

Department of Labor's Final Rule Defining Fiduciary Investment Advice and Conflicts of Interest

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On April 6, 2016, the U.S. Department of Labor (the “DOL”) issued final regulations expanding the definition of a “fiduciary” with respect to pension and retirement plans, IRAs and other accounts under ERISA and the Internal Revenue Code. The regulatory package (collectively, the “**Final Rule**”) follows nearly one year after the DOL’s proposed regulation (the “**Proposed Rule**”).¹ Similar to the Proposed Rule, the Final Rule:

1. significantly expands the definition of who is a “fiduciary” under ERISA by reason of providing “investment advice” to ERISA plans or IRAs;
2. introduces two new DOL “prohibited transaction” class exemptions that may be used by financial institutions that fall under the expanded definition of “fiduciary”, including the Best Interest Contract Exemption (the “**BIC Exemption**”); and
3. amends six existing DOL prohibited transaction class exemptions that are commonly used in the financial sector to limit their availability in certain circumstances and to impose additional conditions on the use of the exemptions.

The Final Rule significantly expands the scope of communications with plans and retirement accounts that may give rise to fiduciary status. If a firm is deemed to be a fiduciary, it will become subject to the prohibited transaction provisions of ERISA and the Internal Revenue Code, which would limit its ability to receive commissions, fees and other compensation. On a going forward basis, firms will need to consider whether their product and service offerings will (i) utilize a business model under which they will not be considered a fiduciary under the Final Rule (e.g., by providing only general educational information) or (ii) cause them to become an ERISA fiduciary, in which case they will need to adjust their business model to receive only a fee from the customer (and not revenues from products purchased) or comply with onerous requirements of the BIC Exemption or another prohibited transaction exemption.

The Final Rule, including the related preamble, exceeds 1,000 pages in length, and although it is not starkly different from the Proposed Rule, it will take time to analyze in detail. Below is a high-level review of the key changes from the Proposed Rule and potential considerations for the financial services community:

- The **effective date** of the Final Rule has been pushed back. The Proposed Rule would have been effective eight months after publication, whereas the Final Rule will be phased in over time, with many provisions becoming effective in April 2017. All of the Final Rule’s requirements will be in effect on January 1, 2018.
- **Appraisals.** Appraisals, fairness opinions or similar statements, which would have been considered fiduciary investment advice under the Proposed Rule, are not addressed in the Final Rule and will instead be subject to subsequent regulatory guidance.

¹ For information regarding the Proposed Rule, see: [Department of Labor – Fiduciary Advice Definition and Conflict of Interest Rule, Proposed New Prohibited Transaction Class Exemptions](#) and [Proposed Amendments to Existing Prohibited Transaction Class Exemptions](#).

- **Investment Education.** The Final Rule provides a description of the types of investment education that would not constitute investment advice. Like the Proposed Rule, the Final Rule narrows the DOL's pre-existing guidance on what constitutes investment education and generally limits asset allocation models and interactive investment materials from identifying specific investment products or alternatives. Unlike the Proposed Rule, the Final Rule would allow the use of specific investment products or alternatives for employee plans under limited circumstances where the product or alternative is a designated investment alternative under the plan and is subject to oversight by an independent plan fiduciary. With respect to IRAs, asset allocation models may not identify specific investment products or alternatives, and investment materials may only identify specific investment products or alternatives that have been specified by the IRA owner. Firms will be forced to consider whether their communications and allocation materials can be structured as investment education under the Final Rule, or whether they will need to concede fiduciary status and whether they can design an approach which complies with the available exemptions, such as the BIC Exemption, for making these communications and offering specific investments pursuant to these communications.
- **Additional Carve-Outs from Fiduciary Status.** Like the Proposed Rule, the Final Rule includes carve-outs for certain communications that would otherwise be deemed to be fiduciary investment advice.
 - The Final Rule slightly expands the "counterparty" or "seller's" exception from the Proposed Rule. Under the Final Rule, subject to certain additional criteria and disclosures, advice provided in an arm's length transaction will not give rise to fiduciary status if the plan or IRA is represented by an independent fiduciary that has financial expertise. Under the Final Rule, an independent fiduciary will be deemed to have financial expertise if the fiduciary is a bank, insurance carrier, registered investment advisor or registered broker dealer, or if the fiduciary has at least \$50 million in assets under management (including plan and non-plan assets).
 - Like the Proposed Rule, the Final Rule includes additional carve-outs for certain swaps and security-based swaps and the communications of employees of the plan sponsor. These carve-outs largely track requirements applicable under the Commodities and Futures Trading Commission's rules.
- **Rollover Advice.** The Final Rule, like the Proposed Rule, treats plan or IRA rollover advice as investment advice. This is a departure from prior regulatory guidance from the DOL, on which many firms had relied.
- **Best Interest Contract Exemption.** In light of the expanded universe of financial service providers that will be deemed fiduciaries under the Final Rule, as part of its rulemaking, the DOL has adopted the BIC Exemption with some changes from the Proposed Rule. Under the Final Rule's BIC Exemption, an investment advice fiduciary may receive compensation that would otherwise be prohibited, provided it meets certain requirements, including an acknowledgement that it is operating in the best interests of its plan client. The following aspects of the Final Rule represent key changes from the Proposed Rule:
 - *The Contract.* The Final Rule does not require a written contract for advice to employee plans subject to Title I of ERISA, although a contract is still required for advice provided to IRAs.
 - *Timing and Delivery of the Contract.* The Final Rule does not require the contract to be provided in advance of the giving of advice, and instead allows the advisor to include the contract with standard account opening documents, provided that the contract retroactively covers any advice given prior to execution of the contract. The Final Rule also allows contracts entered into before January 1, 2018 to address the BIC Exemption requirements

by negative consent, without requiring every customer to affirmatively execute an amendment to their account documents.

- *“Approved Asset List.”* Unlike the Proposed Rule, the Final Rule does not limit the applicability of the BIC Exemption to an approved list of assets. Nonetheless, as the BIC Exemption requires advisors to render advice as to all assets in the best interest of their plan clients, advisors will be forced to consider whether it will be harder to justify the recommendation of certain asset classes and certain investments that entail enhanced fees for the advisor.
- *Proprietary Products.* The DOL has made clear that the Final Rule does not flatly prohibit the sale of proprietary investment products or third-party products that generate distribution fees or other compensation for an advisor. Instead, sellers of proprietary products may rely on the BIC Exemption. Firms relying on this exemption must adopt enhanced conflict policies, represent to clients that they operate in their clients’ best interest and make specified disclosures to clients. Advisors will need to consider the extent to which those requirements will be workable to allow them to sell their proprietary products.
- *Level Fee Fiduciaries.* The Final Rule’s BIC Exemption also exempts “Level Fee Fiduciaries” (*i.e.*, fiduciaries who, together with their affiliates, receive only asset-based fees or set fees that do not vary based on investment) from certain prohibited transactions provided that they meet a streamlined list of requirements.
- *Disclosure and Record Retention.* The DOL has reduced the disclosure and recordkeeping requirements under the Final Rule. Notably, unlike the Proposed Regulation, advisors will not have to provide projections of fees over 1, 5 and 10 year periods. However, the Final Rule’s BIC Exemption does require certain web and transaction disclosures, notice to the DOL of the intention to rely on the BIC Exemption and the retention of certain records for six years.
- Given these changes, the BIC Exemption under the Final Rule may be more workable for some firms than the Proposed Rule would have been. But the feasibility of operating within the BIC Exemption will likely depend on the nature of an advisor’s business and the character and fees of the investments that will be offered.
- **Principal Transactions.** The Final Rule includes an exemption permitting fiduciaries to fill orders from their principal accounts for debt securities, which is substantially similar to the corresponding exemption under the Proposed Rule.
- **PTE Amendments.** Much like the Proposed Rule, the Final Rule amends a number of existing, commonly used prohibited transaction class exemptions, adding a requirement that the fiduciaries relying on these exemptions operate in the best interest of their clients. This new requirement will require firms that had previously relied on these exemptions to reevaluate their compensation structures and the way that they communicate with clients.

While there have been some significant changes to the rule, including the relaxation of some of the Proposed Rule’s more controversial requirements, the Final Rule will require financial firms to reassess and potentially restructure their business models relating to servicing retirement accounts. Firms will need to choose whether to generalize their communications in order to fall outside the scope of the new fiduciary definition, offer advisory services for a fixed fee and forego revenues on sales and products or accept the new requirements imposed by the BIC Exemption and the legal risks associated with operating under that exemption.

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