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EMPLOYEE BENEFITS IN FOCUS: THE DOL FIDUCIARY RULE

June 2016

HIGHLIGHTS

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The DOL Fiduciary Rule: Six Immediate Concerns for Plan Sponsors (Overview)

The Department of Labor (DOL) final conflict of interest rule re-defines fiduciary investment advice under ERISA. Although the rule does not alter a plan sponsor's basic fiduciary obligations under ERISA, it will impact the plan's relationships with its service providers. Below are six immediate concerns to address now:

1. "Updated" Service Agreements. Watch out for updated contracts from your vendors. As plan record-keepers and other service providers become fiduciaries under the new rules, they may try to minimize their liability through revised contractual provisions. Check with your ERISA counsel before signing any new or updated agreements.
2. Counterparty Transactions. The DOL has created an exception from the fiduciary rule for arm's length transactions between investment firms and large plan fiduciaries with financial expertise. This seller's exception will not apply in all cases, and plan sponsors will need to note its limitations.
3. New Hidden Fees. Be on guard for fee increases and new hidden fees. It is anticipated that record keepers will raise fees to compensate for lost downstream income due to fewer IRA rollovers. Scrutinize the 408(b)(2) disclosures from each provider for any new line items.
4. Participant Communications. Plan sponsors will need to review any new participant communications prepared by service providers, to screen for unintended fiduciary investment advice. This includes call center scripts, websites, mobile apps, investment materials, and training programs. Consider conducting spot audits as well.
5. Investment Education. The rules are largely unchanged, but plan sponsors may face heightened exposure for monitoring service provider compliance with specific conditions.
6. Distribution Counseling. Plan sponsors will want to increase their oversight of post-termination messaging to participants, rather than ceding this space to record-keepers and other plan vendors. Expect to see fewer rollovers following termination of employment.

The final rule generally applies on April 10, 2017.

The DOL Fiduciary Rule: Six Immediate Concerns for Plan Sponsors (In Depth)

Fiduciary Fundamentals

The DOL rule does not alter a plan sponsor's basic fiduciary obligations. Plan sponsors are deemed fiduciaries under ERISA due to their authority over plan administration and plan assets. Plan sponsors also remain bound by ERISA's fiduciary obligations to select and monitor qualified service providers to the plan – such as trustees, record-keepers, and investment advisers.

1. "Updated" Service Agreements

Plan sponsors have an ongoing fiduciary obligation to select and monitor the plan's service providers. Under the DOL fiduciary rule, some of these service providers now will be considered fiduciaries. This raises the plan sponsor's risk of co-fiduciary liability for actions taken by a vendor.

It is expected that service providers will proactively seek to revise their service agreements in order to minimize their liability. Investment outfits may redefine their role as providing "research tools" rather than advice.

Plan sponsors will need to review any "updated" vendor agreements with counsel to ensure that the plan's interests are protected.

For example, a record-keeper who provides distribution counseling may have denied fiduciary status in the past. Any revised service agreement will need to reflect the record-keeper's new fiduciary status. The vendor should make additional representations as well, such as:

- that it will not engage in prohibited transactions,
- that it is qualified to serve as a fiduciary under ERISA,
- that it will not steer participants toward proprietary funds, and
- that it will indemnify the plan sponsor for any breach of fiduciary duty.

2. Counterparty Transactions

Large plan sponsors may need to revisit service agreements with private equity firms, research firms, etc., in light of the counterparty or "seller's" exception. This exception allows investment firms to provide arm's length advice to independent plan fiduciaries, without risk of ERISA liability. It generally covers advice given to savvy plan fiduciaries who manage at least $50 million in plan assets.

We anticipate that these investment providers will want to renegotiate their agreements with plan sponsors to disclaim any fiduciary liability under ERISA.

Before signing a new contract, plan sponsors will need to verify that the adviser is indeed eligible for the counterparty exception, and that the required disclosures have been provided. Advisers to smaller plans (< $50 million in aggregated assets) are ineligible.

In addition, even for large plans, the counterparty exception may not shield advisers who are paid from *plan* assets rather than *company* assets. One condition of the exception is that the adviser "does not receive a fee or other compensation directly from the plan or plan fiduciary" in connection with the transaction.

3. New Hidden Fees

Some vendors may seek additional fees from the plan sponsor in return for being treated as fiduciaries. Other vendors may restructure their interaction with the plan to avoid fiduciary status – such as a record-keeper who vacates the distribution counseling space. These service providers may seek to make up for lost 'downstream' income that they otherwise would have received from IRA rollovers. These new fees may be negotiated outright or may be buried in 408(b)(2) disclosures.

In addition, plan sponsors may wish to evaluate the impact of the DOL rule on the vendor's overall compensation, to determine whether it remains competitively priced as a plan service provider.

4. Participant Communications

Plan sponsors will need to assess whether the broad language of the final rule sweeps in routine participant communications.

The DOL regulation is intended to target investment advisers who counsel plan participants for a fee. However, even ordinary communications to plan participants could expose the plan sponsor to fiduciary or co-fiduciary liability if considered investment advice.

Plan sponsors should review the communications and tools listed below, to screen out *any investment advice directed to plan participants* even if not individualized.

Call Center Scripts. Look for advice relating to plan investment funds and distribution options. General information about the plan is fine, but service center personnel should avoid guiding the participant on questions such as:

- Which investment fund should I choose?
- Should I take a distribution now or wait?
- Which form of payment is best for my situation?

Plan sponsors should consider conducting supplemental training and spot audits of the call center, to reduce potential exposure. If the call center is outsourced, the plan sponsor should consider reviewing the training materials prepared by the record-keeper or other vendor.

Investment Materials. Examine any investment-related notices, websites, or materials prepared by the plan record-keeper or other service provider. General information about retirement or investments is unproblematic, as are widely distributed newsletters and bulletins of general circulation.

Plan sponsors could face potential co-fiduciary liability, however, for investment materials *targeted* to specific groups of participants. Avoid directed mailings such as:

- Mailings that promote diversification, directed to participants who invest only in the stable value fund
- Mailings that discourage concentration in company stock, directed to participants heavily invested in the employer stock fund

5. Investment Education

The final rule makes little substantive change to the existing fiduciary exception for investment education. Plan sponsors can continue to offer materials in the four general categories introduced in DOL Interpretive Bulletin 96-1 without venturing into fiduciary territory, with some refinements and new conditions.

However, *plan sponsors may face heightened liability for monitoring service provider compliance* with the new conditions applied to asset allocation models and interactive investment materials. Consult with ERISA counsel to ensure that these rules are met. Also take a hard look at any tools offered by the plan to verify that, in practice, they satisfy the spirit of the regulations.

The four investment education categories remain as follows:

1. Plan information (fees, investment options, risk and return)
2. General financial, investment or retirement information (including longevity risk, inflation, annuitization)
3. Asset allocation models projecting return based on hypothetical fact patterns
4. Interactive investment materials (worksheets, software) allowing plan participants to calculate retirement needs and income

Asset allocation models and interactive programs in a qualified plan can continue to reference the designated investment alternatives by name, subject to certain conditions.

6. Distribution Counseling

Plan sponsors will want to evaluate whether post-termination messaging to participants poses a risk of co-fiduciary liability. This distribution counseling might take the form of:

- Election forms that default a participant's distribution to an IRA rollover with a specific service provider
- Brokers who counsel participants to roll over plan assets to an IRA
- Call center personnel who advise against benefit deferral

Traditionally, plan sponsors have not been involved in distribution counseling, often letting their record-keepers guide participants to proprietary IRA products. Under the new rule, some vendors may scale back communications regarding rollovers and distributions to avoid being cast as a fiduciary.

Plan sponsors will want to oversee any distribution counseling provided to plan participants, and to identify whether the provider accepts fiduciary status or relies upon an exemption.

As vendors retreat from aggressive messaging in the rollover space, plan sponsors may find that more participants elect to leave assets in the plan following termination. This trend may increase plan headcount, which in turn gives plan sponsors additional leverage to negotiate for lower fees on plan investments. At a minimum, plan sponsors should anticipate more investment questions from plan participants.

The DOL Fiduciary Rule: A Primer on the Basics

On April 6, 2016, the Department of Labor (DOL) finalized its new definition of fiduciary investment advice under section 3(21)(A)(ii) of ERISA. The regulation was driven largely by the dramatic shift in the retirement industry, i.e., away from pension plans and toward individual savings vehicles such as 401(k) plans and IRAs.

A central focus of the DOL guidance is to protect individual investors from conflicts of interest that could threaten their retirement savings. The regulation attempts to reduce these potential conflicts by aligning the interests of individuals and their investment advisers.

New Definition of Fiduciary

In 1975, the DOL defined a fiduciary to include a person who *provides investment advice for a fee* with respect to plan assets, subject to a five-part test. This test required an ongoing and mutual relationship between the parties, and advice that was individualized to the participant.

In 2016, the DOL completely rewrote this definition. Fiduciary investment advice is now triggered when a *recommendation* is made for a fee with respect to plan or IRA assets. Neither an ongoing relationship nor individualized advice is required.

What Is A Recommendation?

The DOL defines a recommendation as "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." Specifically, this includes:

- Whether to buy, sell, hold, rollover, transfer or distribute plan assets
- How to invest following rollover
- How to manage plan assets
  - investment strategy
  - portfolio composition
  - adviser selection
  - account selection (brokerage vs. advisory)
- Presentation of a curated list of investments, even absent a suggestion

A communication that has been *individually tailored* to a specific recipient will be more likely to be treated as a recommendation. The determination of whether a recommendation has been made is performed on an objective basis.

Lowering the Bar

Fiduciary status no longer requires that investment advice be given on a regular basis, or that it be individualized to the participant. Under the final rule, fiduciary status will be conferred even if investment advice is provided only on a one-time basis, and even if the adviser doesn't know the participant personally or tailor the advice accordingly. This makes it much easier to trip the fiduciary trigger inadvertently.

Fiduciary investment advice now requires only that the parties have a *written or verbal understanding* that the advice is *based* on the participant's investment needs, or that the advice is *directed* to a specific recipient regarding a particular investment or management decision. Alternatively, fiduciary status can be established if an entity acknowledges its fiduciary role in writing.

What Is A Fee?

The DOL defines a "fee or other compensation" to include any payment – direct or indirect – incident to the transaction in which investment advice is rendered. This includes, for example:

- sales commissions
- loads
- finder's fees
- revenue sharing payments
- shareholder servicing fees
- marketing or distribution fees
- underwriting compensation
- payments to brokerage firms in return for shelf space
- recruitment compensation
- gifts and gratuities
- expense reimbursements

This broad definition may raise concerns for existing vendors who want to pitch a new product or service to the plan. Since the vendors already receive ongoing compensation from the plan, their new proposal may be characterized as a recommendation for a fee – and thus fiduciary investment advice.

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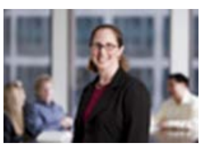

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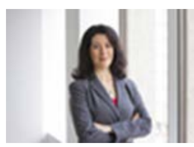

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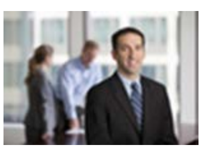

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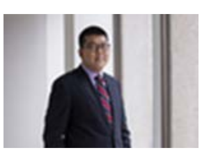

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IPB In The News

Robin Solomon co-authors Mercer GRIST Report on plan sponsor liability for maintaining accurate and complete pension records in light of recent 9th Circuit decision in *Barton v. ADT* (May 19, 2016)

Jonathan Zimmerman and Spencer Walters speak on Executive Compensation and Employment Tax Issues, including 409A corrections and corporate aircraft, at the Tax Executives Institute in Richmond VA (May 18, 2016)

Ben Grosz interviewed by CNBC about recent class action litigation against 401(k) plans and the impact on plan sponsors (May 1, 2016)

Coming Soon...

Jonathan Zimmerman to speak on Executive Compensation and Equity Awards at a UBS seminar for Certified Public Accountants (June 20, 2016)

Robin Solomon and Ben Grosz to present on the DOL Fiduciary Rules and best practices at the Mid-Atlantic Fiduciary Summit (Sept. 20, 2016). A limited number of free passes to the luncheon workshop are available upon request.

EB Update Archives

January 2016 EB Update

March 2016 EB Update

May 2016 EB In Focus: Wellness Plans