely directs the recommendation to a particular recipient.

"Recommendation." A recommendation is defined as 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 test as to whether a communication is a "recommendation" is an objective rather than subjective test. The regulation provides a non-exhaustive list of communications that are generally not recommendations (perhaps most importantly for plan sponsors, plan information, investment education, general investment information and asset allocation models).

Carve-outs. Subject to certain conditions, the new rule also carves out from fiduciary status persons who engage in certain activities involving communications that would meet the definition of a "recommendation," such as (i) persons who provide investment advice or recommendations to plan fiduciaries that manage or control $50 million or more of assets in one or more plans or accounts, provided that the person does not directly receive compensation from the plan or plan fiduciary, (ii) investment platform providers, (iii) swap counterparties, and (iv) certain employees of the plan sponsor, in their capacity as such. The foregoing carve-outs would not apply if the person represents or acknowledges it is acting as a fiduciary.

Exemptions. A new administrative class exemption known as the "best interest contract exemption" (BIC Exemption) was released by the DOL simultaneously with the new rule. The BIC Exemption allows fiduciaries to receive commissions, revenue sharing and other types of compensation that may otherwise give rise to prohibited conflicts of interest, provided that certain conditions are satisfied. The exemption is intended to cover, among other situations, service providers (e.g., recordkeeper and broker-dealers) who may become fiduciaries under the new rule and have compensation arrangements that would otherwise violate ERISA. The central requirement of the BIC Exemption is the "impartial conduct standard," which became effective June 9, 2017. The standard requires that advisors:

- Provide advice that is in the "best interest" of the retirement investor; the best interest standard has two components: prudence and loyalty. Under the prudence standard, the advice must meet a professional standard of care, and under the loyalty standard, the advice must be based on the best interests of the customer, rather than the competing financial interest of the advisor or firm.
- Charge no more than reasonable compensation.
- Make no misleading statements about investment transactions, compensation and conflicts of interest.

Among the conditions that become effective on January 1, 2018, are requirements to execute a contract with IRA investors with certain enforceable promises, make specified disclosures, and implement specified policies and procedures to protect retirement investors from advice that is not in their best interest.

In addition, the exemption in ERISA Section 408(b)(14) and 408(g) in effect prior to the new rule continues to be available to fiduciaries who provide investment advice to participants.

Impact on Plan Sponsor, Plan Committees and Employees of Plan Sponsor

- **Plan Committees.** Individuals designated in the plan as fiduciaries or appointed to act as fiduciaries (such as plan administrative and investment committees), individuals to whom fiduciary duties are delegated, and individuals who though not labeled fiduciaries exercise any discretionary control over plan assets will continue to be fiduciaries with respect to investment decisions made for the plan.
- **Employee Advice to Sponsor.** In the case of other employees of a plan sponsor who develop reports, recommendations, and products for their employer (even in connection with fiduciary activities of the employer) or for a plan committee or other plan fiduciaries, such activity will not be treated as fiduciary investment advice if the employee receives no fee for such service beyond the employee's normal compensation. This carve-out was intended to cover employees working in a company's payroll, accounting, human resources and finance departments, who routinely develop reports and recommendations for the company and other named fiduciaries of the sponsors' plans.

  Example: Mary Smith is assistant treasurer of the Widget Company. Mary is frequently asked to advise and make recommendations to the Investment Committee for the Widget Company Defined Benefit Plan regarding plan investments. Mary is a participant in the plan, but is not a member of the Investment Committee and is not paid any additional compensation for her work in connection with the plan. Mary has no other relationship to the plan. It appears that Mary is not a fiduciary to the plan.
- **Employee Advice to Participants.** The new rule contains a general carve-out from fiduciary status for an employee who provides information to other employees as plan participants, provided that the employee receives no fee for such service beyond the employee's normal compensation. Significantly, however, the carve-out applies only if the duties for which such employee is responsible and compensated do not include the provision of investment advice or recommendations. According to the preamble to the new rule, the conditions of this carve-out were designed to address circumstances where an HR employee may inadvertently

make an investment recommendation within the meaning of the new rule, while still including within the scope of fiduciary activity investment advice and recommendations to participants where such activity is included in an employee's job responsibilities.

Example: John Smith is a benefits administrator for Widget Company and provides participants with information on the Widget Company Defined Benefit Plan, explains to participants their distribution options under the plan and the attendant tax consequences of each, and the mechanics for electing a direct rollover from the plan to an IRA. These activities alone would not cause John to be a fiduciary. John's duties do not include making recommendations to participants on issues such as how to invest their assets, which form of distribution to take, whether to roll over assets, what IRA vendor to select, how to invest IRA assets after the rollover or any other matters that involve "investment advice." One day, in the course of providing plan information on a phone call, John inadvertently makes a statement that could be construed as a recommendation. For this isolated incident, it appears that John would not become a fiduciary.

Impact on Service Providers

- **Carve-out for Platform Providers.** As noted above, investment platform providers will not become investment advice fiduciaries by reason of offering their investment platforms, provided that the platform provider discloses to the plan fiduciary that it is not undertaking to provide impartial investment advice and meets certain other conditions. Platform providers may also identify investment funds on their platforms that meet objective criteria specified by the plan fiduciary without becoming a fiduciary.

  Example: DataEx, Inc. provides recordkeeping and an investment platform for 401(k) plans. The Investment Committee for the Widget Company 401(k) Plan requests that DataEx identify, from the investment options available on the DataEx platform, options that meet certain objective criteria specified by the committee (e.g., stated parameters concerning expense ratios, size of the fund, type of assets or credit quality).

  DataEx has no other relationship to the plan. DataEx will not be a fiduciary. If DataEx were also a trustee, it would be a fiduciary in its capacity as trustee.

- **Carve-out for Advisors of Plan Fiduciaries of Plans with More Than $50 Million in Assets.** A service provider will not become an investment advice fiduciary as a result of advice or recommendations to *plan fiduciaries* (as opposed to participants) that manage or control $50 million or more of assets in one or more plans or accounts, except to the extent that the service provider receives a fee for such advice or represents or acknowledges that it is a fiduciary. This carve-out is subject to certain additional conditions including, *inter alia*, that the plan fiduciary be "independent" of the advisor (as described in the regulation), that the advisor knows or reasonably believes that the fiduciary is capable of evaluating the risks of the investment or transaction independently and that the advisor makes certain disclosures to the plan fiduciary.
  Example: The Widget Company Defined Benefit Plan has $1 billion in assets. The plan sponsor has retained BlueRock Recordkeeping Company to provide non-fiduciary services and pays a fee for those services. If BlueRock gratuitously advises the investment committee for the plan on plan investment matters for no additional fee and without agreeing to assume fiduciary status, it would not be an advice fiduciary, provided that other conditions of the "carve-out" are satisfied.

- **Education for Participants.** Providing plan participants with educational information regarding plan distribution options, asset allocation models, general investment concepts, and interactive materials without making recommendations regarding specific plan investment options is not fiduciary advice, even if the provider of such educational services receives a fee for such services. Asset allocation models and interactive materials may reference the plan's designated investment alternatives without crossing the line from education to fiduciary investment advice.
- **Investment Advice and Recommendations for Participants.** Service providers and employees or representatives of service providers who communicate with plan participants regarding plan investments and who make recommendations regarding distributions and rollovers from a plan may become investment advice fiduciaries under the new rule. Such employees could include call center personnel and financial advisors who make investment and distribution recommendations to plan participants, and sales reps who market investment products to plan participants.
- **Conflict of Interest Issues Associated with Fiduciary Status.** One of the biggest concerns associated with fiduciary status is potential prohibited conflicts. The incentives of recordkeeper service providers and their employees are typically not aligned with the interests of the plan participants because their platforms include affiliated investment funds and products that plan participants could be steered to through such communications (i.e., via recommendation of investment options or recommendation of distribution and rollover to IRA products of an affiliate of the recordkeeper). In addition, the provider may receive revenue sharing, 12b-1 fees, shareholder servicing or other contingent compensation from investment funds, products and services that are not affiliated with the service provider.

  Example: DataEx offers several proprietary mutual funds on its platform for which an affiliate of DataEx acts as investment manager for a fee. DataEx also offers non-proprietary funds on its platform that provide 12b-1 fees to DataEx, and other non-proprietary funds that do not provide DataEx with any distribution fees, revenue sharing or other compensation. If employees of DataEx advise participants on their investment options, the advice is arguably conflicted because DataEx employees could be viewed as having an incentive to steer participants to the DataEx proprietary funds or to those that provide 12b-1 fees. Such an arrangement would be prohibited absent an exemption, even if such funds were good investment options for the participants.
- **Courses of Action for Vendors.** As a result, service providers must either (1) cut back services provided to plan participants; (2) restructure or modify compensation structures to eliminate prohibited conflicts; or (3) comply with the BIC Exemption or another applicable exemption, such as the exemption under ERISA Section 408(b)(14) and 408(g).
- **Exemptions for Investment Advice.** The new BIC Exemption referenced above, along with the exemption at ERISA Section 408(b)(14) and 408(g), are available to vendors who provide participant investment advice. The terms and conditions of the exemptions are different and the activities covered differ somewhat. For example, ERISA Section 408(b)(14) and 408(g) would not cover rollover advice (see below). The requirements in ERISA Section 408(b)(14) and 408(g) are met only if advice is provided by a fiduciary advisor under one of two types of "eligible investment advice arrangement," one based on compliance with a "fee leveling" requirement (imposing limitation on fees and

compensation of the fiduciary advisor); the other, based on compliance with a "computer model" requirement (requiring use of a certified computer model). The conditions of the BIC Exemption are discussed above.

- **Rollover Advice.** As noted above, the ERISA Section 408(b)(14) and 408(g) exemption does not apply to advice regarding distributions and rollovers. If a recordkeeper or other financial institution communicates as a fiduciary with plan participants about plan distribution options and rollovers, and such communications would involve a conflict of interest or prohibited transaction, the financial institution and its advisors must satisfy the BIC Exemption, which will in most cases require[3] (and we believe plan sponsor fiduciaries should demand) that the fiduciary document why a recommendation is in the best interests of the participant. In the case of investment advice to roll over assets from an ERISA plan to an IRA, this documentation must include consideration of the participant's alternatives to a rollover, including leaving the money in his or her current employer's plan, if permitted, and must take into account the fees and expenses associated with both the plan and the IRA; whether the employer pays for some or all of the plan's administrative expenses; and the different levels of services and investments available under each option. Therefore, the plan fiduciaries must be sure that service providers who are permitted to advise plan participants on plan distributions and rollovers have and communicate the relevant information regarding the plan, as well as other information important to such a decision.
- **Limitation on Compensation Paid by Financial Institutions to Advisors.** The BIC Exemption provides that financial institutions[4] cannot use or rely upon quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that are intended or would reasonably be expected to cause advisors to make recommendations that are not in the best interest of the participant investor. As discussed below (in steps for the plan sponsor) this puts some additional burden on the plan sponsor from a due diligence perspective.

Plan Sponsor Action Steps

1. PERFORM AN IN-HOUSE REVIEW.

A. Review Roles and Responsibilities of Plan Sponsor Employees and Communications and Procedures. The plan sponsor should review the current allocation of responsibilities among in-house parties in light of the new definition of a fiduciary and (after taking into account any changes in vendor roles, discussed below) make any desired modifications in responsibilities assigned to in-house personnel. In addition, participant communications, distribution materials and educational materials distributed by in-house parties to participants, in-house call center scripts, and human resource procedures should be reviewed to ensure consistency with each in-house party's intended status as a fiduciary or non-fiduciary.

B. Review Fiduciary Liability Insurance. The relevant committee or plan sponsor should consider whether the company's fiduciary liability insurance coverage is broad enough to cover employees who become advice fiduciaries under the new rule. Note that ERISA bond coverage is not required for persons who merely provide investment advice, so changes to the ERISA bond are not likely to be required.

2. REVIEW WITH SERVICE PROVIDERS THEIR INTENDED ROLES UNDER THE NEW RULE AND DETERMINE COMPLIANCE WITH ERISA.

A. Participant Advisors.

(i) Vendors Who Choose to Remain or Become Non-fiduciaries. If a recordkeeper or other plan service provider cuts back

services in order to avoid fiduciary status under the new rule:

- The plan fiduciaries must understand the limitations and evaluate whether plan participants' needs will continue to be met, or whether it will be necessary to retain additional services to fill the gap.
- If the vendor provides general investment information and education that it intends not to rise to the level of investment advice or recommendations (e.g., asset allocation models and interactive investment tools), the plan fiduciaries still have an ongoing obligation to review the materials (i) to determine that they in fact do not rise to the level of investment advice or recommendations, and (ii) to ensure that the materials provided to participants are not biased.
- The applicable plan fiduciaries continue to be responsible for the prudent selection, retention and monitoring of any service provider, even if the vendor is not a fiduciary (i.e., the party selected must have the requisite expertise, its compensation must be reasonable relative to the services provided, the sponsor must obtain all required ERISA Section 408(b)(2) representations and disclosures, and the sponsor or other fiduciary must be in a position to monitor, and must actually monitor such vendor.) In the same vein, even if a vendor is not a fiduciary, plan fiduciaries should nevertheless review vendor compensation for possible conflicts of interest and discuss with the vendor how it intends to mitigate the effect of any conflicts. We are finding that in the current climate, vendors have become more open about discussing the various components of their compensation, which may allow plan fiduciaries an opportunity to better assess reasonableness and potential conflicts.

(ii) Vendors Who Become Fiduciaries under the New Rule. If a recordkeeper or other plan service provider will become a fiduciary under the new rule as a result of services provided to plan participants, plan fiduciaries must:

- fully understand and evaluate the eligibility and qualifications of such service provider to serve as an investment fiduciary (i.e., the party selected must have the requisite expertise to satisfy the prudent expert standard), its compensation must be reasonable relative to the services provided, the sponsor must obtain all required ERISA Section 408(b)(2) representations and disclosures, and the sponsor or other fiduciary must be in a position to monitor, and must actually monitor such fiduciary;
- determine the extent of any conflicts such service provider may have and whether the service provider can nevertheless act in the best interests of plan participants when providing fiduciary advice;
- assess compliance with the BIC Exemption or other applicable exemptions, such as ERISA Section 408(b)(14) and 408(g) (described below), if necessary. As noted above, the BIC Exemption contains stringent limitations on the compensation that may be paid by financial institutions to employees who act as advisors. Information regarding such employee compensation arrangements will not necessarily be disclosed by a recordkeeper in its routine ERISA Section 408(b)(2) or other disclosures, so may require additional due diligence by the plan sponsor;

- determine whether the plan fiduciary will be able to effectively monitor the performance of the service provider to ensure that the services are consistent with fiduciary standards of care, in the best interests of plan participants and in compliance with the law; and
- obtain appropriate contractual provisions such as those described in Section 3 below.

It should be noted that if the advisor is subject to a conflict of interest and no exemption applies, the plan sponsor may have exposure for participant losses resulting from the advisor rendering investment advice that is subject to a conflict of interest.

B. Plan Fiduciary Advisors.

(i) Vendor Unwilling to Act as Fiduciary to the Plan Committee or Other Plan Fiduciaries, but (X) Willing to Provide Recommendations, or (Y) Concerned That Its Communications Could Be Construed as Recommendations

If the vendor provides or possibly provides recommendations to plan fiduciaries, but wants to avoid fiduciary status under the "$50 million in assets" carve-out, plan fiduciaries should consider the extent to which they expect or desire service providers who make recommendations regarding investment matters to be fiduciaries and be sure that any carve-outs from fiduciary status to which they agree are not overly broad. We find that some of our clients greatly prefer to have all recommendations come from parties acting as fiduciaries in order to ensure that they have some "skin in the game."

- If the plan fiduciaries are amenable to the vendor making recommendations as a non-fiduciary, they will need to obtain certain representations and disclosures from the vendor to ensure its non-fiduciary status and to avoid any possibility of co-fiduciary liability.
- Although the vendor may not receive any fee for its recommendations (in order to preserve non-fiduciary status), the plan fiduciaries should conduct sufficient due diligence to confirm the expertise of the vendor and to determine whether the vendor's advice might be subject to any conflicts before following any recommendations of the vendor.

(ii) Vendor Willing to Act as Fiduciary to the Plan Committee or Other Plan Fiduciary (Presumably for a Fee) All of the ERISA fiduciary standards applicable to the prudent selection, monitoring and retention of a plan fiduciary apply (see Section 2A(ii)).

The foregoing steps in Section 2A and B entail significant due diligence and also may require modification of existing contracts, which we discuss in the next section.

3. REVIEW CONTRACTS.

Existing service agreements may need to be reviewed and/or amended to reflect the new fiduciary status of service providers. The review and amendments might include adding appropriate new ERISA representations, warranties, covenants and reporting provisions, particularly as to the satisfaction of any exemption needed; reviewing the scope of service provider indemnification and exculpation provisions to reflect the ERISA standards of care and carve-outs for breach of fiduciary duty; and considering whether the indemnity provided by the service provider to the plan sponsor should be enhanced to cover potential ERISA fiduciary breach claims triggered by the service provider's conduct. We provide a checklist of some of the principal requirements below, but it is important that each contract receive a legal review from this perspective as the requirements can be quite detailed.

A. Representations and Warranties.

- Vendor acknowledges it is acting as a fiduciary for "in scope" activity described in the contract.
- Vendor represents that it has disclosed all actual and potential conflicts of interest of it and its employees in connection with its fiduciary activity.
- Vendor represents that the conditions of an applicable ERISA exemption are satisfied for all actual and potential conflicts of interest.

  Note: Confirmation of compliance with the specific exemption(s) being relied upon is enough for a representation; it is not necessary to obtain a representation for each component of the exemption. As a diligence matter, however, a plan fiduciary should obtain evidence of compliance with certain requirements, such as a copy of the financial institution's conflict avoidance policies, disclosure of all direct and indirect compensation, disclosure of any affiliations or other arrangements with plan investment options.

- Vendor covenants to meet all requirements of the applicable exemption going forward, including, without limitation, the annual audit requirement of ERISA Section 408(b)(14) and 408(g).

B. Covenants and Standard of Care.

- The existing standard of care, if any, described in the service agreement should be conformed to ERISA's fiduciary standards (e.g., prudent expert and exclusive benefit standard).
- The vendor should agree to deliver any information needed by the plan fiduciaries or their advisors to confirm compliance with ERISA and applicable exemptions.
- The vendor should agree to maintain the level of fiduciary liability insurance normally required by the plan fiduciaries for investment service providers.
- Reporting – Fiduciary providing investment advice to participants should agree to provide reports on number of participants served, action on advice given, results, etc.

C. Indemnity and Exculpation.

- The contract should be revised to eliminate any exculpatory clauses that are inconsistent with ERISA (e.g., clarify that exculpation does not apply in the case of losses suffered by plan for breach of fiduciary duty).
- Indemnification provisions may need to be revised to provide for fiduciary breach carve-out.

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Endnotes

[1] In addition to the BIC Exemption, the DOL issued a related prohibited transaction exemption ("Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs"), which is not the subject of this Legal Update, and made amendments to existing prohibited transaction class exemptions 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128.

[2] On March 28, 2017, the Treasury Department and the IRS issued IRS Announcement 2017-4 stating that the IRS will not apply § 4975 (which provides excise taxes relating to prohibited transactions) and related reporting obligations for any transaction or agreement to which the Labor Department's temporary enforcement policy described in FAB 2017-01, or other subsequent related enforcement guidance, would apply. The Treasury Department and the IRS have confirmed that, for purposes of applying IRS Announcement 2017-4, FAB 2017-02 constitutes "other subsequent related enforcement guidance."

[3] The documentation requirement is associated with a variant of the BIC exemption that applies in the context of advisors with certain types of level fee arrangements.

[4] Bank, insurance company, broker dealer or registered investment advisor.