Department of Labor Finalizes Retirement Advice Regulation

A Practical Perspective for 401(k) Plan Sponsors and Investment Committees

By Sheldon M. Geller

The retirement plan marketplace has confused, if not outright misled, CPAs, their plan sponsor clients, and investment committees with the many types of nonfiduciary and fiduciary advisor designations. Commission-based brokers and fee-based advisors provide similar services, making it difficult for sponsors and committees to determine whether their retirement plan advisor is a fiduciary or is selling a product that may not be in their best interest. The failure of many advisors to acknowledge fiduciary status or to disclaim fiduciary responsibility has led to excessive plan expenses and poor fund performance, thereby placing employers and committees at risk.

Background

The Department of Labor (DOL) has recognized that employers and employees must be able to rely upon their plan advisors to act in their best interest. In 1975, the DOL defined who is a plan fiduciary and distinguished between fiduciary investment advice and investment product sales. The 1975 definition regulates most fee-based advisors, but does not apply to most commission-based brokers. Since 2012, the DOL has required service providers to give plan sponsors annual fee disclosures, which sponsors use to determine whether plan fees are "reasonable" in order to comply with yet another DOL regulation and avoid a fiduciary breach and monetary sanctions.

Now, in 2016, the DOL has finalized its proposed regulation (29 CFR 2510.3-21) defining who is a “fiduciary” of a retirement plan under the Employee Retirement Income Security Act (ERISA) and defining the “best interest contract exemption” intended to protect plan sponsors from self-dealing conflicts of interest. Under the regulation, virtually every person who provides retirement investment advice for compensation will need to be a fiduciary or held to a fiduciary standard. Advisors will be required to provide investment advice that reflects loyalty to the “best interest” of participants and disclose any potential conflict. Failure to do so may subject advisors, and the plan sponsors that retain them, to participant lawsuits and monetary sanctions. Therefore, plan sponsors and investment committees must determine whether their 401(k) service and fee arrangement is impacted by the DOL's finalized regulation and the related exemption in order to avoid a breach of their fiduciary duties of loyalty and prudence.

Regulatory Objective

The DOL's stated objective is to mitigate conflicts of interest that exist between retirement plan advisors and plan sponsors and to address concerns that advisors are incentivized to recommend proprietary products and high-expense share classes that pay unreasonable and excessive compensation to the detriment of plan participants. The DOL considers these regulatory changes necessary to make fiduciary conduct uniform in the current retirement plan marketplace. The final regulation is viewed as the most comprehensive legislation governing retirement advisors since the enactment of ERISA, matching plan advisors' management with plan sponsors' expectations.

Currently, brokers may sell financial products that benefit themselves more than benefit the plan because they owe no fiduciary duty of care to the plan. This is not to suggest that brokers are unscrupulous; however, their recommendations may be tainted. The regulation will transform the retirement advisor marketplace by causing existing non-fiduciary brokers receiving commissions to either convert to a fiduciary advisor fee-based arrangement (e.g., annual charge based on plan assets) or utilize the best interest contract exemption allowing brokers to receive commissions. Other brokers who are unable to subscribe to a fiduciary standard of care may partner up with an advisor who can serve as a fiduciary. Brokers who wish to receive commissions will be required to sign a "best interest" contract with their plan sponsor clients stipulating that their recommendations are in the best interest of the plan. Brokers and wire house advisors will be required to act in the plan's best interest, avoid misleading statements, adhere to certain impartial conduct standards, and seek to obtain the best execution and fee arrangement reasonably available under the circumstances. Finally, the principal transaction exemption will permit brokers and advisors serving as fiduciaries to offer their own proprietary products, including mutual funds managed by their broker-dealer, in 401(k) plan investment menus.

Definition of a Fiduciary

The regulation defines when a person providing investment advice to an employee benefit plan [e.g., 401(k) plan] or individual retirement account (IRA) is considered a fiduciary under ERISA. It extends the definition of a fiduciary to retirement plan and IRA advisors, thus requiring these advisors to give advice that is in the "best interest" of 401(k) plan participants and IRA owners, rather than advice that is merely "suitable."

A "best interest" standard means that the advisor must be able to demonstrate that their advice was in the plan's or participant's best interest and that the advisor's compensation was "reasonable." A "suitability" standard, a much lower standard of care, means that the retirement plan advisor must be able to demonstrate that the investment was suitable for the plan or participant, even if the advisor receives more compensation by selling a more expensive product or fund, without having to make certain that plan cost is reasonable.

Prior to the rule's enactment, by way of example, a certified financial planner (CFP) could act as either a non-fiduciary or a fiduciary providing 401(k) advisor services, notwithstanding an employer's expectation that the CFP was always a fiduciary. Now a CFP will, in all events, be considered a fiduciary if they are providing 401(k) plan services. Other potential conflicts still exist, however, such as when insurance agents and brokers are required to sell proprietary products. Advisors offering a limited range of products must document the limitations they place on their recommendations and the conflicts associated with their proprietary products. These advisors must reasonably conclude that the limitations will not cause them to receive excessive compensation.

Best Interest Contract Exemption

The DOL developed the best interest contract exemption to allow brokers to continue to receive commission-based compensation, provided they comply with specific requirements. The point of sale requirement, for example, mandates that a financial institution must disclose the total cost of each new investment, including the cost at inception, over various holding periods, upon sale, and any other cost that reduces the rate of return. Advisors must also provide annual disclosures of expenses and compensation.

Reasonable Compensation

Plan sponsors and investment committees must make certain that an advisor's compensation is "reasonable" under ERISA. They will need to understand their broker's different levels of commissions, or the amount of their fiduciary advisor's fee, in order to determine such reasonableness. Broker compensation tends to be higher than advisor fee-based compensation because broker-dealer products can be more complex, carry higher asset-based percentages, are made part of fund expenses, and are not billed separately.

Sponsors whose investment menus utilize "A" share class funds are paying additional compensation that is embedded in the "A" share class expense. The new rule permits brokers to be paid this additional compensation; however, it must now be fully disclosed. Thus, sponsors will need to understand that this conflicted compensation will continue to exist in 401(k) plan investment menus.

The new fiduciary rule does not eliminate self-dealing and conflicts; it merely requires disclosure. Sponsors and committees must be more proactive in reviewing compensation and conflicts disclosure, given the new rule's compliance requirements and a participant's private right of action.

The new rule will likely compress fund expenses, as brokers will be less likely to sell high-expense mutual funds based upon the expected commission trail without the ability to rely on the lenient suitability standard. It will also lead to the use of more exchange-traded funds, index funds, and lower-expense share classes of actively managed funds. The new rule will likely improve the quality of 401(k) plan management and compress advisor compensation as well. Plan sponsors will gravitate towards the retention of independent named fiduciaries and 3(38) investment advisors because they offer the highest standard of fiduciary care while assuming sole responsibility for the selection, monitoring, and replacement of plan investments and service providers.

Best Practice

Plan sponsors and investment committees should select an advisor who acknowledges fiduciary status in writing, subscribes to a fiduciary standard of care, avoids conflicts of interest, provides impartial advice, accepts no third-party payments, and receives no more than reasonable compensation. Once an advisor becomes a 401(k) plan investment fiduciary, the plan sponsor and investment committee can rely upon their fund selection, retention, and replacement recommendations.

Investment advisors will have to document why a product, investment platform, service provider, or fund recommendation is in the plan's best interest. Similarly, plan sponsors and investment committees will need to document why they accepted an advisor's recommendation in order to demonstrate they are acting in the plan's best interest. Plan sponsors must engage in a formal plan governance process, including the conduct of at least annual committee meetings and the maintenance of meeting minutes.

Positive Development

In this author's opinion, the finalized regulation is a positive development because it will eliminate most self-dealing and conflicts of interest in the 401(k) plan marketplace. It will have a significant impact on wealth managers, brokers, insurance agents, and asset managers serving 401(k) plans, who customarily do not serve as fiduciaries and who receive variable (i.e., commission) compensation. Any financial advisor serving an ERISA retirement plan will have to serve in a fiduciary capacity or adhere to a fiduciary standard, whether as a broker or registered investment advisor, enabling plan sponsors, plan participants and investment committees to rely upon their advice.

A fiduciary advisor or broker adhering to a fiduciary standard of care will reduce plan sponsor and investment committee risk. ERISA's requirement that a fiduciary advisor follow a prudent process will help sponsors and committees demonstrate their own compliance and provide a defense against an excessive fee claim or fiduciary breach action.

Broker-dealers will likely require more sophisticated brokers to offer level fee advice and require less sophisticated brokers only to recommend service provider platforms incorporating a 3(21) or a 3(38) fiduciary capability. The 3(38) designation offers the highest standard of fiduciary advisor care, as 3(38) advisors become solely responsible for the selection, monitoring, and replacement of plan investments and service providers. Robo-advisory and online advice programs using digital tools to make fund recommendations, although legally compliant, cannot replace the human element and plan governance provided by a 3(38) advisor.

Department of Labor Enforcement

An advisor's failure to comply with the new fiduciary rule will cause their compensation to be a prohibited transaction and expose the sponsor and committee to DOL enforcement sanctions. Moreover, the sponsor and committee will be required to reverse the transaction, make the plan whole, and pay excise taxes. The fiduciary rule ensures that advisors are accountable to their client plans and that sponsors are accountable to the DOL. Although the 401(k) marketplace is already well versed in excessive fee litigation, the new rule will grant participants a stronger claim against brokers and sponsors for fiduciary breach under ERISA. Enforcement will occur naturally as a result of the threat of enforcement, if not by investigations and enforcement actions for failure to mitigate conflicts of interest.

Fiduciary Advisor Status

Sponsors and committees will need to determine the extent to which they wish to assume fiduciary responsibility for fund and service provider selection and monitoring—and therefore the fiduciary status of their advisor—taking into account the choices available in the marketplace. Not all fiduciary advisors assume the same level of responsibility, nor do they offer the same level of services. It is better to retain a fiduciary advisor with experience and one who is a fiduciary by choice and business model, rather than one who is forced to act like one or become one under the new rule.

Under the new rule, sponsors and committees may select among the following fiduciary advisor models:

- A broker subscribing to the fiduciary standard and making product and fund recommendations subject to sponsor/committee approval
- A 3(21) investment advisor, a co-fiduciary, making fund recommendations subject to sponsor/committee approval
- A 3(38) investment manager, a fiduciary, making fund recommendations and taking full responsibility for those recommendations and all plan investments
- A named fiduciary, with 3(21) and 3(38) designations, mak-

ing fund recommendations and taking full responsibility for those recommendations, all plan investments, and the reasonableness of plan expenses.

Any broker or advisor recommendation approved by a committee is a recommendation for which the committee will assume responsibility. Accordingly, 3(21) investment advisors provide limited protection, whereas 3(38) investment managers and named fiduciaries provide greater protection with respect to fund selection, investment menu monitoring, and investment platform selection. Although both 3(21) and 3(38) advisors must have a defined, documented process in place, 3(21) advisors limit the breadth of their fiduciary relationship and place more responsibility on plan sponsors. Although 3(21) advisors may represent themselves as ERISA fiduciaries, their service agreements disclaim responsibility and provide an illusion of greater protection.

Plan Sponsor/Investment Committee Action

Plan sponsors and investment committees are named fiduciaries, obligating them to act in the plan's best interest when selecting and monitoring advisor services. Although the new rule is directed at advisors who provide retirement plan services, it will increase plan sponsor and investment committee compliance obligations. That is, sponsors and committees will need to reevaluate the relationship they have with their advisors, confirm their advisor's fiduciary status, and benchmark their advisor's compensation. Sponsors and committees will also need to meet with their 401(k) plan advisors to understand their service and fee arrangement and fee amount to determine how their advisor, and by extension they, will comply with the new investment advice rule. A committee's failure to do so could be deemed a fiduciary breach.

Committees that retain a fiduciary advisor who also provides broker services (e.g., dual registration) will need to make certain that they have retained the advisor on a fee basis only and not by commission as well. Committees must pay close attention to the flow of revenue generated on plan asset investments, noting the amounts paid to retirement advisors and service providers. They will need to determine that advisor compensation is not excessive, as measured by the fair market value of the specific advisor services that generated the compensation paid by the plan.

Sponsors and committees will need to document that they are acting in the best interest of the plan and that advisor compensation is reasonable. Individuals charged with plan governance should adopt review protocols and anti-conflict policies and procedures to ensure ERISA compliance.

Those sponsors and committees that continue to retain brokers will need to review new or modified documentation as brokers seek to qualify under the rule's exceptions or exemptions and to clarify their fiduciary status. This documentation may take the form of a negative consent requiring no affirmative sponsor or committee action. Accordingly, active committee oversight is needed to approve investment advisory agreements and service provider (e.g., recordkeeping) agreements.

The failure to provide advice that is in the plan's best interest or to disclose any potential conflict will subject that advisor, and the sponsor and committee that retained them, to ERISA liability, as well as participant lawsuits. Plan sponsors have a continuing duty to satisfy these new obligations to monitor advisor compliance, plan cost, and fund performance no less frequently than annually. Moreover, plan sponsor investment menu selection remains subject to ERISA's tough prudence and loyalty standards.

Currently, brokers held to a suitability standard may recommend 401(k) plan investments that fit the plan's needs but may result in higher compensation for the broker and a corresponding higher plan cost than would competing, lower-fee investments. Imposing a fiduciary standard on plan advisors will increase their potential liability and reduce their willingness to provide high-cost investments. The new rule will cause many brokers to avoid commission-based compensation and switch to an asset-based fee, and cause other brokers to no longer serve 401(k) plans at all.

It would appear desirable, if not advisable, for sponsors and committees to replace their brokers with fiduciary advisors to avoid compliance risk and reduce responsibility as a result of the rule's extension of fiduciary status. Moreover, it would appear prudent for sponsors and committees to retain fiduciary advisors with extensive experience and whose practices focus on retirement plan governance.

Committees should embrace a holistic approach, including the assessment of the quality, experience, and subject matter expertise of the advisor, as well as their fee and governance process, to achieve successful outcomes. While having the flexibility of judgment, committees must retain strong fiduciary principles and purpose, knowing that participants have clear recourse in the event of a fiduciary breach. Proactive plan sponsors and investment committees will retain an experienced 3(38) fiduciary advisor whose service model will provide the maximum protection under ERISA consistent with the spirit and intent of the finalized regulation. ❑

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