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DOL Update

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DOL Finalizes New Definition of "Investment Advice"

On April 8, 2016, the US Department of Labor (Department or DOL) published its final regulation (Final Regulation) on the definition of "investment advice" under the Employee Retirement Income Security Act, as amended (ERISA) and the Internal Revenue Code of 1986, as amended (the Code). In addition, the Department introduced a new prohibited transaction exemption called the best interest contract exemption and revised several existing exemptions. There are some important differences between the definition of investment advice and the exemptions in the Final Regulation and the regulation proposed by the Department last April (the Proposal).

As a result of the Final Regulation, many companies and individuals that sell investment products and services and provide services to ERISA-governed plans as well as individual retirement accounts and other tax-favored accounts defined in Code Section 4975(e) (IRAs) will be fiduciaries for purposes of ERISA or the Code. The Final Regulation will have a significant impact on the compliance functions of many financial services companies. It will also fundamentally impact how many of these companies conduct their businesses. I provide below a summary of the changes to the definition of "investment advice" and point to some of the key changes to the exemptions.

The current definition of investment advice and the new definition of investment advice under the Final Rule are substantially different. Under the current regulation, a person provides investment advice if he or she:

(1) renders advice to a plan as to the value of securities or other property, or makes 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 understanding;
(4) that such advice will be a primary basis for investment decisions; and
(5) that the advice will be individualized to the plan.

This is commonly known as the five-part test for determining fiduciary status with respect to the provision of investment advice. The regular basis, mutual understanding, primary basis, and individualized components of the test often result in a person not being a fiduciary with regard to a plan or IRA, particularly when he or she sells an investment product or service.

Pursuant to the Final Regulation, a person provides investment advice if (i) certain types of recommendations are made (Covered Advice) and (ii) a relationship condition (Relationship Condition) is met. The Covered Advice that gives rise to fiduciary status includes the following:

(1) a recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property;
(2) a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA;
(3) a recommendation 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 investment advice or investment management services, selection of investment account arrangements (for example, brokerage versus advisory); or
(4) recommendations with respect to rollovers, transfers, or distributions from a plan or IRA.

The definition of "recommendation" is very broad and includes 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 Department points to SEC and FINRA guidance as being informative as to what is a recommendation but stopped short of adopting the same definition.

If a person provides Covered Advice, he or she will be a fiduciary if one of the following Relationship Conditions is met:

(i) he or she represents or acknowledges that he or she is acting as a fiduciary within the meaning of ERISA or the Code;
(ii) he or she 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
(iii) he or she directs the advice to a specific advice recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.

Under the Final Regulation, a person can be the representative, agent, or similar individual who provides the advice and, possibly, entities such as the firm supervising those individuals. The use of the term "adviser" in this summary generally refers to such representatives, agents, or similar individuals who provide advice to plans and to IRAs. Further, the Department confirmed that advice provided through electronic media or technology platforms (for example, web-based, apps) is investment advice under the Final Regulation.

Just as under the Proposal, the definition is intentionally broad so that many more financial services companies and their employees, agents, representatives, and independent contractors who deal with plans and IRAs are fiduciaries. Therefore, a number of activities that are not fiduciary in nature today will be investment advice (for example, sales of investment products and services, many communications about rollovers, recommendations regarding participation in transaction-based versus fee-based accounts). Further, rather than limiting advice to situations in which the recommendation is individualized and the primary basis for the investment decision, the Final Regulation only requires that a recommendation be specifically directed to an advice recipient or recipients.

The language in the Final Regulation defining the term "investment advice" addresses some concerns expressed by many in the financial services industry that the definition in the Proposal is too broad, including activities that were never intended to be included in that definition. For example, the Department clarified that most advertisements on television or advertisements in widely circulated newspapers will not be investment advice. Further, the use of the term "investment property" in the definition is intended to clarify that recommendations of health insurance, long term disability, and term life insurance to plans and to IRAs are not investment advice. However, if insurance has an investment component, such recommendations would be investment advice. Thus, recommendations of universal life policies (and, possibly, whole life policies) to plans appear to be investment advice.

The Final Regulation also provides for a number of specific instances in which a person might be providing investment advice, but the Department has concluded that they should not be treated as such for purposes of the Final Regulation. These include the following:

(i) investment education;
(ii) arm's length sales to plans or IRAs that are advised by a specified independent fiduciary with financial expertise (specified broker dealers, registered investment advisers, banks, and insurance companies) or represented by an independent fiduciary that have at least $50 million of assets under their responsibility or control (but not including IRA owners and beneficiaries);
(iii) making available investment platforms to plans (not IRAs) and the provision of limited information about the investments on the platform;
(iv) general communications; and
(v) advice given in connection with certain swap transactions.

The Final Regulation also affirms the DOL's longstanding position that the mere execution of securities transactions, without providing a recommendation (for example, order taking), is not investment advice. The Final Regulation provides very specific conditions in order for the DOL to view the above-described activities as not investment advice. The Department also stated that an activity is not "investment advice" simply because it may not fit within the above-described activities.

The determination as to whether a person is a fiduciary with regard to a plan or IRA is important. A fiduciary must comply with ERISA's fiduciary standards, ERISA's prohibited transaction provisions, and the Code's prohibited transaction provisions in the case of ERISA-covered plans. Further, the fiduciary must comply with the Code's prohibited transaction provisions, which largely mirror those in ERISA, in the case of IRAs. In order to avoid non-exempt prohibited transactions (and the legal liability associated therewith), the fiduciary must comply with a number of statutory prohibited transactions found in ERISA Section 408(b) and Code Section 4975(d). Alternatively, the fiduciary should comply with a class exemption issued by the DOL. Importantly, however, the Department substantially revised the current class exemptions and created a new exemption called the best interest contract exemption (BICE).

A key component of the revised exemptions and the BICE is that advisers and their supervising institutions comply with Impartial Conduct Standards, which include a best interest standard. In order to be acting in the best interest of the investor, the adviser and financial institution must "act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims would exercise based on the investment objectives, risk tolerance, financial circumstances, and the needs of the [investor] without regard to the financial or other interests of the adviser, financial institution, affiliate, or certain other related entities." The DOL intends that the best interest standard be interpreted in accordance with the duties of prudence and loyalty under ERISA Section 404(a). In other words, the Department uses the exemptions as a mechanism to hold advisers and financial institutions that rely on those exemptions to a fiduciary standard, even when they are not subject to such a standard under other applicable law or rules, such as SEC, and FINRA.

The Department intends that the BICE allow advisers, financial institutions, and affiliates to receive transaction-based compensation (for example, commissions) and payments from third parties (for example gross dealer concessions; revenue sharing payments; 12b-1 fees; distribution, solicitation or referral fees; volume-based fees; and fees for seminars and educational programs). Such payments, in the DOL's view, would otherwise result in non-exempt prohibited transactions. Additionally, the Department intends that most prohibited transactions arising in connection with the provision of investment advice to retail investors, which it calls Retirement Investors, be addressed through the BICE rather than through other exemptions. In general, such investors include participants and beneficiaries in ERISA-covered plans, IRA owners and beneficiaries, and small employee benefit plans that are not represented by a fiduciary with financial expertise and are independent from the person providing the investment advice.

The BICE includes several substantial compliance requirements, which include the following:

(1) acknowledgement of fiduciary status;
(2) Impartial Conduct Standards (including the "best interest" standard);
(3) implementation of policies and procedures designed to prevent violations of the Impartial Conduct Standards;
(4) for IRAs, warranties that the BICE conditions will be met;
(5) contract, transaction/point of sale, and website disclosures about fees and other aspects of the relationship; and
(6) prohibitions against exculpatory language and limitations on ability to participate in class action law suits in contracts.

Furthermore, a streamlined version of the BICE is available for Level Fee Fiduciaries as defined in the BICE.

In general, the BICE in the Final Regulation appears to be an improvement over the BICE introduced in the Proposal. The changes to the contract and disclosure requirements should help with the operationalization of the BICE. However, the BICE will require a substantial compliance effort on the part of advisers and their supervising institutions. Further, the BICE uses the threat of class action litigation to encourage industry compliance with the BICE.

Notably, the Department appears to intend that almost all conflicts arising in connection with recommendations to plan participants and IRA owners to take a distribution from a plan or IRA and rollover the proceeds to another IRA or use those proceeds to buy another product (for example, annuity, life insurance) be addressed through the BICE. Additionally, such recommendations (in the event the distribution is from an ERISA-governed plan) appear to result in the adviser and, possibly, the supervising financial institution, being a fiduciary for purposes of ERISA. Subsequently, many more advisers and firms will be fiduciaries under ERISA, even if their advice activities are traditionally limited to IRAs, because of the distribution recommendation. Importantly, the personal liability and remedial provisions under ERISA would apply (not the remedial provisions created via the contract requirements in the BICE) in such cases.

In summary, the Final Regulation will have a significant impact on the compliance and business operations of many financial services firms and will touch all of these companies in the way they do business with investors and each other. The new definition, the changes to the current exemptions and some of the BICE provisions are applicable on April 10, 2017. The remainder of the BICE provisions become effective January 1, 2018. Therefore, during the next 12 to 18 months, advisers and the supervising firms must evaluate how the Final Regulation impacts them and implement substantial changes to their current processes and procedures.

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