Regulatory Brief: The final DOL fiduciary rule: What it means to plan sponsors

Executive summary

On April 6, 2016, the U.S. Department of Labor (DOL) released its final regulatory package updating the definition of fiduciary investment advice under the Employee Retirement Income Security Act (ERISA). This is the final step of a process that began in 2010 with a proposed rule that was subsequently withdrawn under industry and political pressure in 2011. The DOL reproposed the rule in April 2015, and it was equally controversial, resulting in a record number of public comments.

The 1,000-plus-page final fiduciary rule package substantially broadens the definition of investment advice and introduces a new “best interest contract” prohibited transaction exemption (the BIC Exemption). The rule also amends other existing prohibited transaction exemptions. These exemptions permit various services and transactions with clients of investment advice fiduciaries under certain protective conditions established by the DOL. The new rule is generally applicable April 10, 2017, with some of the more complex conditions of the BIC Exemption effective January 1, 2018.

The new rule expands the universe of plan service providers who may be considered investment advice fiduciaries under ERISA to include anyone who provides a “recommendation” regarding investment transactions, retirement accounts, or retirement distribution decisions for a fee. “Recommendation” is defined broadly to include communications that are likely to be considered a suggestion to take, or to refrain from taking, a particular course of action. The new rule has little or no direct impact on a plan sponsor’s in-house fiduciaries (e.g., plan investment or administrative committees).

Also, under the new rule, anyone who is or becomes an investment advice fiduciary will generally be subject to a “best interest” standard when providing investment advice. This standard requires that the advice be in the best interest of the plan or plan participant and for the advice provider to receive only reasonable compensation for the provision of that advice.

This Regulatory Brief explores the definition of “recommendation,” the related exceptions and exemptions, as well as how the new regulation will impact plan sponsors.

Vanguard believes that those who provide investment advice should be required to act in their clients’ best interest. The DOL took steps to simplify many of the most unworkable aspects of its earlier proposals and has crafted a fiduciary rule that balances investor protections and procedural concerns about implementation and administration. We have completed much of our analysis of Vanguard’s services and products and will be fully compliant with the DOL fiduciary rule by the April 2017 deadline, and we do not anticipate any delay in implementation as a result of legislation or legal challenges to this rule.
Background

More than 40 years ago, the DOL issued guidance defining who is an investment advice fiduciary under ERISA. The original definition included a five-part test that had to be satisfied in its entirety for fiduciary status to apply. At the time, the retirement landscape was very different—most plans were defined benefit pension plans with professionally managed investments. The risk of investment performance was borne primarily by the plan sponsor, not plan participants.

Over time, there has been a dramatic shift away from defined benefit pension plans to defined contribution plans, such as 401(k) plans. But these plans also shift the investment risk for saving for retirement to plan participants because most 401(k) plans give participants responsibility for selecting their own investments from a plan investment lineup. Participants are also more likely to have amassed a majority of retirement assets in a defined contribution plan today, requiring them to make more complicated decisions about their approaches to retirement withdrawals and spending. As a result, it is increasingly important for participants to obtain high-quality advice.

In part, this changing landscape led to the DOL’s desire to update the fiduciary definition. In particular, the DOL wanted to protect retirement plan participants who may be encouraged to roll over their retirement plan accounts into potentially higher-priced investment products or services in IRAs.

Client planning note: Consistent with this objective, the final fiduciary rule generally does not expand the types of activities that will lead to fiduciary status for plan sponsors or plan committee members. As under current law, those that exercise discretion over or have responsibility for the management of a plan or its assets (e.g., a plan investment or administrative committee) will be fiduciaries. In addition, the rule does not alter the fiduciary duties that ERISA imposes on fiduciaries, including plan committee members. In this regard, fiduciaries remain subject to ERISA’s fiduciary obligations, including duties of loyalty and prudence.

1 Under the prior five-part test, a person was a fiduciary only if he or she: 1) makes recommendations on investments 2) on a regular basis, 3) pursuant to a mutual understanding that the advice 4) will serve as the primary basis for investment decisions, and 5) will be individualized to the particular needs of the plan. These activities were covered under the prior five-part test if they were provided “for a fee”—which was interpreted broadly to include any compensation to the fiduciary, its employer, or affiliates.
Fiduciary investment advice
Under the final rule, a fundamental question in establishing if there is fiduciary investment advice is whether a “recommendation” has been provided regarding the investment, distribution, or account management of a retirement account. A “recommendation” is any communication that, based on its content, context, and presentation, would be reasonably viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action.

Fiduciary investment advice includes recommendations on the advisability of the purchase, sale or holding of investments, and recommendations as to the management of retirement accounts, including, for example, distribution and rollover decisions. Under the new rule, a person will be considered an investment advice fiduciary if he or she provides a recommendation with respect to an investment, distribution, or account management decision in a retirement account for a fee or other compensation.

Client planning note: The more individually tailored the communication is to a specific recipient, the more likely it is that the communication will be viewed as a recommendation. Generally, if a communication is viewed as a recommendation regarding a retirement investment or distribution transaction, it will be considered fiduciary investment advice.

Regulatory exclusions from fiduciary investment advice
The rule provides examples of activities that should not be considered fiduciary investment advice and excludes certain actions or communications from the definition of investment advice, even if the conduct might otherwise be considered a recommendation. Specifically, the rule excludes the following activities from the definition of investment advice:

- Communications among employees of the plan sponsor.
- Selection and monitoring assistance from a recordkeeper when identifying investment alternatives on the recordkeeper’s platform that meet objective criteria specified by a plan sponsor fiduciary.
- General communications (e.g., newsletters, conferences, research reports).
- Certain communications to a bank, insurance company, registered investment advisor, or broker-dealer acting as an independent investment fiduciary (e.g., a fiduciary plan consultant).
- Recommendations to plan fiduciaries who hold, manage, or control at least $50 million in retirement plan assets.
- Asset allocation models for participants in defined contribution plans if the models reference only designated investment alternatives in the plan lineup (that is, they exclude brokerage windows).

Client planning note: General discussions about whether to roll over from an employer-sponsored plan to an IRA should not be considered a recommendation subject to a fiduciary standard if those discussions are limited to the pros and cons of each of a participant’s options, such as staying in the plan, rolling over, or taking a distribution, without suggesting a specific course of action. However, conversations about distribution planning and rollovers that go beyond a mere discussion of pros and cons of each option potentially would make those discussions subject to the new fiduciary rule.

2 Accounts covered by the rule include ERISA-covered employee benefit and 403(b) plans, individual retirement accounts (IRAs), SEPs, SIMPLE IRAs, health savings accounts, and Coverdell Education Savings Accounts. Non-ERISA plans, such as governmental and most church plans, are not subject to the rule.
BIC Exemption

Fiduciaries have a duty under ERISA to act prudently and in the best interest of their clients. ERISA fiduciaries must also avoid participating in prohibited transactions. Generally, the prohibited transaction rules expressly prohibit certain conflicts of interest unless the parties involved meet the conditions of a prohibited transaction exemption. One consequence of the final rule is that many more investment consultants and providers will be considered fiduciaries when they provide retirement investment and distribution advice, and as a result their compensation arrangements will have to comply with an exemption in most cases. For example, variable compensation that is the consequence of a fiduciary “recommendation” is a prohibited transaction that requires an exemption. In order to allow investment advice providers to continue to provide services to their plan clients while receiving compensation through otherwise conflicted means (e.g., commissions or revenue sharing), the DOL has created the BIC Exemption.

In general, the BIC Exemption allows financial institutions and their employees to continue to receive variable compensation if certain requirements are met. Under the BIC Exemption, the advice provider must (1) acknowledge fiduciary status with respect to the investment advice being provided and (2) adhere to impartial conduct standards. The impartial conduct standards require the advice provider to act in a client’s best interest, receive no more than reasonable compensation, and avoid material misrepresentations in the advice provided. The best interest standard requires prudent advice that is based solely on the (i) investment objectives, (ii) risk tolerance, (iii) financial circumstances, and (iv) needs of the investor.

The advice provider must also have a series of policies and procedures designed to prevent violations of the impartial conduct standards (e.g., to ensure that any variable compensation earned is not at odds with the client’s best interest), identify and document material conflicts of interest, and name a person to address material conflicts of interest and monitor advisors’ adherence to the impartial conduct standards. All of this information must be disclosed in writing, along with information about the services provided and fees charged by the advisor, at or before any transactions based on the advice are executed. This information also must be available to investors on a website. Lastly, the advice provider must notify the DOL of its intent to rely on the exemption before executing any transactions based on the advice and to retain supporting documentation establishing its compliance with the exemption.

Client planning note: The BIC Exemption is just one way a fiduciary can comply with the prohibited transaction rules. Other methods of prohibited transaction compliance, such as DOL Advisory Opinion 2001-09A (relating to the use of an independent third-party advice methodology to avoid a prohibited transaction) and advice exemptions under the Pension Protection Act of 2006, remain available under the final rule.
Plan sponsor considerations

Although the primary goal of the final rule was to subject more advisors to ERISA’s fiduciary standards when providing investment advice, the rule raises several important considerations for plan sponsors. Primary issues include human resources/employee benefits departments, investment education, distribution discussions and related communications (including rollovers), and sales activities.

**Human resources/Employee benefits departments**

The final rule clarifies that advice from employees of the plan sponsor to plan fiduciaries, such as from your human resources/benefits staff to your plan committees, will not be subject to the fiduciary rule as long as the employee providing the advice does not receive compensation beyond his/her normal salary or is not otherwise employed specifically to provide investment advice. Additionally, employees who communicate information about the plan to plan participants will not be considered fiduciaries as long as their job functions do not include advising participants.

**Investment education**

The DOL recognizes the importance of encouraging investment education and confirmed that providing investment education will generally remain a nonfiduciary act. This means that service providers such as Vanguard can continue to provide your participants (1) plan information, (2) general financial, investment, and retirement planning (including lifetime income) information, (3) asset allocation models, and (4) interactive investment materials, without the information being considered fiduciary investment advice.

Accordingly, information such as terms of the plan, benefits of participation, benefits of increasing contributions, impact of withdrawals, risk and return characteristics, and retirement income needs are examples of plan information that is not investment advice.

For ERISA-covered plans, specific investment alternatives may be included as examples in presenting hypothetical asset allocation models offered to plan participants if the identified investments in the model include all designated investment alternatives in an identified asset class in the plan. Interactive investment materials such as questionnaires and worksheets may also reference specific investments if certain criteria are met.

Client planning note: The final fiduciary rule does not change a plan fiduciary’s responsibility. The key fiduciary duties (exclusive benefit, prudence, diversification, and documentation) remain the same. To help plan sponsors understand and comply with their fiduciary duty, Vanguard has developed fiduciary best practices materials. For more information, please contact your Vanguard representative.
Distribution discussions and related communications

General discussions about the distribution options available in the plan and the pros and cons of each of those distribution options should not constitute investment advice. However, any recommendation relating to the management of retirement assets, including a suggestion to leave assets in the plan or roll them over to an IRA or another qualified plan, would be fiduciary investment advice.

Client planning note: Vanguard is conducting a thorough review of all of our investment education materials and related services under the new rule. We will notify plan sponsors well in advance of any changes to our services that may result from the rule.

Sales activities

Investment communications are generally not considered fiduciary investment advice when provided to a “sophisticated fiduciary.” Sophisticated fiduciaries include large plan sponsors with control of $50 million or more in assets and plan consultants that are also banks, insurance companies, registered investment advisors, or broker-dealers acting as plan fiduciaries. Regardless of the amount of assets under control or whether there is a fiduciary plan consultant, sample investment lineups provided in response to a request for proposal generally will not be considered investment advice.

Vanguard’s suite of advice services

The final fiduciary rule does not directly affect Vanguard’s current retirement plan investment advice or management services (Personal Online Advisor, Vanguard Financial Planning Service, Vanguard Managed Account Program, or Vanguard Investment Advisory Services®) because Vanguard already assumes fiduciary status for those services and complies with an alternative exemption or method to avoid conflicts of interest.

Vanguard is analyzing the rule and its potential impact on all our areas of business and will update our systems and services as appropriate. We will continue to provide updates as we interpret and implement this new regulation. Please contact your Vanguard representative if you have questions or need additional information.

For more information on how the final fiduciary rule impacts financial advisors, please see our Regulatory Brief The final DOL fiduciary rule: What it means to financial advisors.

3 For IRAs, asset allocation models that reference specific investments will be considered fiduciary investment advice.