THE DEPARTMENT OF LABOR'S FINAL RULE ON CONFLICTED INVESTMENT ADVICE

AN UPDATE:
What's Changed, and What Plan Sponsors Need to Know

Fisher Investments®
401(k) Solutions

Publish Date 5/23/2016

Plan Sponsors and Investment Advisers:

WHAT YOU NEED TO KNOW ABOUT THE DEPARTMENT OF LABOR'S FINAL RULE ON CONFLICTED INVESTMENT ADVICE

In mid-March of 2016, we published a discussion of the Department of Labor's ("DOL") proposed rule change to address the issue of financial advisers giving conflicted advice to retirement savers and investors. On April 6, 2016, the DOL finalized that rule change—with some important modifications. To recap, the thrust of the new rule is to hold more financial advisers to the standards of a "fiduciary" under the Employee Retirement Income Security Act ("ERISA") and require that the investment advice they give is in the "best interests" of retirement plans, plan sponsors and participants. The rule aims to address conflicted advice; advice that increases a financial adviser's own compensation, often at the expense of the recipient. As we discussed in the March publication, the White House Council on Economic Advisers believe that the cost of conflicted advice to plans and participants is $17 billion annually—almost half a trillion dollars over 20 years. Many people who have a 401(k) or an IRA can invest in that account for a career of 30 years or longer. The cost of conflicted advice over that period can be quite significant.

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The way the DOL addressed the cost of conflicted advice is to amend their rules to make any individual receiving compensation for making investment recommendations to a particular plan, plan participant or IRA owner a fiduciary. Fiduciaries under ERISA are generally held to a high standard of providing recommendations that must be free from conflicts and in the best interest of their client. With the new rule, the DOL hopes to improve the quality of advice plans and participants receive, reduce conflicts of interest, and provide a means for enforcement should an adviser fail to act in a plan or participant's best interest.

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As with the proposal, the final rule extends fiduciary responsibility to advisers who provide investment advice to the:

- plan,
- plan's sponsor (an employer who provides a retirement plan, like a 401(k), for employees),
- plan's participants, and
- owners of IRA's

The rule covers advisers who advise on taking distributions from a retirement plan.

The final rule modifies some of the provisions that were in the proposal, and in many cases incorporates changes that address some of the concerns that were raised in four days of "live" testimony and thousands of submitted written comments. The final rules also eliminated some provisions relating to asset appraisals being fiduciary functions, and deferred those issues for future rulemaking. This "update" will discuss impacts to plan sponsors and others, who are the "winners and losers" as a result of those changes, and what the changes to the rule means to plan sponsors.

What's Changed?

Most of the comments and testimony given to the DOL after they issued the revised proposed rule in April 2015, centered on the workability and costs associated with complying with the proposed rule. The DOL made a number of changes to the rule in order to address these concerns and clarify the types of activities that advisers can engage in. These changes essentially fall into broad categories: activities that are truly educational in nature and are not "investment recommendations" given to the recipient; and, certain activities that otherwise would be prohibited but for the implementation of a "Best Interest Contract" (often called the "BIC exemption") that obligates the adviser to disclose any potential conflict of interest, and to operate in the best interests of the client despite the inherent conflicts of interest.

Education v. Advice

An important change in the final rule for plan sponsors is the clarification of the rules concerning the differences between education and advice. Being able to communicate with participants without taking on (more) fiduciary responsibility was a major concern expressed in comments on the proposed rule. In the proposed rule, the DOL drew a line between non-fiduciary educational activities—helping participants understand the plan, investing concepts and processes—and making recommendations on investment selection. The proposed rule caused what many considered normal and routine educational activities to be on the "fiduciary" side of the line, and that concerned service providers and plan sponsors alike. The DOL made several modifications to their proposed rule to clarify when "education" is not advice, and to allow—as non-fiduciary activities—much of what service providers and plan sponsors routinely provide as "educational service."

The final rule exempts much of what plan sponsors have come to expect from service providers as "education" and even exempts communications between the plan sponsors staff and employees from being regulated as "advice." By way of example, the DOL lays out specific types of communications not considered "recommendations," including:

- Marketing materials a plan service provider distributes to plan sponsors and other plan fiduciaries describing the available investment options available on their platform, including screening other investment options to potentially replace an underperforming option;

- General plan information (including investment options available to plan participants) and information about plan features (including distribution options—such as the differences between lump-sum and annuitized distributions—and the consequences of each);
- General financial, investment and retirement information (that doesn't mention specific investment options), including concepts like "risk and return," diversification, historical rates of return for various asset classes, and the like; and
- Asset allocation "models" and interactive investment materials.

The last point—dealing with asset allocation models and interactive investment materials caused some concern among those who commented on the proposed rule. Often, retirement plan education sought to provide illustrations of these various asset allocation strategies or models that might be applicable to certain types of retirement plan investors—and to make the education applicable, those strategies would often identify which investment options fit within each asset allocation strategy, and the types of participants to which a particular strategy might apply. Sometimes the educational programs would actually include a "quiz" or "checklist" that participants could use to determine what type of investor they might be, and consequently which asset allocation strategy they should use.

The DOL's proposed rule saw this as actual "advice" to the participant, and made providing that type of educational program a "fiduciary" endeavor. That effectively would have eliminated many "off-the-shelf" educational materials from being used, and would have left plan sponsors and service providers with little left to educate participants about the plan, and the value of long term investing for retirement. Since naming actual investment options would make the educator a fiduciary—and require them to personalize that advice to each participant, the only prudent means of communication would have been one-on-one meetings, and the industry considered that not cost-effective, if even possible given the number of participants who would have to be reached. While not completely eliminating "fiduciary" standards applicable to retirement plan education, the DOL did modify the final rule to allow for specific education that names investment options in asset allocation strategies or models, and allows for tools to be used that help participants select certain asset allocation strategies—with some conditions. According to the DOL, these conditions are designed to ensure the educational communications are presented as hypothetical examples that help participants and beneficiaries understand the educational information and not as "investment recommendation." These conditions include:

- Any specific investment alternatives used must be a "designated investment alternative" ("DIA")—that is, it must be an option that can be selected by a participant as a single investment choice;
- A plan fiduciary other than the fiduciary that offers investment alternative or materials must have chosen the DIA;
- The educational materials must specifically identify all other DIAs with similar risk and return characteristics; and the educational materials must include a statement of where additional information on the DIA can be found.

These conditions soften the requirements contained in the proposed rule, and favor a trend in the industry of providing "model portfolios" or interactive investment materials available to plan participants.

Some plans engage the services of a 3(38) "investment manager" who not only can make recommendations concerning the investment option within a plan, but can also select those investments, monitor them and update them as appropriate. Using such a professional—who is a fiduciary under ERISA—can reduce your legal liability and regulatory risk.

IRAs are a special case, there is no "independent ERISA" fiduciary who selects the model as an investment option. Advisers who discuss the use of an asset allocation model or provide interactive investment materials to an IRA owner is performing a fiduciary function and must do in the best interests of their client.

Expansion of the "BIC" Exemption; "Best Interest Contract"

Perhaps one of the most controversial provisions in the proposed rule was the "best interest contract" exemption—that while complying with the BIC exemption didn't exempt an adviser from being a fiduciary—it did allow advisers to receive variable compensation (compensation that varied based on the advice given) provided the advice was nonetheless in the best interests of the client, and other conditions were met. As originally proposed, many thought the BIC exemption requirements were so onerous that few, if any, advisers would actually attempt to comply, and many would avoid servicing retirement plans and participants altogether. Not many people considered the BIC exemption to be useful, and previous discussions about it concentrated on how unworkable it would be—and not something plan sponsors would need to be concerned with since it would rarely be used. However, the modifications to the BIC exemption greatly expand its usability to advisers, and specifically the ability of advisers to continue to receive variable compensation based on their recommendations. This variable compensation is still conflicted advice, but it is just permitted conflicted advice. Plan sponsors and other fiduciaries should understand how the BIC exemption applies and how advisers are compensated.

The BIC exemption rules are very complex and were issued in a separate "prohibited transaction exemption" published at the same time as the final fiduciary rule. The exemption essentially provides a set of requirements advisers must comply with in order to receive commissions and similar compensation. The rules do not exempt the adviser from being a fiduciary, but simply provide an exemption from enforcement action and penalties for providing advice that would otherwise be prohibited under ERISA. The final rule differs from the proposal by expanding the exemption to include virtually all types of investments and asset classes—including proprietary investment products—and by reducing some of the requirements to document compliance with the BIC exemption. The changes to the documentation requirements should be of particular concern to plan sponsors, so that they pay attention to, and understand, some of the new documentation that they may receive.

Two changes made in the final rule may make this more difficult for plan sponsors and possibly even cause them to overlook important provisions that define the adviser's role with respect to the plan:

1) A separate contract will not be required between the adviser and plan fiduciary containing the terms required by the BIC exemption. The BIC exemption contract terms can now be included in "account opening" documents provided by the financial institution that will be holding the assets, and not in a separate "advisory agreement" entered into with the adviser individually.

2) For those plans that currently have a relationship with an adviser that will be seeking the BIC exemption, the financial institution that the adviser is affiliated with can simply send a notice to the plan fiduciary with the BIC exemption terms, and put them into effect using "negative consent."

In other words, unless a plan sponsor or other plan fiduciary reads the notice, and objects to it in a timely manner, the BIC exemption terms will automatically become effective.

Winners, Losers and Now What? A Plan Sponsor's Guide

Changes made to the proposed rule created some clear winners specifically, advisers and other service providers who work with retirement plans and receive compensation that varies according to the advice given. The changes address many (if not most) of the concerns that were raised, and especially the concerns about the ability to even continue to provide educational and investment advisory services to small and mid-sized plans (where arrangements often included variable compensation, commissions, and other "indirect" forms of payment). Expansion and simplification of the BIC exemption will allow many advisers who currently have relationships with plans to continue to do so, with no change in compensation, provided they operate in the best interests of those clients consistent with the regulations. In addition, service providers and plan sponsors have scored a "win" as a result of the changes as the ability to continue to provide valuable educational services has not been overly restricted. In reality, the only change from past education and communication practices to the future under the rule involves not specifically naming investment options in asset allocation models or interactive investment materials unless certain conditions are met.

Plan participants have both won and lost under the final rule. They are winners because more service providers are obligated to act in their best interests. They have lost somewhat, however, as a result of the watering down of some of the requirements between the proposed rule and the final rule. Expanding the BIC exemption allows many advisers—especially those who receive commission income—to continue to do so, provided they warrant that the investment recommendations they make are in the "best interests" of the plan and the participants. Whether or not they actually meet that standard is something yet to be determined, and the only way to enforce the standard is through litigation.

In issuing the final rule, the DOL provided an extended effective date to give plan service providers time to prepare to comply with the new requirements. Generally, nothing in the final rule becomes effective before April of 2017 and the BIC exemption provisions are phased in over time, not fully becoming effective until the beginning of 2018.

Prior to this new rule becoming effective, plan sponsors should start to think about how their relationships with service providers and advisers may—or should—change. Fiduciaries have a duty to understand the services provided, and the costs associated with those services to their plans. Given the new DOL rule, plan sponsors should also consider:

- Reviewing their educational programs and materials to verify they will qualify as education, and not investment recommendations, under the new rule.
- Asking your service provider if the DOL rule now makes them a fiduciary for the 401(k) plan, or if they were already a plan fiduciary.
- Reviewing the plan's relationships with advisers and financial institutions to confirm whether the relationship is a fiduciary one and, if appropriate, if they will rely on the BIC exemption.
- Keeping an eye out for future communications from financial institutions and reading them—to make sure you understand if they are going to amend your arrangement with them to be BIC exemption compliant through "negative consent."
- Working towards level fee arrangements (eliminating all variable compensation).

Given the lengthy time the DOL took to propose, review, and finalize the rules, and the significant amount of industry and stakeholder comments considered, it's clear the DOL is serious about protecting the retirement assets of employees and retirement savers, and continuing work to ensure these requirements are adhered to.

About the Author

Michael J. Olah's career as an employee benefit consultant and attorney spans all aspects of retirement plan design, documentation, administrative process and procedures, compliance testing, controversy resolution and fiduciary concerns. He is a 30+ year industry veteran, having practiced in law firms, as in-house counsel, and as member of the senior management at several bundled and un-bundled retirement plan service providers. His "inside insight" allows him to not only discuss the highly technical legal requirements of ERISA and the Internal Revenue Code, but to also discuss what actually works in the real world. He often provides "fiduciary training" to plan sponsors and others, is a frequent conference speaker on fiduciary issues, and is a subject matter resource to many in the industry.

About Fisher Investments 401(k) Solutions

Fisher Investments 401(k) Solutions is dedicated to bringing superior retirement plan services to small and mid-sized businesses and their employees. Fisher's unique service offering is built on 35+ years of successful wealth management experience and includes our flexible investing platform with actively-managed funds. Business owners will experience the benefit of ongoing support from a dedicated Retirement Counselor whose focus is making the management of a 401(k) retirement plan easier, while helping employees plan for a comfortable retirement.

Fisher Investments, as a "3(38) investment manager" and an ERISA fiduciary with respect to the plans it services accepts only compensation on a "fee for service" basis. We charge a transparent fee for our services, based on total plan assets, regardless of the investment choices made. We operate our business with the philosophy that plan participants and IRA owners should be protected from conflicts of interest and particularly fee-based conflicts by plan fiduciaries.

*The content contained in this article represents only the opinions and viewpoints of Michael J. Olah.