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Special Focus

The Accidental Fiduciary: The Unexpected Reach of the New Fiduciary Rule

On June 9, 2017, after over forty years of "banking" on a simple understanding of the fiduciary rule, the initial phase of the Department of Labor's (the "DOL") new and controversial fiduciary rule was implemented. The new rule, applicable to financial service firms that manage retirement assets, expands the scope of who is a fiduciary under the Employee Retirement Income Security Act ("ERISA"), which in turn triggers a number of fiduciary investment advice responsibilities for such individuals. Under the new fiduciary rule, a fiduciary is required to put the client's best interest first, act in a prudent manner, avoid misleading clients, provide complete disclosures of all relevant information and avoid conflicts of interest.

Although the new fiduciary rule has been in the works since 2010, many financial institutions have been caught off guard by the application of the new rule to their employees and banking operations. In particular, the rule expands the types of situations where communications with customers may be deemed investment advice subject to the rule. Banks must carefully consider how the new rule will impact their operations in order to ensure that communications with customers will not inadvertently trigger the application of the fiduciary rule. In the alternative, financial institutions with trust departments, investment advisory and broker-dealer operations, and other wealth management lines of business will need to develop and execute plans to bring their operations into compliance with the new fiduciary rule.

History

Adopted in 1975, the old fiduciary rule created a strict five-part test that determined whether an individual was a fiduciary. Under the old rule, an individual would be deemed a "fiduciary" if he or she rendered advice: (1) as to the value of securities or other property, or made recommendations as to the advisability of investing in, purchasing or selling securities or other property; (2) on a regular basis; (3) pursuant to a mutual agreement, arrangement or understanding with the plan or the plan fiduciary; (4) that served as a primary basis for investment decisions with respect to plan assets; and (5) that was individualized based on the particular needs of the plan or IRA. To avoid application of the old rule, a person needed only to eliminate one (or more) of the five aforementioned elements from the customer relationship. For example, so long as the customer only received investment advice periodically (i.e. not on a regular basis), the old fiduciary rule would not have been triggered.

The 1975 regulation was adopted prior to the existence of wide-spread use of IRAs, participant-directed 401(k) plans, and the now commonplace rollover of plan assets from ERISA-protected plans to IRAs. This prior regulation also allowed some advisors, brokers and consultants to play a central role in shaping employee benefit plan and IRA investments without being subject to fiduciary obligations under ERISA or the Internal Revenue Code.

Fiduciary Rule

Effective June 9, 2017, the new fiduciary rule amends the regulatory definition of fiduciary investment advice to replace the limited five-part test with a new and much broader definition. The new 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 first describes the kinds of communications that constitute investment advice and then describes the types of relationships in which such communications give rise to fiduciary investment advice responsibilities.

What is investment advice under the rule?

A person gives investment advice if he or she provides, for a fee or other compensation (direct or indirect), the following types of advice:

- Recommendations regarding the advisability of buying, holding, selling, or exchanging securities or other investment property, including recommendations as to the investment of securities after the securities are rolled over or distributed from a plan or IRA;

- Recommendations as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide other investment advice or investment management services, and selection of investment account arrangements; or
- 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 such a rollover, transfer, or distribution should be made.

The fundamental threshold element in establishing the existence of fiduciary investment advice is whether a "recommendation" has occurred. A recommendation is a communication that, based on its content, context and presentation, would reasonably be viewed as a suggestion that the recipient engage in or refrain from taking a particular course of action. According to the DOL's Frequently Asked Questions on the fiduciary rule, published in January 2017, the more selective and specifically tailored the advice, the more likely it is to be considered as a recommendation and, therefore, trigger the new fiduciary rule if it is coupled with a financial incentive.

In addition to a recommendation, there must be a fee or other form of compensation associated with the investment advice. Fees can be (i) direct, meaning any compensation or fees received from the customer that is explicitly connected to the investment advice given, or (ii) indirect, meaning any compensation or fees received from any other source in connection with the recommended transaction or service. Examples of the types of fees that trigger the fiduciary rule are: commissions; loads; finder's fees; revenue sharing payments; shareholder servicing fees; marketing or distribution fees; underwriting compensation; payments to firms in return for shelf space; recruitment compensation; gifts and gratuities; and expense requirements.

What is not covered under the rule?

Not all communications with financial advisors or employees will be covered by the new fiduciary rule. Specific examples of communications that would not rise to the level of a recommendation and therefore would not constitute fiduciary investment advice include:

- **Investment Education:** The DOL created exemptions from the definition of "recommendations" for certain educational information and materials. Delivery of such information or materials to a customer will not be considered "recommendations." Examples of such educational information include:
  - Plan and investment information: information and materials that describe investment or plan alternatives without specifically recommending particular investments or strategies;
  - General financial, investment, and retirement information: any general financial, investment, or retirement information is non-fiduciary as long as it does not cross the line of recommending a specific investment or investment strategy;
  - Asset allocation models: financial institutions can provide materials on hypothetical allocations provided that they do not cross the line of making specific investment recommendations or referring specific products. These models must be based on generally accepted investment theories and explain the assumptions on which they are based; and
  - Interactive investment materials: financial institutions can provide questionnaires, worksheets, software and similar materials that enable retail investors to estimate future needs. As with the asset allocation models, the investment materials cannot cross the

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line of making specific fiduciary investment recommendations or referring to specific models.

- **General Communications:** Examples of general communications that a reasonable person would not view as fiduciary investment advice include:
  - General circulation newsletters;
  - Commentary in publicly broadcasted 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.

The Best Interest Contract Exemption

ERISA and the Internal Revenue Code generally prohibit fiduciaries from receiving payments from third parties and from acting on conflicts of interest, including using their authority to affect or increase their own compensation, in connection with transactions involving an employee benefit plan or IRA. For example, an advisor has a conflict of interest when the advisor recommends that a participant roll money out of an employer plan, such as a 401(k) plan, into an IRA that will generate ongoing fees for the financial institution.

In addition to adopting an amended definition of fiduciary, the DOL also implemented a new exemption from prohibited transactions, which is referred to as the Best Interest Contract Exemption ("BIC exemption"). According to the DOL, the BIC exemption is designed to promote the provision of investment advice that is in the best interest of retail investors, such as plan participants and beneficiaries, IRA owners and small plans. To facilitate continued provision of advice to such retail investors, the exemption allows investment advice fiduciaries, including investment advisors and broker-dealers, and their agents and representatives, to receive fees and compensation that, in the absence of an exemption, would not be permitted under ERISA and the Internal Revenue Code.

The BIC exemption permits financial advisors (i.e., individuals who are representatives of investment advisors, broker-dealers or banks or similar financial institutions) and the financial institutions that employ them to continue to rely on many current compensation and fee practices, as long as they meet specific conditions intended to ensure that financial institutions mitigate conflicts of interest, and they and their financial advisors, provide investment advice that is in the best interests of the customers. Specifically, in order to rely on the BIC exemption after December 31, 2017, a financial institution generally must:

- Acknowledge fiduciary status for itself and its advisors;
- Adhere to basic impartial conduct standards (described below);
- Commit to such impartial conduct standards in an enforceable contract when providing advice to an IRA owner;
- Implement policies and procedures reasonably and prudently designed to prevent violations of such impartial conduct standards;
- Refrain from giving or using incentives for financial advisors to act contrary to the customer's best interest; and
- Fairly disclose the fees, compensation, and material conflicts of interest associated with their recommendations.

Under the BIC exemption, a financial institution which provides fiduciary advice must maintain and regularly update a website that includes information about the financial institution's business model and associated material conflicts of interest; a schedule of a typical account fees; a model contract; a written description of the financial institution's policies and procedures that mitigate conflicts of interest; a list of all product manufacturers and other parties that provide third party payments with respect to specific investment products or classes of investments; a description of the third party arrangements, including a statement on whether and how these arrangements impact financial advisor compensation, and a statement on any benefits the financial institution provides in exchange for the payments; and disclosure of compensation and incentive arrangements with financial advisors. Individualized information about a particular advisor's compensation is not required to be on the website. All financial institutions relying on the BIC exemption also must notify the DOL in advance, and retain records that can be made available to the DOL and retirement investors for evaluating compliance with the exemption.

Furthermore, the exemption provides for enforcement of the standards it establishes in the form of a contract. When providing advice to an IRA owner, the financial institution must commit to the impartial conduct standards in an enforceable contract. In the contract a financial institution must acknowledge its fiduciary status and that of its financial advisors. ERISA investors can directly assert their rights to proper fiduciary conduct under

ERISA's statutory protections within the contract. If financial advisors and financial institutions do not adhere to the standards established in the exemption, retirement investors will have a way to hold them accountable—either through a breach of contract claim or under the provisions of ERISA.

Impartial Conduct Standards

Initially, the BIC exemption was supposed to be implemented in its entirety on June 9, 2017. However, during a transition period that will run until January 1, 2018, only the "Impartial Conduct Standards" provisions of the BIC exemption will be required of financial advisors and financial institutions that have fiduciary responsibilities. Specifically, during this transition period, in order to rely on the BIC exemption, financial advisors and financial institutions with fiduciary responsibilities must:

- Give investment advice that is in the "best interest" of the retirement investor. The best interest standard has two main components: prudence and loyalty.
    - **Prudence:** Recommendations must reflect the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity familiar with such matters would use in the conduct of an enterprise of a like character with like aims.
    - **Loyalty:** Recommendations must be based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor, without regards to the financial or other interests of the investment advisor representative, employee, advisor, or any related entity or other party.
- Charge no more than reasonable compensation. The obligation of service providers to charge no more than reasonable compensation has long applied to advisors. The reasonableness of the fees depends on the facts and circumstances.
- Ensure that statements about services, recommended products and transactions, fees and compensation, material conflicts of interest and other relevant matters are not materially misleading at the time made.

Absent further action from the DOL, all other requirements of the BIC exemption will become effective on January 1, 2018. Although most aspects of the BIC exemption have not been implemented yet, financial institutions need to have policies in place to comply with the Impartial Conduct Standards and plan ahead for compliance with the rest of the rule at the beginning of next year.

Conclusion

As of June 9, 2017, financial institutions must fully understand (1) the new definition of a "fiduciary" and how to keep employees from inadvertently becoming a fiduciary, and (2) depending on what kind of services a financial institution offers, how to instruct their existing employees who do have a fiduciary duty to comply with the "Impartial Conduct Standards" of the BIC exemption. For most financial institutions, the goal will be to ensure that routine communications with the customers regarding retirement assets, such as advice regarding IRA accounts, do not trigger the fiduciary rule. For other financial institutions, the goal will be to implement an appropriate plan to ensure compliance with the fiduciary rule during the transition period and after the delayed effective date. Although this task may seem daunting at first, it is not impossible. Due to the fact that the majority of the BIC exemption has been delayed until January 1, 2018, now is the time for financial institutions to implement policies and procedures to meet the current requirements and plan ahead to ensure they are adequately prepared for the implementation of the remaining parts of the BIC exemption. A financial institution's policies and procedures should be thoughtfully drafted and include specific guidelines for employee conduct. Additionally, financial institutions should review their investment advisory agreements, brochures and compensation structures to ensure they do not create a potential conflict of interest.

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