DOL's Conflict of Interest Rule: Where Do We Go From Here?

Think the proposed rule won't affect TPAs and recordkeepers? **Think again.**

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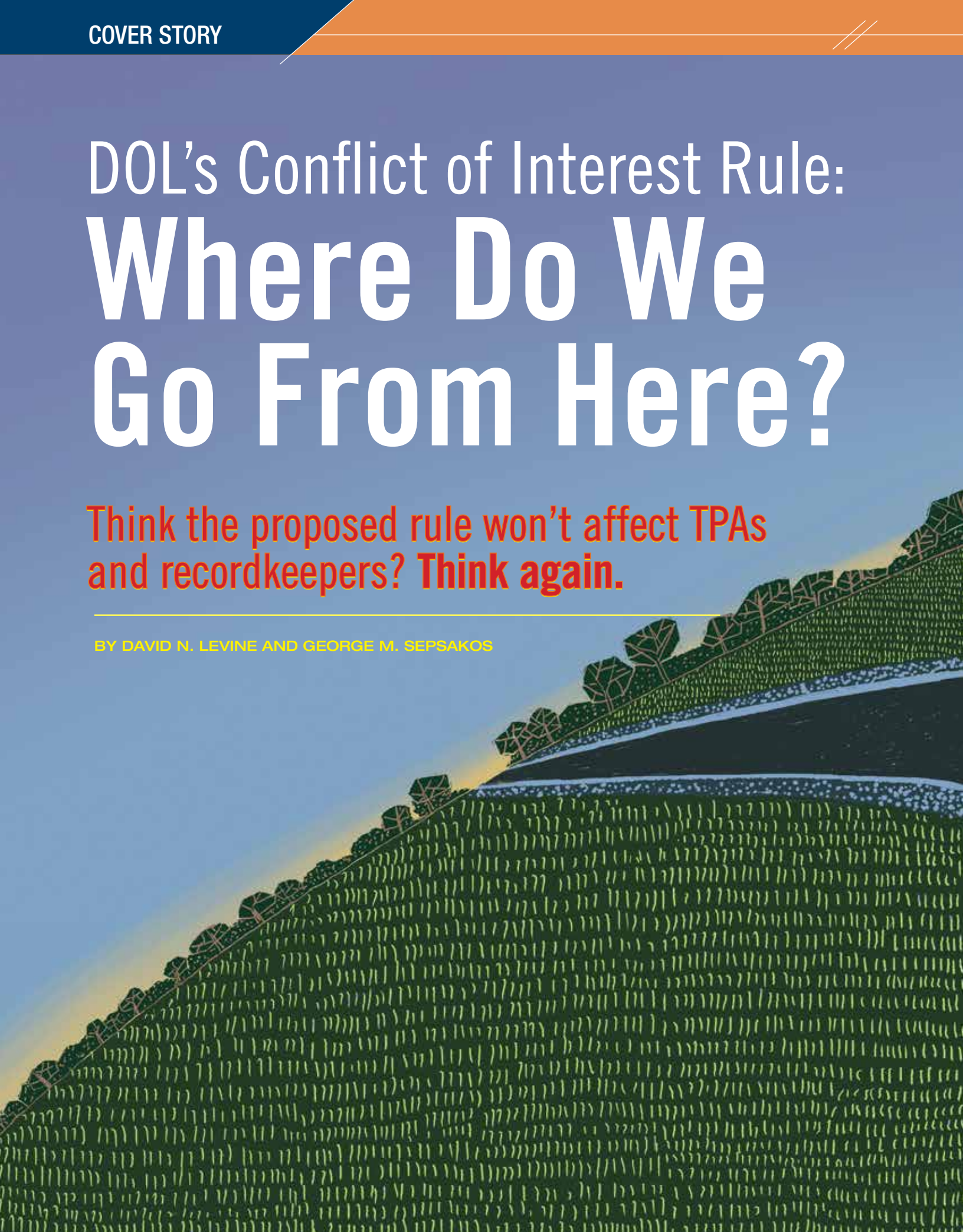


FIDUCIARY INVESTMENT ADVICE
THIRD PARTY PLATFORMS
IRA ROLLOVERS
CARVE-OUTS
REVENUE SHARING
PROPRIETARY PRODUCTS
DC TPA

In April 2015, the Department of Labor released its complex package of proposed guidance on the so-called "conflict of interest" rule. In the six months that have passed, more attention has been paid by industry and mainstream media to defined contribution plans than in decades. More than 2,000 comments have been submitted to the DOL, including one from the American Retirement Association addressing concerns raised by ASPPA members.[1] This article reviews the proposal and looks at how it could impact third-party administrators and recordkeepers.

BACKGROUND

Ever since ERISA was enacted in 1974, ERISA section 3(21) has contained a definition of the term "fiduciary." ERISA section 3(21)(a)(ii) provides that any individual who "renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so" is a fiduciary. This "type" of fiduciary is often referred to as an "investment advice fiduciary." Notably, ERISA section 3(21) provides that other individuals — such as those making discretionary decisions about plan administration — are also fiduciaries.

As TPAs' and recordkeepers' businesses have evolved since 1974, many have put in controls and processes to ensure that they are not fiduciaries by avoiding making discretionary decisions about plan administration. These steps have generally been successful at preventing TPAs and recordkeepers being labeled as fiduciaries. Furthermore, under regulations issued in 1975[2] and still in force today, most TPAs and recordkeepers have had little concern that their traditional TPA and/or recordkeeping services could result in their classification as an investment advice fiduciary. The proposal dramatically changes this perceived level of comfort.

THE BASICS OF THE RULE

At first glance, a TPA or recordkeeper might assume that the DOL's proposal of the definition of an investment advice fiduciary will have little or no impact on their activities. However, the proposal's broad scope makes this assumption incorrect in many cases. To provide a framework for understanding the impact on TPAs and recordkeepers, let's review the key features of the proposal.

How the Proposal Is Structured

To understand how the proposal holds the potential to significantly impact TPAs and recordkeepers, it is essential to first understand how it is structured. The proposal does not merely create a new definition of investment advice fiduciary. Instead, with a proposed definition of investment advice fiduciary that also contains numerous "carve-outs" from the definition, changes to a number of prohibited transaction exemptions, and the proposal of a new prohibited transaction exemption called "best interest contract exemption" (sometimes called the BIC exemption or the BICE), the proposal establishes a process that any potential investment advice fiduciary — including a TPA or recordkeeper — will need to go through to determine whether or not it is an investment advice fiduciary and whether its business practices will be affected.

A Brief Summary of the Proposal

The proposal itself is extremely complex, with numerous moving parts. However, there are a number of key steps that will be directly relevant to a TPA or recordkeeper.

First, the proposed amendment to the fiduciary regulation would provide

1 http://asppa-net.org/Portals/2/PDFs/Comment%20Letters/ARA%20Fiduciary%20Comment.pdf.
2 29 U.S.C. section 2510.3-21(c)(1).

that a person is an ERISA investment advice fiduciary if he or she:

- provides one of the following four types of advice directly to a plan, a plan fiduciary, a participant or beneficiary, an IRA or an IRA holder: (1) recommendations about the advisability of acquiring, holding, disposing or exchanging securities or other property, including recommendations to receive a distribution of benefits or roll over assets from a plan or IRA; (2) recommendations about the management of securities or other property, including recommendations as to the management of assets be rolled over to or distributed from an IRA; (3) appraisals or fairness opinions concerning the value of securities or other property if made in connection with a specific transaction involving a plan or IRA; or (4) recommendations of a person who will also receive a fee or other compensation for providing any of the three categories listed above; *and*
- either directly or indirectly (whether through or together with an affiliate), represents or acknowledges fiduciary status, or provides the advice under an agreement, arrangement or understanding that the advice is individualized to, or specifically directed to, the recipient of the advice for consideration in making investment or management decisions with respect to securities or other property.

Second, after creating this more expansive definition of investment advice fiduciary, the proposed amendment offers several "carve-outs" that generally exclude persons from being treated as investment advice fiduciaries. Key carve-outs that could impact a TPA or recordkeeper include the following.

- *Counterparties*. Persons involved in sales to plans and transactions between counterparties. It is only applicable to sales to certain plans, not to individual plan participants or IRAs. Numerous procedural requirements need to be satisfied, depending on whether: (1) the plan fiduciary representing the plan has fiduciary responsibility for managing more than $100 million in assets; or (2) the plan has 100 or more participants. Notably, these requirements make the counterparty carve-out unavailable to many small plans.
- *Platform Providers*. Organizations that market and make available platforms for a plan fiduciary to select and monitor investment alternatives that are offered to participants and beneficiaries, provided that the person acknowledges in writing that they are not providing investment advice to the plan.
- *Selection and Monitoring Assistance*. Organizations that, in connection with platform provider services, "merely identifies investment alternatives that meet objective criteria specified by the plan fiduciary (*e.g.*, stated parameters concerning expense ratios, size of fund, type of asset, credit quality)" or "merely provides objective financial data and comparisons with independent benchmarks to the plan fiduciary."
- *Investment Education*. Persons who provide "investment education." Notably, this carve-out would replace existing DOL guidance that has long been relied on to draw the line between investment education and advice.[3] One key distinction between the existing DOL guidance and this new carve-out is that the information and materials provided as part of "education" may not include advice or recommendations regarding specific investment products, specific investment managers or the value of particular securities or other property.

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The proposal also establishes the new "best interest contract exemption." This exemption's stated intent is to address distributions and rollovers from a plan or IRA, and investment advice provided to participants, beneficiaries, IRA owners, and plan sponsors of a non-participant directed plan having fewer than 100 participants. As drafted, it would be the lead exemption in dealing with plan distribution and IRA advice. The exemption includes numerous requirements that, if applicable to a TPA or recordkeeper, would result in significant new compliance requirements and costs.

Lastly, numerous existing prohibited transaction exemptions would be revised under the proposal. A key theme of these changes would be that the terms of existing exemptive relief would be significantly tightened and a common set of "impartial conduct standards" would apply across a wide range of prohibited transaction exemptions.

IMPACT ON TPAs AND RECORDKEEPERS

While each TPA and recordkeeper operates in a different manner, there are numerous areas in which the proposal could directly impact all TPAs and recordkeepers.

3 Interpretive Bulletin 96-1, 29 CFR 2509.96-1.

> "The use of the actual plan investments in educational activities would now be swept into the definition of fiduciary investment advice."

TPAs and recordkeepers regularly serve as the main coordinator of an employer's retirement plan and may serve as a single point of contact in order to reduce the administrative burden imposed on employers. In fact, it is this personalized level of service that often leads to the selection of a specific TPA or recordkeeper. However, it is this same level of service that could lead a TPA or recordkeeper to be classified as an investment advice fiduciary.

Below we highlight a number of TPA and recordkeeper activities and services that could be impacted by the proposal.

Vendor Recommendation

A key feature of the proposal is that a recommendation of a person who would be classified as an investment advice fiduciary themselves because of the services they will provide will make a TPA or recordkeeper into an investment advice fiduciary. Examples of this rule affecting a TPA or recordkeeper include the following:

- *Recommendation of an Adviser to Select Funds.* A TPA or recordkeeper may recommend third party advisers who can recommend or select specific funds for inclusion in a plan's core lineup. Since the selection of these funds would likely result in the third party being an investment advice fiduciary, the recommending TPA or recordkeeper would likely be considered an investment advice fiduciary as well.
- *Recommendation of Managed Account Solutions.* More and more plan sponsors are looking to managed account providers to help participants allocate their investments among the funds in a plan's investment lineup. In some cases, a TPA or recordkeeper may already have a relationship with a managed account provider that is integrated with their systems and processes. Because the managed account provider would probably be an investment advice fiduciary, the recommending TPA or recordkeeper would probably be considered an investment advice fiduciary as well.

Numerous comments submitted to the DOL on the proposal address both of these situations and many hope that final guidance will allow TPAs and recordkeepers to continue providing these services — whether through an expansion of the platform provider carve-out or similar relief.

Sales Activities

TPAs and recordkeepers are provided some relief for providing platforms to under the platform provider carve-out and for "selling" their services under the counterparty carve-out. However, numerous areas remain a concern for TPAs and recordkeepers to consider:

- *Collaborative Sales of Solutions to Clients.* As drafted, the platform provider carve-out can be framed as a carve-out from fiduciary status for direct sales of a retirement platform to a plan sponsor in the small plan market. However, many TPAs and recordkeepers work in collaborative arrangements involving TPAs, recordkeepers and components of larger "platforms" that might be able to utilize the platform provider carve-out themselves. These multi-party arrangements do not have clear relief from triggering investment advice fiduciary status under the proposal.
- *Sales Presentations.* Significant concerns have been raised that sales presentations made by a TPA or recordkeeper before the TPA or recordkeeper is hired could lead to fiduciary status if a proposed investment lineup is included in the sales presentation.
- *Ancillary Services.* As the retirement services industry has consolidated, many TPAs and recordkeepers have branched out into new services — either directly offered by them or through collaborations. Because of the expansive definition of investment advice fiduciary contained in the proposal, these ancillary services provided by TPAs and recordkeepers may be swept in and considered fiduciary acts. Furthermore, with the counterparty exemption generally unavailable to small plans, TPAs and recordkeepers may be unable to use the counterparty carve-out from investment advice fiduciary status.

Investment Education and Advice

As noted above, the DOL's existing guidance on the line between investment education and advice would be replaced and restricted under the proposed education carve-out. Some TPAs and recordkeepers may currently provide education to plan participants where they reference specific investments in the fund lineup chosen by a plan sponsor or plan fiduciary. Under the proposal, the use of the actual plan investments in educational activities would now be swept into the definition of fiduciary investment advice, and would not be carved out as education. Thus, TPAs and recordkeepers providing this

> "The exemption includes numerous requirements that would result in significant new compliance requirements and costs."

education could be characterized as investment advice fiduciaries.

Distribution and Rollover Advice

One part of the proposal that has received significant attention is that the act of recommending a distribution or rollover from a plan can trigger investment advice fiduciary status. While many TPAs and recordkeepers may not make these recommendations directly, they may recommend one or more third-party advisers who will make these recommendations to individual plan participants. As already discussed, the recommendation of someone who is an investment advice fiduciary can make the recommender an investment advice fiduciary. Accordingly, TPAs and recordkeepers who maintain relationships with other parties to facilitate this advice could wind up classified as investment advice fiduciaries under the proposal.

The Impact of Being an Investment Advice Fiduciary

To the extent that TPAs and recordkeepers are swept into investment advice fiduciary status when the proposal is finalized, it may not be a major disruption of their business model. However, it will be necessary for affected TPAs and recordkeepers who are classified as investment advice fiduciaries to evaluate whether this status will result in any potential prohibited transactions — most commonly due to the payment of compensation to the TPA or recordkeeper in connection with their advice to a client. The BIC exemption is complex, but in some cases, it may provide an avenue to continuing existing business activities.

Alternatively, affected TPAs and recordkeepers might instead look to the revised preexisting exemptions for potential relief. In the worst case, a TPA's or recordkeeper's contracts and other agreements would likely need to be revisited and revised quickly, since the transition relief in the proposal is extremely limited and provides very little protection against liability after the regulations become "applicable" (*i.e.*, 8 months after the publication of the final rule). As such, if it appears that the proposal would significantly impact a TPA's or recordkeeper's contracts, it may be advisable to consider what steps will be necessary to ensure compliance (and provide contractual protection and/or necessary insurance coverage) before final guidance is issued.

WHERE THE PROCESS GOES FROM HERE

As we sit here in October 2015, several steps remain ahead. As the comments on the proposal and public testimony have highlighted, there are numerous concerns and questions about the proposal. However, barring congressional activity or court intervention, it is likely that we will see a finalized version of the proposal in early 2016. This finalized version will likely include revisions, although not wholesale revisions, to the proposed regulation and prohibited transaction exemptions, including potential new prohibited transaction exemptions (or subparts of prohibited transaction exemptions). For political reasons, the regulations are likely to be "effective" by May 2016 and "applicable" before the next presidential inauguration on Jan. 20, 2017. Will there be delays in enforcement of these rules? Most likely.

However, now is not the time to dawdle. No matter what your role in the retirement ecosystem — TPA, recordkeeper, adviser, platform provider or other service provider — these regulations will probably affect your operations, relationships and services. Taking the time to systematically review your present and future services and relationships (including your insurance coverage and contract terms) will allow you to consider what steps to take to be prepared and take advantage of the changing concept of an investment advice fiduciary. PC

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