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Mixing Up the Puzzle Pieces

This DOL's redefinition of who is an ERISA fiduciary is the farthest-reaching piece of retirement regulation promulgated in more than 40 years. The fiduciary rule will result in more parties labeled as fiduciaries, more actions qualifying as fiduciary activities, and more investors benefiting from ERISA's protections. Although we don't know how all the details will shake out, we do want to share what we know at this point.

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My family and I traveled to our favorite local lake this Memorial Day weekend. Unfortunately, my wife, three kids, and I spent much of Sunday indoors due to rainy weather. We spent part of the day putting together jigsaw puzzles. As focused on the fiduciary rule as I had been, it struck me as we were putting together and taking apart (and sometimes putting back together) these puzzles that this is analogous to what plan sponsors will be doing in the coming months as they respond to the recently released *conflict of interest rule*—also known as the *fiduciary rule*.

It seems like a lifetime ago since the Department of Labor (DOL) released its first proposed rule aimed at updating who is a fiduciary under Section 3(21)(a) of the Employee Retirement Income Security Act of 1974 (ERISA). And for purposes of where the final rule, released April 6, ended up, the first proposal might as well have happened a lifetime ago.

The initial proposal, released in 2010, was eventually recalled by the DOL when it met resistance from the financial services industry and politicians. Interestingly, that first proposal, which was originally positioned as a tool to improve the DOL's success in employee stock ownership plan (ESOP) valuation litigation, was nowhere near as impactful as the 2016 final rule will likely be. Ironically, ESOPs aren't even included in the final rule, but individual retirement accounts (IRAs), qualified retirement plans, health savings accounts, Coverdell education savings accounts, and medical savings accounts are. This redefinition of who is an ERISA fiduciary is the farthest-reaching piece of retirement regulation promulgated since ERISA's passage more than 40 years ago. The new fiduciary rule will result in more parties labeled as fiduciaries, more actions qualifying as fiduciary activities, and more investors benefiting from ERISA's statutory protections.

The fiduciary rule is less than three months old, and we still have many questions. We expect the DOL will provide guidance that clarifies many open issues in the coming months, but that will take time. Although we don't know how all the details will shake out in the end, we do want to share what we know at this point. To be clear, most of the effects of this rule will be felt by financial institutions working in various capacities with retirement investors[1]. While the rule doesn't specifically change plan sponsors' fiduciary duties and responsibilities, it does influence how they fulfill these duties, most notably how they hire and monitor service providers.

Moving to the Fiduciary Standard

One of the rule's key aspects that many of the brokers and other agents serving IRAs will struggle with is the *fiduciary standard* of care itself—the requirement to put client interests above one's own and to only make recommendations that are in the client's best interest. Brokers, for example, have been operating under the *suitability standard* for IRA recommendations. The suitability standard requires that the broker have a reasonable basis to conclude a recommendation is appropriate for a client when it is made. A broker's recommendation to buy an investment, call it Investment A, can be considered suitable over another investment (Investment B), even if Investment A generates higher compensation for the broker than Investment B. By contrast, an ERISA fiduciary may have a difficult time recommending Investment A over B, given the inherent conflict that exists, without showing that Investment A would be in the best interest of the investor.

Since the DOL did not wish to pick winning business models among those serving IRAs—namely brokers that may have variable compensation and fee-based registered investment advisors—it needed a way for parties with conflicted compensation models to give advice to IRA accountholders. The DOL's solution came in the form of a prohibited transaction exemption called the *Best Interest Contract Exemption*, more commonly known as the BIC Exemption—or just the BIC. The BIC uses a combination of a contract, disclosures, representations, warranties, and rigorous compliance with best interest contract standards, to allow a party with conflicted compensation to provide advice to IRA accountholders and ERISA plan fiduciaries responsible for less than $50 million in assets.

Back to the Puzzle Pieces

Most plan sponsors have implemented fiduciary processes and governance programs to meet their fiduciary requirements. This completed puzzle, if you will, is going to change as a result of the DOL's rule. Plan sponsors will have to stop, take their puzzles apart, shake the pieces up, and put them back together in a new configuration. They must adapt to altered roles and perhaps more fiduciaries working with their plans and participants.

We have drafted a five-question framework to help you reconstruct your puzzle. While further details will emerge, we believe this framework will help you respond to the changing landscape:

Do we know all the third parties acting in a fiduciary capacity to our plan or plan participants under the new rules, and what conflicts do these third parties have?

Given the broadened ERISA fiduciary definition under the new rules, it is likely that some of the roles played by the third parties involved with your plan or plan participants will change from non-fiduciary to fiduciary. Your responsibilities as a plan fiduciary include the duty to monitor and the duty to avoid prohibited transactions. The starting point for both of these duties is to first know who works with your plan and participants and the capacity in which they work, including:

- *Advice to plan sponsors*—Gone are the days of working as an advisor to qualified retirement plans without acting in a fiduciary capacity. Because it defines more acts as fiduciary, the new rule will make it harder for advisors and consultants providing investment advice or suggestions to avoid fiduciary status.
- *Advice to plan participants*—Similarly, to the extent an advisor or recordkeeper is interacting with your participants, you will want to understand if they are doing so in a fiduciary capacity. While the rule reiterates that it is possible to provide education and guidance to plan participants without it becoming fiduciary advice, it also makes it easier to trip into the advice category with certain topics, namely those related to distributions from plans, including rollovers. As a result, many of the guidance or education services provided by your plan's recordkeeper today may need to be delivered under a best interest approach and through an arrangement in which your provider is acting as an ERISA fiduciary.
- *Understanding conflicts*—The BIC Exemption allows fiduciaries—including plan advisors, consultants, and recordkeepers—to provide services despite their conflicts of interest. In this new environment where conflicted fiduciaries can exist, you will want to understand if a conflict exists, and if so, what that conflict is. You will then need to determine if you are comfortable with the particular conflict. Conflicts under the new rule can range from firm-level third-party payments—which may include such things as conference sponsorships or fees paid by asset managers in exchange for shelf space—to conflicts at the individual client level, including variable compensation by investments in the plan.

What are these third parties' compliance policies and procedures that will ensure these conflicts do not influence the advice they are providing to our plan or participants?

Beyond simple awareness of the source of the conflict, you will want to understand your advisor or recordkeeper's policies and procedures that are intended to prevent these conflicts from affecting the advice you or your participants receive. You may want to consider:

- *Prohibited transactions*—Given your fiduciary duty to avoid plan-related prohibited transactions, if possible, you will want to secure assurances that your fiduciary service providers adhere strictly to their policies. You may also want to pursue amendments to existing contracts that add attestations and assurances of compliance.
- *Contract Amendments*—Once you have reevaluated your third-party relationships, you will need to amend your contracts with service providers for whom you have discovered that previously non-fiduciary actions may now be fiduciary. In those amendments, you should ask for written affirmation of fiduciary status as well as descriptions of their relevant policies and any conflicts of interest. Recordkeeper contracts will most likely need to be amended; we expect most will opt to act as a fiduciary to your participants for activities related to participant distributions from your plan.

What is our perspective on investment advice (as now defined) for our participants?

Activities that were previously considered guidance have been redefined as advice under the new rule, and service providers who were previously not fiduciaries will become fiduciaries under this new regime. Many of these service providers are able to accept this fiduciary responsibility in spite of their inherent compensation-related conflicts. The BIC Exemption provides a path for these conflicted parties to act as fiduciaries by complying with the requirements laid out in the exemption. As a plan fiduciary, you will need to decide how comfortable you are with your participants receiving advice delivered under an exemption that allows for conflicts.

What is our benefit philosophy regarding terminated participants?

The new rules extend ERISA investment fiduciary coverage to IRAs. As a plan fiduciary, you may wonder why this change impacts you or how this could affect your fiduciary duties. In short, transactions such as rollovers and other plan distributions will more often than not trigger fiduciary status for the parties involved. Given the more stringent requirements and increased risks imposed on ERISA fiduciaries, we expect there to be fewer third parties seeking rollovers. This change may mean that many plan participants—particularly those with smaller balances—have fewer options available to them when they separate service. Ultimately, this could result in many participants wishing to stay in your retirement plan after they separate service. You will want to evaluate your philosophy surrounding how open you are to keeping these terminated participants in your plans.

Should we update our plan design to align with our philosophy on terminated participants?

Plan sponsors who decide to accommodate terminated participants staying in their plans may wish to update their plan designs to allow roll-ins and consolidation of other qualified assets eligible to roll into their plans. Plan sponsors will want to evaluate their comfort with creating methods for participants to keep their account balances in the plan and providing them with the flexibility to withdraw money when needed.

Less than three months after the final rule's issuance, these are still early days for an industry piecing together the impacts and adapting to these updated rules. While we don't have all the puzzle pieces needed to complete the picture, we expect further details to emerge as April 2017 nears, and we will keep you informed. Nonetheless, irrespective of how interpretations may change as the effective date nears, we are confident the series of questions we pose here will be relevant for plan sponsors as they consider the impacts of the new rule on their plans and participants.

[1] *Retirement investors* here includes not only ERISA-qualified retirement plans, but also participants and beneficiaries to those plans, as well as individual retirement account (IRA) accountholders and their beneficiaries.

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