Insights: Alerts

Fiduciary Rule: June 9 & Beyond

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On May 22, Department of Labor (DOL) Secretary Alexander Acosta announced that, despite President Trump's memorandum ordering further analysis of the fiduciary investment advice rule (Fiduciary Rule), there was no legal justification for a further delay of the rule's applicability date.[1] Accordingly, the Fiduciary Rule will become applicable on June 9, causing registered investment advisers, broker dealers, and certain other service providers to retirement plans and IRAs to become subject to the standards of conduct required of ERISA fiduciaries and the prohibited transaction rules of ERISA and the Internal Revenue Code (Code) with respect to investment advice provided to 401(k), pension, or other plans subject to Title I of ERISA (ERISA Plans) and their participants, as well as IRA owners. However, the DOL has also provided a transition period, running from June 9, 2017 through December 31, 2017, during which the DOL will implement certain policies (discussed below) that will make compliance with the Fiduciary Rule considerably easier.

This alert provides a high level summary intended to help ERISA Plans and service providers to ERISA Plans and/or IRAs better understand some of the Fiduciary Rule's compliance requirements, as well as those of the Best Interest Contract (BIC) Exemption, an exemption that is expected to be relied upon by many financial advisers.[2] The BIC Exemption requirements become partially effective June 9 and fully effective on January 1, 2018. This alert discusses the BIC Exemption requirements and when they apply to financial advisers below. As discussed below, it is possible that changes are made to the BIC Exemption prior to the end of the transition period, but until any changes are actually made, service providers, who may need to rely on the BIC Exemption, should work toward full compliance by January 1, 2018.

June 9 Applicability Date

Beginning June 9, the Fiduciary Rule will expand the scope of fiduciary investment advice that is subject to the rules of ERISA and the Code. Under the Fiduciary Rule, fiduciary investment advice is any communication, made for a fee, that objectively constitutes a recommendation for the recipient to take some course of action regarding his or her investment assets. The Fiduciary Rule addresses "investment advice," which occurs when another party (like an ERISA Plan fiduciary or IRA owner) is making the ultimate investment decision. Service providers to ERISA Plans and IRAs, who have discretionary authority over investment decisions, are fiduciaries without regard to the Fiduciary Rule.

If one is deemed to provide fiduciary investment advice, then the prohibited transaction rules of ERISA and the Code impact the fees and compensation that fiduciaries may receive for services to plans and IRAs. All direct and indirect compensation received by service providers to ERISA Plans and IRAs must comply with exemptions from the prohibited transaction rules. For service providers to ERISA Plans or IRAs not considered fiduciaries,3 ERISA Section 408(b)(2) provides a statutory exemption if the service providers receive no more than "reasonable compensation" for the services provided, which requires disclosures of the fees received for investment-related services provided for ERISA Plans. But Section 408(b)(2) does not cover direct or indirect compensation received by fiduciary service

providers to the extent the fiduciary has the authority to increase its compensation. Accordingly, fiduciary service providers, who may receive additional direct or indirect compensation in connection with investment decisions for which they have provided advice, must comply with another prohibited transaction exemption. This may be implicated in a number of contexts, including when:

- Investment advisers recommend a client roll over plan assets to an IRA,
- Nondiscretionary advisers receive additional fees or commissions resulting from investment decisions, and
- Broker-dealers receive transaction fees.

Under such circumstances, service providers need to have a prohibited transaction strategy in place to avoid a nonexempt prohibited transaction and the penalties imposed for engaging in such transactions. In conjunction with its issuance of the Fiduciary Rule, the DOL also issued new (and revised some existing) prohibited transaction exemptions. The primary exemption for compensation received by service providers is the BIC Exemption, which if satisfied, exempts compensation received by fiduciaries that are financial institutions, their affiliates, and advisers (parties relying on the BIC Exemption, collectively, BIC Advisers), as the result of investment advice from the prohibited transaction rules of ERISA and the Code.

A "financial institution" is any of the following:

- A registered investment adviser,
- A qualified bank,
- A qualified insurance company, or
- A broker-dealer.

The BIC Exemption's requirements vary depending on the type of compensation the BIC Adviser receives. BIC Advisers receiving a level fee for their advice (e.g., only a flat fee or assets under management fee) will have to comply only with scaled back requirements to satisfy the exemption. The scaled back compliance requirements for level fee fiduciaries are informally known as "BIC Light." BIC Advisers who receive variable fees based on their advice, such as from commissions (including sales loads and Rule 12b-1 payments) or transaction costs, would have to comply with the more onerous conditions of the full BIC Exemption.

Given the complexity of satisfying the requirements of both the BIC Exemption and BIC Light, the DOL made concessions to those falling within the Fiduciary Rule's coverage. First, the DOL has stated that BIC Advisers will not fail to fall within the exemption if, acting with reasonable diligence and compliance efforts, certain errors occur as long as the errors are remedied within certain parameters provided by the DOL.

And second, the DOL created a transition period during which the compliance requirements for the exemption are significantly reduced. The transition period runs from the Fiduciary Rule's applicability date on June 9 to December 31, 2017. On January 1, 2018, the transition period is set to end and BIC Advisers will have to comply with the full exemption requirements to continue to receive relief from the prohibited transaction rules, unless further changes to the BIC Exemption are made during the transition period.

Transition Period of June 9 to December 31

During the transition period, BIC Advisers (both fiduciaries eligible for the BIC Light and the full BIC Exemption) will

only have to comply with the impartial conduct standards to receive relief from the prohibited transaction rules under either the BIC Exemption or BIC Light.

Impartial Conduct Standards. Compliance with the BIC Exemption during the transition period (and, as noted below, following the end of the transition period) requires the BIC Adviser to comply with the following standards:

- At the time of recommendation, the recommendation is in the best interest of the advice recipient,
- The recommended transaction does not cause the BIC Adviser to receive, directly or indirectly, more than reasonable compensation for its services, and
- Statements made by the BIC Adviser regarding the recommendation or fees are not materially misleading.

BIC Advisers are not required to change their compensation systems to avoid compensation that could result in conflicts of interest during the transition period as long as the advice provided meets the impartial conduct standards.

The DOL also notes in a set of Frequently Asked Questions that during the transition period BIC Advisers will have the "flexibility to choose precisely how to safeguard compliance with the impartial conduct standards."[4] Additionally, the DOL noted that BIC Advisers do not have to have policies and procedures ensuring compliance with the impartial conduct standards in place on June 9, but rather may use the transition period to develop policies and procedures to implement by January 1, 2018.

Further, on May 22, the DOL issued a temporary enforcement policy (FAB 2017-02) announcing that until January 1, 2018, it will not take any enforcement action against "fiduciaries who are working diligently and in good faith to comply with the fiduciary duty rule and exemptions."[5] Note, however, that this enforcement policy applies only to the DOL and would not prevent private rights of action by retirement investors on the basis of the Fiduciary Rule and a service provider's compliance with the BIC Exemption's transition rules.

January 1, 2018

Although DOL Secretary Acosta believes the DOL cannot delay the effective date of the Fiduciary Rule any longer, he has made clear that the DOL will continue its evaluation of the Fiduciary Rule's economic impact, as directed by President Trump's memorandum. Secretary Acosta has stated that the results of the DOL's evaluation may lead it to consider changes to the rule as it is slated to take effect on January 1, 2018 and may even lead the DOL to extend the transition period beyond the end of the year. Further, as noted below, SEC Chairman Jay Clayton recently issued an announcement seeking comment on the Fiduciary Rule. Some speculate SEC action would bolster the argument to delay the implementation of the Fiduciary Rule and the full BIC Exemption requirements — i.e., the Fiduciary Rule and the BIC Exemption should not be implemented until the DOL and SEC can align their regulatory schemes. At this time, however, the SEC has not taken formal action.

Despite the uncertainty as to the form the Fiduciary Rule will take on January 1, 2018, a general overview of the basic requirements of BIC Light and the BIC Exemption as they are currently scheduled to go into effect as follows.

BIC Exemption - Level-fee Exemption (BIC Light). If the BIC Adviser receives only a level fee from the transaction seeking a BIC Exemption, the BIC Adviser should be able to comply with BIC Light. For example, an investment adviser, who receives no compensation with respect to an IRA account other than a fee fixed as a percentage of plan

assets under management, would be able to comply with the BIC Exemption by satisfying only the BIC Light requirements. However, BIC Advisers that charge different fees for different strategies (e.g., equity vs. fixed income) or that offer proprietary products (e.g., mutual funds or private funds managed by the BIC Adviser or its affiliate) will likely face additional challenges if they seek to qualify as a level-fee adviser.

The BIC Light Exemption requires the BIC Adviser to do each of the following:

- Affirm the BIC Adviser's fiduciary status.
- Comply with the impartial conduct standards.
- In cases of a recommendation to roll over assets to an IRA from an ERISA plan, document why the recommendation was in the client's best interest, including a consideration of alternatives to rollover (such as leaving money in the plan) and taking into account the fee structures of the IRA and the plan.
- In cases of a recommendation to roll over from an IRA or switch from a commission-based account to a level-fee arrangement, document why the recommendation was in the client's best interest, including consideration of services that will be provided for the fee.

Full BIC Exemption. Whereas the BIC Light requirements apply only to level-fee fiduciaries, the full BIC Exemption provides relief from the prohibited transaction rules applicable to investment advice fiduciaries for receiving:

- Variable compensation based on the advice provided (revenue sharing or commissions) or
- Transaction-based fees.

Written Contract. The full BIC Exemption requires a written contract (which can be the standard investment advisory agreement) for advice provided by BIC Advisers to IRA owners. The contract requirement does not apply to advice for ERISA Plans. Additionally, BIC Advisers may provide fiduciary investment advice prior to executing the contract as long as the contract, when executed, covers advice provided prior to the contract's formation.

For existing customers, BIC Advisers may satisfy the BIC Exemption by amending the contracts for existing customers prior to January 1, 2018. BIC Advisers may rely on the negative consent of their existing customers (i.e., if existing customers don't object to the revised contract within 30 days, financial institutions and their advisers may deem their existing customers to have accepted the new terms of the contract). Amended contracts may be delivered to existing customers by mail or electronically, but BIC Advisers may not impose any new contractual obligations, restrictions, or liabilities on their customers through negative consent.

BIC Adviser contracts complying with the full BIC Exemption will need to contain provisions that do each of the following:

- Affirm fiduciary status and compliance with the impartial conduct standards (defined above), and
- Affirmatively warrant that:
    - They have adopted and will comply with written policies and procedures designed to ensure BIC Advisers adhere to the impartial conduct standards,
    - They have documented their material conflicts of interest and have considered their conflicts of interest in the design of their policies and procedures,
    - They have designated a person or persons to be responsible for addressing material conflicts of interest

and monitoring the BIC Advisers' adherence to the impartial conduct standards, and

- The policies and procedures adopted require that the BIC Advisers cannot rely upon quotas, appraisals, performance actions, bonuses, contests, special awards, etc. that may cause conduct not in best interest of investors.

Prohibited Contract Provisions. BIC Advisers must avoid incorporating ineligible contract provisions into their contracts with customers for whom the BIC Adviser is seeking to rely on the BIC Exemption. Ineligible contract provisions include any of the following:

- Exculpatory provisions limiting liability of the BIC Adviser for violations of the contract's terms,
- Provisions limiting the investor's right to bring or participate in a class action, and
- Agreements to arbitrate or mediate individual claims in venues that unreasonably limit investor's ability to bring claims.

Disclosures. BIC Advisers must make certain disclosures to customers for whom they seek to rely on the full BIC Exemption in a contract or in a separate written disclosure provided to customers with the contract, or for ERISA Plans, in a written disclosure provided contemporaneously with the recommended transaction. The required disclosures for the BIC Exemption may be classified into three categories, which together form a tiered approach, generally providing for automatic disclosure of basic information on conflicts of interest and the advisory relationship but requiring more detailed disclosures only upon request (and free of charge). The categories for the full BIC Exemptions disclosure requirements are:

- Contract disclosures. In the contract or in a separate written disclosure, the contract disclosures require the BIC Adviser to, among other things, state the best interest standard of care, the services the BIC Adviser will provide, disclose the BIC Adviser's fees, and disclose material conflicts of interest.
- Pre-transaction disclosures. Pre-transaction disclosures are designed to supplement the contract disclosures temporally closer to the transaction. They do not have to be repeated more than annually after the initial disclosure for the same investment product.
- Web-based disclosures. Web-based disclosures are public disclosures designed to promote transparency in the retirement investment advice market. These disclosures provide information about the BIC Adviser's arrangements with product manufacturers and other parties for third-party fees in connection with investments that the BIC Adviser recommends.

Notification to DOL. BIC Advisers must notify the DOL (by email at e-BICE@dol.gov) of their intention to rely on the full BIC Exemption. The notice will remain in effect until the BIC Adviser revokes the notice in writing.

Recordkeeping Requirements. BIC Advisers must maintain records demonstrating their compliance with the BIC Exemption for a particular transaction in a form reasonably accessible for examination by customers and DOL and IRS officials for six (6) years following the transaction.

ERISA Plans. BIC Advisers seeking to rely on the full BIC Exemption for transactions involving ERISA Plans must comply with essentially each requirement listed above applicable to IRAs and non-ERISA Plans except that instead of having to avoid certain ineligible contract provisions, BIC Advisers to ERISA Plans must avoid purporting to disclaim any responsibility or liability for any responsibility, obligation, or duty imposed by ERISA.

Proprietary Products. BIC Advisers that offer their clients proprietary products, such as mutual funds or private funds (e.g., hedge funds) that are also advised by the BIC Adviser, will likely need to take additional steps to comply with the Fiduciary Rule in connection with offering such products. These considerations will vary based on the facts and circumstances of each particular offering. For example, BIC Advisers offering proprietary mutual funds will likely need to comply with long standing Prohibited Transaction Exemption (PTE) 77-4, which has been recently amended to require compliance with the impartial conduct standards in addition to its previously existing conditions, such as waiving duplicative advisory fees and not charging commissions (i.e., sales loads). BIC Advisers that sponsor private funds cannot rely on PTE 77-4 and will likely have to rely on the BIC Exemption, which will present challenges, especially for IRA investors, since unlike ERISA Plans, IRA investors do not typically engage an expert fiduciary upon which the BIC Adviser may rely to qualify for certain exemptions. As a result, many registered investment advisers may choose not to offer private funds to their clients until clearer guidance from the DOL is available in this regard.

Possible SEC Coordination

One of the controversial aspects of the Fiduciary Rule is that it bootstraps the DOL's authority for interpretation of the prohibited transaction rules under a 1978 Executive Order that extends its regulatory authority covering service providers to IRAs, such as investment advisers and broker-dealers, who have traditionally been subject to regulation by the SEC. While critics have considered this an overreach, the SEC until recently had declined to become involved with the Fiduciary Rule.

On June 1, 2017, SEC Chairman Jay Clayton issued a public statement on the Fiduciary Rule signaling that the SEC intends to "engage constructively" with the DOL in analyzing the appropriate standards of conduct for investment advisers and broker-dealers who provide advice to retail investors. The DOL has also suggested that further changes to the Fiduciary Rule and/or related exemptions are possible before the transition period ends and the rule becomes fully effective on January 1, 2018, and is expected to issue another request for comments on the Fiduciary Rule shortly.

However, because the Fiduciary Rule was issued as a final regulation, any changes would have to go through the regulatory notice and comment process. Service providers to ERISA Plans and IRAs should be mindful that this process can make it difficult to make significant changes. Accordingly, service providers intending to rely on the BIC Exemption should be preparing for full compliance by January 1, 2018.

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[1]Alexander Acosta, Deregulators Must Follow the Law, So Regulators Will Too, WALL ST. J., May 22, 2017, https://www.wsj.com/articles/deregulators-must-follow-the-law-so-regulators-will-too-1495494029.

[2]This prohibited transaction exemption will exempt compliant financial advisers from penalties and ERISA fiduciary standards of conduct should the Fiduciary Rule bring the financial advisers within its scope.

[3]Because a service provider is a "party in interest" with respect to an ERISA Plan and a "disqualified person" with respect to an IRA, an exemption to the prohibited transaction rules is necessary in order for the services to be provided to ERISA Plan or IRA, as applicable.

[4] See Conflict of Interest FAQs; available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-transition-period.pdf.

[5] See FAB 2017-02; available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2017-02.

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