First look: inflated risk from the new DOL fiduciary standard conundrums

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The key question facing today’s financial services firms is how to assess and mitigate risks from the Department of Labor’s (DOL) expanded definition of “investment advice fiduciary” under the Employee Retirement Income Security Act of 1974 (ERISA). The common theme among much of the early thought leadership seeking to assist with that assessment — uncertainty.

Uncertainty itself is not much of a surprise. Like Sarbanes-Oxley and Dodd-Frank, this new rule is intended to shake things up. In the near term and possibly the medium term, there will be questions not easily answered. Decisions having to be made on imperfect information will likely follow conservative interpretations, but even so, there will be increased risk, including that of surprises — the risks that we don’t know we don’t know. While some of the early thought leadership has sought to help identify the unknown or unexpected, nearly everyone agrees we are facing a period of transition while uncertainties play out.

Increased litigation would not be unexpected either. This new rule is about holding more people to higher standards. With the new standard broadening the array of potential plaintiffs, we can expect that the character of litigation, especially fee litigation, will get worse, too. The baseline, today, is an already expanding, lawyer-driven, fee-litigation trend. As the new fiduciary standard goes into effect, that trend will likely worsen with more cases, and potentially more defendants in each case, profoundly increasing the complexity and associated costs. This impact will in all probability be felt not just by the financial services professionals targeted by the new standard but by other ERISA fiduciaries as well.

What changed? Broader definition of “fiduciary” could mean more defendants

Under the rule change, any individual, firm, financial institution or affiliate (including relatives) receiving compensation, either directly or through an indirect fee arrangement, for advice that is directed to a particular plan sponsor or participant, or an IRA owner considering a retirement investment decision, is a fiduciary. Financial planners and advisors, analysts, insurance brokers or agents, insurers and others could soon find that they qualify as an “investment advice fiduciary” under ERISA. For that reason, even if the financial services your business provides does not include traditional investment advice, we recommend that you reach out to your broker, and together, proactively vet your coverage to assess how well it will respond when the DOL’s rule becomes effective.
End of the trusted relationship test could also mean more defendants
Since 1975, an investment professional has been deemed a “fiduciary” and held to ERISA’s fiduciary standards if they provide investment advice to a client on a regular basis pursuant to a mutual understanding between them, written or otherwise, that such advice serves as the primary basis for the client’s investment decisions and that the advice is individualized to the particular needs of the plan.

The new DOL rule will eliminate the “regular basis,” “mutual understanding” and “primary basis” elements of the test. The rule also expands the definition of “investment advice” to include investment management and certain types of investment advice that were previously excluded from the definition, such as referrals to other providers and recommendations regarding rollovers or distributions from a plan or IRA, including whether, in what amount, in what form and to what destination a rollover, transfer, or distribution should be made. There are still conditions that cover most types of fee-sharing arrangements (as well as future fees) and provide that the provider receive a fee for these activities (that fee does not need to be paid directly by the recipient of the services, however).

Ultimately, the expansion of the definition of “investment advice” will likely result in more claims against a broader set of advisers.

Enforcement of the new standard
Potential administrative and enforcement actions include:

- The Department of Labor bringing enforcement actions against fiduciary advisors to plan sponsors and plan participants and beneficiaries who do not provide advice in their clients’ best interests
- The Internal Revenue Service imposing excise taxes on covered transactions with plans, plan participants and beneficiaries, and IRA owners that do not satisfy an exemption
- Plan Sponsors or Participants or their beneficiaries bringing civil actions seeking to hold fiduciary advisors accountable for breach of fiduciary duties, breach of contract and liquidated damages and, if permitted, punitive damages

This expands the scope of enforcement from current regulations under which neither the Internal Revenue Service nor individuals can easily hold an advisor accountable for conflicted advice and decisions they later regret.

Exemptions
The new definition provides an exemption for certain compensation arrangements that are inherently conflicted.

Best Interest Contract Exemption allows otherwise “conflicted compensation” (e.g., commissions, brokerage fees and, in some cases, level fees) to be paid if the terms of the exemption requirements are met. Nevertheless, the BIC exemption does not relieve a provider from fiduciary duties of prudence and loyalty or the due diligence and documentation obligations associated with those duties.

Recommendations
For now, it seems the professional and fiduciary liability insurance markets remain ready, able and willing to insure the uncertainties arising from the new DOL standard’s conundrums. While current policy wording largely responds well to these risks, there are a few potential wrinkles that warrant professional attention.

- Review your ERISA Exclusions. These exclusions could apply to professional services provided to others. Acceptable wording should be limited to excluding losses from ERISA violations solely with respect to any plan of which a covered organization is the plan sponsor. Rather than professional liability policies, fiduciary liability coverage typically responds to that exposure. Before the DOL proposal goes into effect, you may want check on this feature of your coverage.
- Beware of Ancillary Exposures: The new, broader interpretation of both adviser and advice may result in greater exposure for the investment industry. For example, a provider of lists and reviews of third-party investment products could be characterized as a fiduciary if the plan invests in one of the listed products. It is possible that the financial professional services policy would not be broad enough to cover that ancillary exposure.
- Reconsider the Impact of Indemnification and Align It to Coverage Terms: With the increased risk of co-defendants, there is likely a corresponding risk that indemnification rights will trigger. Review the commitments made to you, when they trigger, the ability of the counterparty to pay, and whether those commitments (or the associated risks) are covered by insurance.

With more litigation likely and the associated costs likely to increase, it may also be time to consider whether you have enough fiduciary or professional liability insurance coverage.
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