Overview of the New Fiduciary Rule
with Respect to IRAs and HSAs and
its Effect on Employers and Advisors

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Introduction:

Advisors (including brokers, registered investment advisers, insurance agents) regularly make recommendations to consumers on how to invest their retirement savings, which are generally held either in participant directed employer-sponsored plans (such as 401(k) or Individual Retirement Accounts (IRAs)). Employee funded savings or joint employer/employee savings for medical care are also becoming more popular, with the savings for medical care being held primarily in Health Savings Accounts (HSAs). Under current law, advisors who make investment recommendations to employer-sponsored retirement plans, generally, are subject to the fiduciary rule under the Employee Retirement Income Security Act of 1974 (ERISA) and are subject to an excise tax under the Internal Revenue Code of 1986 (Code) for any fiduciary violations. However, under current law, advisors who make investment recommendations to the holders of IRAs and HSAs are generally not subject to ERISA's fiduciary protections, and can also often find an exemption from the Code's excise tax for fiduciary violations.

On April 8, 2016, the Department of Labor (DOL) issued final regulations which revise its current definition of a fiduciary and affect both IRAs and HSAs. The final rule was the culmination of a multiple year effort by the DOL. Although the new rule became effective on June 7, 2016, initial compliance with the rule is not required until April 10, 2017 and full compliance is not required until January 1, 2018. Generally, under the new rule, if an advisor is paid a fee and provides investment advice or a recommendation under either an IRA or HSA, he or she will be considered a fiduciary. Absent an exemption, fiduciaries of qualified pension or profit-sharing plans or ERISA-covered HSAs are prohibited from engaging in certain transactions (such as receiving certain fees for their services) and are subject to excise taxes under Code Section 4975. Absent an exemption, fiduciaries of welfare plans are also prohibited from engaging in certain transactions but are subject to a penalty under ERISA section 502(i). As discussed below, satisfying an exemption comes with its own challenges and may result in exposing the fiduciary to a risk of litigation.

Going forward and absent a repeal of the rule, advisors will have no choice but to comply with the fiduciary rule and its associated exemptions or find a communication carve-out, which would exempt them from being classified as fiduciaries. Since only certain types of communications can be classified as carve-outs under the rule, this new rule will widen the scope of individuals who are deemed to be fiduciaries.

Background on IRAs and HSAs:

IRAs were first introduced with the purpose of providing individuals with a vehicle to save for their retirement outside of their workplace. Since 1974, the rules for IRAs, as well as the retirement savings landscape have changed in many meaningful ways, making investing in IRAs more desirable for many individuals.[1] DOL's revision of the rules resulted, in part, from the DOL's belief that its job is to protect and safeguard retirement funds. Its ability to satisfy that responsibility is being compromised, since in today's world IRAs hold significantly more retirement assets than employer-sponsored account-based plans.[2]

HSAs, on the other hand, were not introduced by Congress until 2003 and did not become effective until 2004. Although HSAs are used for the purpose of reimbursing an individual's unreimbursed medical expenses, HSAs are very similar in nature to IRAs. Just like the rules applicable to IRAs, HSAs are subject to limitations on contributions, restrictions on distributions, but have tax-deferral advantages, and provide individuals with the ability to save for medical expenses incurred during the retirement years. Additionally, assets held in HSAs after age 64 can be withdrawn for any reason and be subject solely to ordinary income taxes (no penalty taxes). Although the concept of HSAs is relatively new, HSAs are viewed by the DOL, for this purpose, as retirement vehicles, because money put away into an HSA can be invested in similar investment vehicles as IRAs and be withdrawn penalty free at a later age even if not used for medical expenses. As a result, because advisors can provide investment advice to HSA account owners, and many account owners view HSAs as vehicles to save for retirement, it is the DOL's belief that account owners of HSAs are owed the same protections as account owners of IRAs.

Background of the DOL's Final Rule:

Prior to the new rule, advisors providing investment advice for a fee were required to satisfy a five-part test to be considered a fiduciary, permitting some advisors to escape the status as a fiduciary by not satisfying one or more conditions of the test. That rule was developed when assets being invested by fiduciaries primarily were held in large, defined benefit plans. Today, most retirement assets are held in defined contribution accounts, including IRAs and HSAs. Under the new rule, the five-part test has been replaced with a much simpler fiduciary definition which generally only requires proof that, for a fee, an investment recommendation has been directed at a specific recipient.

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[1] See: Thomas L. Hungerford and Jane G, Gravelle, *Individual Retirement Accounts (IRAs): Issues and Proposed Expansion* (2012), *available at* http://www.pensionrights.org/sites/default/files/docs/crs_report_individual_retirement_accounts_iras_-_issues_and_proposed_expansion_2.pdf.

[2] Testimony of Phyllis C. Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration Before the House Committee on Education and the Workforce, Subcommittee on Health, Employment, Labor, and Pensions (July 26, 2011).

This new definition of a fiduciary will now make most advisors who provide investment advice to consumers of IRAs and HSAs subject to the new rule. Under both the current and the new rule, if an advisor is considered a fiduciary, he or she is prohibited from engaging in certain activities (such as receiving certain compensation for their services), unless the DOL has created an exemption for such an activity and the advisor satisfies all of the conditions of the exemption.

One such exemption is specifically targeted at advisors who provide investment advice to account owners of IRAs and HSAs. This new exemption is called the Best Interest Contract Exemption (BICE). The BICE exemption, among other conditions, requires a financial institution to: acknowledge that it and its advisors who make recommendations to consumers are fiduciaries, enter into a written contract with the consumer, establish written policies and procedures designed to ensure compliance with the rule, provide certain disclosures to consumers and the DOL, and retain records proving that the conditions of the exemption have been satisfied. The most important aspect of BICE is the obligation to give prudent advice that is in the consumer's best interest. This means the advisor must avoid making misleading statements and can only receive reasonable compensation for the advice. This "best interest" concept is a mirror image of ERISA's provisions and, in the past, only applied to ERISA-covered plans. Any advisor that intends to meet this new exemption will, in fact, be subjecting himself or herself to the same fiduciary obligations as have historically applied to only ERISA-covered plans. (The requirements to satisfy BICE become much simpler in cases of level fee compensation.) Unless a plan is subject to ERISA (and most IRAs and HSAs are not), the DOL has no authority to enforce the failure to satisfy the new exemption. The IRS has minimal resources to enforce the rule, so the requirement of a written contract provides individuals with a private right of action. It is, therefore, anticipated that an advisor's failure to meet the requirements of the BICE exemption will be enforced by individuals and their lawyers, and potentially result in class action lawsuits.

Alternatively, if the advisor's activities do not constitute a "recommendation" under the new rule, the advisor may find an exemption from the definition of a fiduciary.

An investment recommendation is considered to be made if 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," based on an objective inquiry.[3] Certain communications are not considered to be "recommendations" under the new rule, for example, educational material or general communications. The determination of whether a communication falls outside the scope of a "recommendation" will be based on facts and circumstances of each case. Making even one error in judgement may subject the professional's recommendation to the new rule, exposing the advisor to penalties under the Code for compensation received, as well as a potential lawsuit by the consumer.

[3] Department of Labor, 81 Fed. Reg. at 20,997 (final April 8, 2016) (to be codified at 29 C.F.R. Parts 2509, 2510, and 2550).

Effect on Employers:

In most respects, the impact on advisors is much more significant than it is on employers.

Employers are generally not affected by the overhaul of the rule with respect to IRAs, unless the IRAs are subject to ERISA.

Most IRAs are not subject to ERISA, unless they are maintained by the employer and otherwise do not meet the requirements of DOL Reg. Sec. 2510.3(d) which, among other requirements, prohibit the employer from making contributions to the IRA.

As with IRAs, employers will not have any additional responsibilities with respect to investment advice provided for assets held in HSAs. Employers have always been subject to fiduciary responsibility with respect to HSAs that are subject to ERISA. This is a good opportunity for employers to review their HSA designs and confirm whether those HSAs are subject to ERISA.

An employer can set up an HSA for the benefit of its employees. The design of an HSA established by an employer will have a significant impact on whether an HSA is or is not subject to ERISA. An HSA will not be subject to ERISA as long as the employer limits its involvement with an HSA to those activities that are permitted under Field Assistance Bulletins 2004-01 and 2006-02 (which generally permit the employer to restrict HSA contributions to one provider, pay HSA fees, and include the HSA in its cafeteria plan). HSAs established by individuals outside of their workplace are also not subject to ERISA.

Effect on Advisors:

On the other hand, advisors have the majority of the burden of complying with the new fiduciary rule. Speaking broadly, IRA and HSA providers and advisors that are involved with investing HSA assets need to analyze the rule to determine which of their products sold and services provided will become subject to the rule and whether any carve-outs can be utilized in any aspects of their business. All advisors who interact with consumers will need to be educated, making sure that they understand the rule, understand how their activities will impact their fiduciary obligations and understand the potential risk of non-compliance. The rule will have an impact not only on the business processes, but also on the infrastructure of the business, requiring potential technical changes to its information technology systems, controls and processes. Contracts will need to be developed, fees received will need to be reviewed for reasonableness and, possibly, the structure of the fees will need to revised. Additionally, disclosures and communications will need to be drafted, and custodial agreements will potentially need to be revised, all in a relatively short period of time before the effective date of April 10, 2017.

Using BICE (which requires the acknowledgement of fiduciary status) eliminates an advisor's defense of not being a fiduciary. Any misleading statements, unreasonable compensation, acts of impropriety, or failure to follow its policies will deem to violate contractual fiduciary obligations, thus causing a potential lawsuit, likely as a breach of contract. It’s fathomable that using BICE may cause many consumers to require written follow-up from their advisors and may also cause consumers to ask for a confirmation that those advisors are acting in a fiduciary capacity. Consumers may also require for their advisors to agree to conduct themselves as fiduciaries. The compensatory structure and performance of investments may be litigated.

At this point, there have been a number of efforts to rescind the rule, including a lawsuit filed by the U.S. Chamber of Commerce together with the financial industry in early June 2016, followed by two more lawsuits led by the annuity industry and the insurance industry. A joint resolution was passed by Congress to block the implementation of the rule, but the action was vetoed by the President. If the DOL’s rule withstands the attempts to rescind it or stop its implementation, it is probable that the DOL will achieve its objectives, making most advisors fiduciaries and, as a result, subjecting them to possible litigation in the case of a dispute.

Conclusion:

In conclusion, most employers will not see much effect from the new fiduciary rule with respect to investment advice made to holders of IRAs or HSAs. Advisors, on the other hand, will need to not only modify the way they interact with consumers, but also modify the entire infrastructure of their business model. Ignoring the rule may have broad implications for advisors and their financial institutions, including exposure to both individual lawsuits and class actions.