

Cutting Through the Fog: The Applicability of DOL Conflicts of Interest Rule to Financial Advisors

By Lori T. Oliphant

The Department of Labor's (DOL's) new Conflicts of Interest rule¹ expands the scope of the definition of "fiduciary" under ERISA² and the Code³ to cover more classes of financial advisors. This rule replaces a long-standing regulatory interpretation of the term "fiduciary" as it relates to the provision of investment advice for employee benefit plans and other tax-advantaged accounts, such as individual retirement accounts and health savings accounts (collectively referred to herein as IRAs).⁴ While the final rule became effective on June 7, 2016, it does not become applicable until April 10, 2017. This article addresses common questions related to the final rule and provides recommendations of actions for advisors to take prior to its applicability date.

How is the term fiduciary defined under ERISA and the Code?

Under ERISA and the Code, the term "fiduciary" is defined on a functional basis to include, among others, any person, to the extent he or she has or exercises certain discretionary authority, responsibility, or control with respect to plan assets and administration. The final rule does not change the fiduciary status of such "discretionary" advisors. For example, investment managers with discretionary authority to manage plan assets will continue to be fiduciaries following the applicability date of the final rule.

In addition, however, a person is a fiduciary under ERISA and the Code to the extent he or she renders investment advice for a fee or other compensation with respect to plan assets, or has any authority or responsibility to do so. Note, that this portion of the definition could include "non-discretionary" advisors.

Prior to the final rule, a "non-discretionary" advisor had to meet a 5-factor test in order to be considered a fiduciary under this portion of the definition. Generally, the *advice* had to relate to the value of the plan assets or the acquisition or disposition of plan assets, be provided on a *regular basis* to the plan pursuant to a *mutual understanding* of the parties that the advice would serve as the *primary basis* for investment decisions with respect to plan assets, and the advice had to be

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individualized based on the particular needs of the plan. If any factor of this regulatory test was not satisfied, the person rendering the advice would not be considered a fiduciary by virtue of providing such advice. As a practical matter, then, many investment advisory agreements often included provisions that would specifically thwart the applicability of one or more of these factors and such advisors would not be considered fiduciary under either ERISA or the Code. Further, under certain common fact patterns in the retirement industry, advisors would not be considered fiduciaries under this 5-factor test. For example, persons who provided one-time advice, like recommendations to make a rollover from a qualified plan or to make an investment of a rollover into an insurance or annuity product, were not considered fiduciaries because such advice was not provided on a *regular* basis.

The final rule replaced the 5-factor test with a broader regulatory definition of fiduciary advisors. As a result, many financial advisors who were previously not considered “fiduciaries” under this latter part of the definition may now be considered fiduciaries.

What types of advice are covered by the final rule?

It is probably not surprising that covered advice under the final rule includes a recommendation about the advisability of acquiring, holding, disposing of or exchanging securities or other investment property, as well as a recommendation as to the management of securities or other investment property, including a recommendation on investment policies or strategies or portfolio composition, as these concepts were expressly included in the prior regulation. Additionally, covered advice continues to encompass the rendering of ongoing investment advice to a participant or beneficiary in a participant-directed ERISA plan (such as a 401(k) plan) or an IRA owner.

What has changed (and in some respects become clearer) under the final rule is that covered advice also includes the following:

- a) A recommendation as to how securities or other investment property should be invested after being rolled over, transferred, or distributed from an ERISA plan or IRA,
- b) A recommendation regarding the selection of other persons to provide investment advice or investment management services,
- c) A recommendation regarding the selection of investment account arrangements (e.g. commission-based brokerage v. fee-based advisory), and
- d) A recommendation with respect to rollovers, transfers, or distributions from an ERISA plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer or distribution should be made.

As a result, following the applicability of the final rule, investment advice provided to an individual ERISA plan participant or IRA owner regarding rollovers, transfers and distributions affecting his or her plan or IRA account will fit squarely within the final rule.

Does the final rule apply to me if I am not a registered investment adviser?

It could. The final rule is not limited to registered investment advisers. Any person who provides covered advice could be considered a fiduciary under the final rule, unless an exception applies. This could include, for example, financial advisors who are investment advisers (registered or unregistered), broker-dealers, financial planners, wealth managers, retirement planners, insurance agents, plan consultants and plan record keepers. Remember, the definition of fiduciary is determined on a functional basis and is not limited to persons with specific titles, registrations or status under securities or other laws.

What type of communication is considered a “recommendation” under the final rule?

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 final rule imposes an objective standard that looks at whether there is a “call to action” that a reasonable person would believe was a suggestion to make or hold a particular investment or pursue a particular investment strategy.

For these purposes, investment activities are evaluated at each step of the transaction. For example, a recommendation to an ERISA plan participant to take a distribution of his or her plan account balance and invest in an annuity product is considered two recommendations – the first, with regard to taking the distribution, and the second, with regard to

the actual investment. It is this concept that could implicate even those advisors who are investment managers of separately managed accounts or entities that allow investments by ERISA plans and IRAs (even if such entities are not considered to hold plan assets). A simple marketing technique where the advisor recommends that the investor utilize his or her retirement account to purchase an investment product could be considered a “recommendation” under the final rule.

Note, however, the final rule includes a non-exhaustive list of activities that are not considered recommendations, including the offering of an investment platform for participant-directed plans; the provision of investment education information and materials to plan participants or IRA owners, including asset allocation models and interactive investment materials for plan

- a) Represents or acknowledges that it is acting as a fiduciary within the meaning of ERISA or the Code,
- b) Renders the 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; or
- c) Directs the advice to a specific advice recipient(s) regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.

As mentioned above with regard to the now replaced 5-factor test, there no longer needs to be a mutual understanding of the parties that the advice will serve as the primary basis of the recipient’s investment decisions or that the advice will be individualized in order for the advisor to be a fiduciary.

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participants; and general or public communications. Some of these exceptions are conditioned upon specific disclosure requirements. Any advisor who believes that he or she engages in an activity that could fit within one of these exceptions should work directly with his or her ERISA counsel to ensure that the conditions of the applicable exception are satisfied.

Does the recommendation need to be made under any certain circumstances in order to implicate the final rule?

Yes. Not all recommendations will implicate the final rule. Rather, the recommendation must be made directly or indirectly by a person who:

Does the final rule only apply if I give the covered advice to an ERISA plan?

No. The final rule is not limited to advice provided to ERISA plans and their fiduciaries, such as plan administrators and trustees. The definition of fiduciary following the applicability of the final rule continues to encompass investment advice provided to individual participants and beneficiaries in an ERISA plan as well as advice provided to IRA owners with respect to the ongoing investment

of their accounts. As noted in Question 2 above with respect to the types of advice covered by the final rule, what has changed is that fiduciary investment advice now includes a broad range of recommendations provided to an IRA or IRA owner, or to an ERISA plan participant or beneficiary with respect to more discrete transactions, such as a rollover.

Is free advice covered by the final rule?

No. A financial advisor must receive a fee or other compensation for the advice to be covered under the final rule. However, this concept is extremely broad and applies with respect to various cash and non-cash arrangements, such as

commissions, loads, finder's fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, underwriting compensation, payments to brokerage firms in return for shelf space, recruitment compensation paid in connection with transfers of accounts to a registered representative's new broker-dealer firm, gifts and gratuities, and expense reimbursements.

The real question is whether the fee or compensation would not have been paid but for the recommended transaction or advisory 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. It is irrelevant whether the fee or compensation is paid by the customer or by a third party, and whether it is paid directly to the advisor or to an affiliate.

Are there any exceptions provided under the final rule for advice that is considered a recommendation?

Yes. Even if the advisor receives a fee or other compensation in connection with advice that is considered a recommendation, it will not be a fiduciary advisor under the final rule if any one of three regulatory exceptions applies.

The first regulatory exception covers certain transactions, such as sales pitches, that are part of an arm's length transaction with a sophisticated plan fiduciary – i.e. a bank, insurer, registered investment adviser, registered broker-dealer, or fiduciary of a plan or IRA with at least \$50 million in assets under management - where neither side assumes that the counterparty to the plan is acting as an impartial or trusted advisor, provided certain conditions and disclosures are satisfied. A financial advisor who intends to rely on this exception must retain appropriate documentation reflecting that all requirements of this exception have been satisfied with respect to each transaction.

The second regulatory exception is for certain communications and activities conducted during the course of swap or security-based swap transactions. The third regulatory exception covers certain advice provided by employees of the plan sponsor (or an affiliate) to other employees or independent contractors of the plan sponsor. This last exception would not, however, cover recommendations provided to employees in their capacities as plan participants and beneficiaries, as those communications are governed by the general fiduciary standards of ERISA.

What are the implications of being considered a fiduciary under the final rule? Why should I care?

A financial advisor that is considered a fiduciary of an ERISA plan (or with respect to an ERISA plan participant or beneficiary) is subject to the fiduciary responsibility rules of ERISA, which are considered the “highest known to the law” – and a standard that most certainly would exceed the “suitability” standard applicable to broker-dealers under current law, and probably even the fiduciary standard applicable to investment advisers under the federal securities laws. For example, an ERISA fiduciary is required to act in the *sole interest* of the participants and beneficiaries of the plan and with the prudence of an *expert* knowledgeable in the field. In addition, ERISA fiduciaries are subject to a number of reporting and disclosure requirements and are personally liable for losses to the applicable plan that results from a violation of the fiduciary responsibility standards under ERISA.

ERISA also prohibits fiduciaries from engaging in prohibited transactions, including self-dealing transactions where conflicts of interest may be present. This is particularly apparent with respect to variable fee and commission-based arrangements, as well as other arrangements that result in additional compensation or other benefits to the advisor. While similar prohibited transaction rules are prescribed under the Code (and would apply to IRAs, for instance), there is no fiduciary standard of care imposed under the Code with respect to IRA accounts. It is important to remember that there is no defense to a self-dealing transaction under ERISA or the Code. It is irrelevant whether the amount of the compensation is reasonable, whether it was disclosed, and whether the transaction was intentional.

Violations of the prohibited transaction rules under either ERISA or the Code can result in significant excise taxes (of up to 100% of the amount involved) being imposed by the Department of Labor or the Internal Revenue Service upon the parties involved in the transaction (such as the financial advisor); however, there is no statutory right on the part of IRAs to pursue any action against an investment advisor for breach of fiduciary duty. Note, however, a financial advisor that relies on the Best Interest Contract Exemption described in Question 14 below is required to provide the IRA owner to whom it provides covered advice a contractual right to sue the advisor for failure to satisfy the requirements of the

exemption, including the impartial conduct standards prescribed under the exemption.

Will I become subject to ERISA with respect to covered advice provided to an IRA or IRA owner?

No. While the same definition of fiduciary applies under ERISA and the Code, a fiduciary advisor to an IRA or IRA owner will not be subject to the fiduciary responsibility rules or prohibited transactions rules prescribed under ERISA. Rather, such advisor *is* subject to similar prohibited

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transactions rules appearing in the Code. As mentioned previously, however, advisors who rely on the Best Interest Contract Exemption described in Question 14 will contractually be subject to similar standards of conduct as apply to ERISA fiduciaries.

Does the DOL have authority to prescribe a rule that covers advisors to IRAs?

In adopting the final rule, the DOL relied on a longstanding rule⁵ that provides the DOL interpretative authority over the prohibited transaction rules prescribed under both ERISA and the Code. The issuance of the final rule is not the first time the DOL has issued a regulation that applies to IRAs.⁶ Similarly, as a result of this long-standing rule, the DOL has the sole authority and responsibility to issue advisory opinions and

other guidance regarding the interpretation of the prohibited transactions under both ERISA and the Code. As a result, a financial advisor to an IRA owner would normally rely on DOL guidance regarding whether a particular transaction constitutes a prohibited transaction under the Code.

However, many advisors and industry groups have taken issue with the DOL's exercise of such authority and multiple cases have been filed seeking an injunction against the applicability of the final rule.⁷ Unfortunately, with the applicability date looming in the not-so-distant future, wise advisors are proceeding with their compliance efforts under the assumption that the rule will be applicable on April 10, 2017, as originally envisioned.

Are there any types of compensation arrangements that will not be implicated by the final rule?

While the definition of “fee or compensation” under the final rule includes many if not most compensation arrangements, the receipt of a level fee or a flat fee will not implicate the prohibited transaction rules under ERISA or the Code. A “level fee” refers to a fixed percentage of the value of a customer's assets under management, where such values are determined by readily available independent sources

or independent valuations. Note, however, that even if you receive a level fee following a recommended investment, you may have been operating under a conflict of interest with respect to the initial advice to make the rollover or to invest in the annuity, for example, and will implicate the prohibited transaction rules with respect to that portion of the transaction.

Am I prohibited from receiving variable compensation (like commissions) following the applicability date of the final rule?

Yes, if you provide fiduciary investment advice under the final rule, then the receipt of variable compensation, such as commissions, after the applicability date would generally result in a prohibited transaction under ERISA and the

Code. However, advisors who satisfy the conditions of an applicable prohibited transaction exemption may continue to receive variable compensation even after the applicability date of the final rule.⁸

Of importance, the DOL issued a new prohibited transaction exemption simultaneously with the final rule.⁹ It is referred to as the “Best Interest Contract Exemption.” It is limited to prohibited transactions arising in connection with covered advice provided to “retail investors” – which is defined as participants and beneficiaries of participant-directed plans, IRA owners, and fiduciaries of plans and IRAs with less than \$50 million in assets under management – and it is conditioned on the satisfaction of several requirements.

What do I have to do to comply with the Best Interest Contract Exemption?

An advisor who desires to rely on the Best Interest Contract Exemption must provide a written acknowledgement of its fiduciary status to the investor and the advisor must adhere to certain impartial conduct standards which are intended to mirror existing fiduciary standards under ERISA – namely, that the advisor act in the best interest of the customer and without regard to the advisor’s financial interests, that the compensation to be received be reasonable, and that the advisor make no misleading statements. The exemption also requires a written contract for arrangements with IRA owners as well as the adoption of policies and procedures to address conflicts of interest and the appointment of a person to oversee compliance with such policies and procedures. However, many advisors may already have contracts, policies, and supervisory controls in place, which should be reviewed and revised to the extent necessary if they intend to rely on the exemption. There are a number of disclosure requirements applicable under the exemption, some of which will be satisfied up front, in an investment advisory agreement, and others which must be satisfied at the time of a transaction and continually on a publically-accessible website. An advisor that wants to rely on this exemption must notify the DOL of such reliance, retain records of compliance for at least 6 years, and allow its clients or customers and the DOL to inspect relevant documents.

Note, the Best Interest Contract Exemption provides streamlined compliance procedures for advisors that make recommendations where the subsequent compensation will

be paid under a level fee arrangement. Advisors with such arrangements would be well advised to review the conditions of such procedures.

What should financial advisors do if they think they might be a fiduciary?

While this is not an exhaustive list, the first step should be for the financial advisor, in consultation with his or her legal counsel, to determine whether the advisor is a fiduciary under the final rule. Remember, in order to be a fiduciary under the final rule, the financial advisor must (a) provide covered advice (see Question 2), (b) that constitutes a recommendation (see Question 4), (c) that is made under specified circumstances (see Question 5), (d) for a fee or other compensation (see Question 7), and (e) that is not otherwise excepted from coverage under the final rule (see Question 8).

If an advisor determines that it will be a fiduciary, the next step is to review the investment advisory arrangement to determine if he or she (or an affiliate) is entitled to receive compensation that results in a conflict of interest under the final rule (see Questions 12-13). If the fiduciary advisor will receive such compensation, then the advisor needs to determine whether the arrangement can satisfy a prohibited transaction exemption in order to avoid violations of ERISA and the Code, such as the Best Interest Contract Exemption (see Question 14).

Reliance on a prohibited transaction exemption may require revisions to existing contracts, policies and supervisory controls. Furthermore, ERISA plan fiduciaries may require that investment advisory contracts be revised to reflect the new fiduciary standard that applies under the final rule, as well as increased indemnification provisions. Fiduciary advisors should also consider purchasing fiduciary liability insurance to protect against the increased exposure to liability under the final rule.

Conclusion

Financial advisors to ERISA plans, IRAs, participants and beneficiaries may initially have been surprised to discover that they are fiduciaries under the final DOL Conflicts of Interest rule. However, now that the initial shock has started to settle, advisors should not delay in determining their fiduciary status and preparing a plan of action for compliance.

ENDNOTES

- ¹ The new rules and related materials can be accessed on the DOL's website at: <https://www.dol.gov/ebsa/regs/conflictsofinterest.html>. The new rules were published on April 8, 2016.
- ² ERISA is the acronym for the Employee Retirement Income Security Act of 1974 (Pub.L. 93-406, 88 Stat. 829, enacted September 2, 1974, codified in part at 29 U.S.C. ch. 18), which constitutes the key federal statute governing employee pension and welfare benefit plans sponsored by employers and employee organizations.
- ³ Code refers to the Internal Revenue Code of 1986, as amended.
- ⁴ The reference to tax-advantaged accounts also includes SEP-IRA accounts, SIMPLE IRA accounts, Roth IRA accounts, Archer MSAs and Coverdell Education Savings Accounts. Note, however, that governmental plans, foreign plans and nonelect-
- ing church plans are excluded from the scope of the final rule. Plans maintained by tax-exempt entities under Code Section 403(b) are also excluded, unless the arrangement is considered an ERISA plan.
- ⁵ See Reorganization Plan No. 4 of 1978.
- ⁶ For example, the plan asset rule prescribed under ERISA (29 CFR Part 2510) applies equally to IRAs in determining whether private companies in which IRAs invest are considered to own plan assets. This determination is important for determining whether the investment by the IRA implicates the prohibited transaction rules of the Code.
- ⁷ Three lawsuits have been filed in U.S. District Court for the Northern District of Texas located in the Fifth Circuit – the first by the U.S. Chamber of Commerce, the Securities Industry and Financial Markets Association and 6 other trade associations, the second by the American Council of Life Insurers and National Association of Insurance and Financial Advisors, and the third by the Indexed Annuity Leadership Council. The National Association of Fixed Annuities filed a federal lawsuit in the D.C. District Court and Market Synergy Group filed a lawsuit in the District Court of Kansas located in the Tenth Circuit.
- ⁸ Note, however, that the Best Interest Contract Exemption provides an exemption for certain compensation related to pre-existing transactions.
- ⁹ The DOL also issued a new prohibited transaction exemption to cover principal transactions and amended several existing prohibited transaction exemptions to incorporate similar standards as apply under the Best Interest Contract Exemption.

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