ERISA Advisory

The Department of Labor's Final Rule Redefining Fiduciary

April 13, 2016

Almost a year after the Department of Labor (DOL or Department) re-proposed its regulation defining "investment advice fiduciary" under the Employee Retirement Income Security Act, as amended (ERISA) and the Internal Revenue Code of 1986, as amended (Code), the DOL has finalized the regulation and the exemptions accompanying it.[1] The breadth of the definition itself will make virtually anyone speaking with a plan participant or an individual retirement account (IRA) owner into a fiduciary unless an exception is met. Rollover recommendations are now defined as fiduciary advice, as is advice on the type of account (brokerage versus advisory) and lists of securities that might meet a plan or IRA client's needs.

The final rule has been changed to stagger the implementation dates. Under the final rule, the changes in the definition of fiduciary are effective June 7, 2016, but are not applicable until April 10, 2017. Between June 7, 2016 and April 10, 2017, the prior regulation (as it appeared in the Code of Federal Regulations in 2015) continues to apply. The new and amended exemptions accompanying the final rule are likewise effective June 7, 2016, but inapplicable until April 10, 2017. However, the new "Best Interest Contract" (BIC) exemption and the exemption for "Principal Transactions in Certain Assets" also provide for a "transition period" between April 10, 2017 and January 1, 2018, during which relief will be available under fewer conditions.

Significant changes from the proposal include:

- Valuations and appraisals under the final rule will no longer make a person a fiduciary
- Under the BIC exemption, the "legal list" of assets has been eliminated
- Under the BIC exemption, ERISA plans do not need a contract, but failure to comply with the best interest standard and a financial institution's policies and procedures to mitigate conflicts will cause the loss of exemptive relief

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[1] The DOL first proposed this rule change in October 2010. Proposed regulation on the "Definition of the Term Fiduciary," 75 Fed. Reg. 65263 (Oct. 22, 2010). The DOL withdrew it on September 19, 2011. The new proposal was issued on April 20, 2015. Proposed regulations on the "Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, Employee Benefits Security Administration, U.S. Department of Labor, 80 Fed. Reg. 21928 (April 20, 2015). The final rule was published in the Federal Register on April 8, 2016, 81 Fed. Reg. 20945.

- Under the BIC exemption, the annual disclosure and performance reporting requirements are eliminated
- A grandfather rule under the BIC exemption is added
- The principal transaction exemption no longer requires disclosure of markups and markdowns and uses the FINRA standards for best execution
- Under the principal transaction exemption, the tests for liquidity and credit quality only apply to purchases
- Under the principal transaction exemption, any asset can be sold on a principal basis from the plan or IRA to the financial institution

Significant issues that were not fixed, or were made more difficult include:

- Fiduciary advice under the final rule encompasses recommendations regarding what type of account to have (advisory or brokerage)
- Under the final rule, IRAs, when receiving education, cannot see examples of available funds in various asset classes
- Platform providers for IRAs are likely fiduciaries under the final rule to the extent they narrow the list of securities available
- The final rule defines “fee” to include recruitment bonuses paid to brokers moving from one firm to another, and the BIC exemption requires financial institutions to post that information, along with a description of the financial institution’s compensation grid for advisers, on the firm’s website
- Under the final rule, there is no sophisticated investor exception for IRAs
- Under the BIC exemption, a financial institution’s failure to maintain and comply with the required anti-conflict of interest policies and procedures will cause the loss of relief under the exemption
- The BIC exemption includes two new provisions relating to “level fee fiduciaries” and proprietary products and third party payments that were not subject to notice and comment

Open questions include:

- When does the payment of a recruitment bonus to a broker leaving one firm for another require compliance with the BIC exemption and how does one comply with respect to past transactions?
- Does the rephrased relief in the sophisticated fiduciary exception – i.e., “with respect to an arm’s length sale, purchase, loan, exchange, or other transaction related to the investment of securities or other investment property” – remedy the proposed rule’s exclusion of service providers?
- Can a person use the level fee fiduciary provision in the BIC exemption if it receives the same amount of third party fees from every mutual fund it offers, rather than receiving a level fee from the plan, or along with a level fee from the plan?
- Does the recommendation of a custodian to a plan constitute investment advice because the custodian may sell foreign currency to the plan?

As under the proposed rule, it will be nearly impossible for retail brokers, insurance agents and consultants to avoid fiduciary status when dealing with plans or IRAs. The final rule does not cut back on the circumstances in which discussing investments with ERISA plans or IRAs will make a person a fiduciary under ERISA and the Code. The major changes in the final regulatory package are in the BIC exemption and the principal transaction exemption.

Part I – The Final Rule Redefining Fiduciary Investment Advice

Background: "Investment Advice" and Fiduciary Status

As we noted in our ERISA advisory when the proposal was issued,[2] fiduciaries with respect to plans subject to ERISA are required to carry out their duties solely in the interest of plan participants and "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." ERISA § 404(a)(1)(A), (B) (often referred to as duties of loyalty and prudence). Fiduciaries that breach these duties are subject to personal liability for resulting losses. Fiduciaries to IRAs are not subject to a statutory standard of care, because the Code does not contain such a standard. The DOL proposed to remedy this gap by forcing all retail accounts, including IRAs, into the BIC exemption, which required this standard as a contractual matter.[3] This construct has not changed in the final rule. Thus, unless a financial institution can operate programs that do not depend on third party compensation, transaction-based compensation, or other features of current brokerage arrangements, the entire business model of most financial institutions will need to change.

Defining Fiduciary Investment Advice

For the 41 years prior to this final rule, under the DOL's regulations, a person would be deemed to be providing "investment advice" within the meaning of ERISA § 3(21)(A)(ii) only if:

> (i) Such person *renders advice to the plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property*; and
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> (ii) Such person either directly or indirectly (*e.g.*, through or together with any affiliate)—
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> …

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[2] *See* Steptoe & Johnson, LLP ERISA Advisory, *The DOL's Re-Proposed Redefinition of Fiduciary*, May, 1, 2015 (May 2015 Advisory)

[3] The net effect of ERISA and the Code's prohibited transaction provisions is that, without an exemption, a fiduciary cannot exercise the authority that makes it a fiduciary to increase its compensation or otherwise collect payments from third parties in connection with transactions involving the plan or IRA for which the fiduciary acts. Without an exemption, even reasonable compensation is subject to excise taxes and, in the case of ERISA plans (though not IRAs), DOL enforcement action. In addition, without an exemption from the prohibition against self-dealing, a fiduciary under ERISA or the Code cannot engage in principal transactions (*i.e.*, selling products out of inventory) with or extend credit to a plan or IRA. Furthermore, without an exemption, a fiduciary cannot recommend the purchase of affiliated (*i.e.*, proprietary) products or services.

> (B) Renders any advice described in paragraph (c)(1)(i) of this section *on a regular basis* to the plan *pursuant to a mutual agreement, arrangement or understanding*, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, *that such services will serve as a primary basis for investment decisions* with respect to plan assets, *and that such person will render individualized investment advice* to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.

The italicized language established a five-part test: to provide "investment advice," a person must (1) render advice as to the value of securities or other property or make recommendations as to the advisability of investing in, purchasing or selling securities or other property (2) on a regular basis (3) pursuant to a mutual agreement, arrangement or understanding that (4) the advice will serve as the primary basis for investment decisions, and that (5) the advice will be individualized based on the particular needs of the plan.

The final rule adheres to the proposal to a significant extent, dramatically departing from the original regulation. Like the proposal, it eliminates the "regular basis" and "primary basis" tests, drops the word "mutual" from the concept of an understanding, and includes any recommendation that a person might consider.

Commenters had asked the Department to drop its proposal to include valuations and appraisals in the four proposed kinds of "recommendations" that would make a person a fiduciary.[4] The Department did so. The Department notes in its preamble that it has reserved rulemaking on the issue of valuations and appraisals until a future date.

In addition, commenters strongly urged the Department not to make a distribution or rollover suggestion into fiduciary advice. The final rule does not change the proposal – advice on distribution or rollovers remains fiduciary advice. Thus, the position that the DOL took in 2005, when it opined that advising a plan participant about whether to take a distribution and whether and where to roll it over was not a fiduciary act, is withdrawn. *See* ERISA Adv. Op. 2005-23A (Dec. 7, 2005). We assume the withdrawal of that opinion is effective as of the applicability date, but the withdrawal's effective date is an issue that may be worth clarifying. The final rule also treats as fiduciary advice a recommendation of a manager or of an

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[4] (i) A recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
(ii) A recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
(iii) An appraisal, fairness opinion, or similar statement whether verbal or written concerning the value of securities or other property if provided in connection with a specific transaction or transactions involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA;
(iv) A recommendation of a person who is also going to receive a fee or other compensation for providing any of the types of advice described in paragraphs (i) through (iii). Proposed Regulation, 29 C.F.R. §2510.3-21(a)(1).

advisory program, thus resolving, e.g., the longstanding question whether a suggestion that an IRA enter into a manager of managers wrap program is fiduciary advice. The final rule is explicit and very broad in this regard:

> (ii) A recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (*e.g.,* brokerage versus advisory); or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer, or distribution should be made

This is the broadest formulation of investment advice that we can imagine, and it raises questions as to whether conversations only tangentially related to investment will also be captured. For those financial institutions that offer several advisory and nonadvisory programs, their contractual and marketing documents will need to contain strong and explicit disclaimers on any information differentiating the programs available and financial institutions will need to provide significant training of individual advisers to avoid stating a view on the appropriate or "best" program for any particular client instead of simply saying, "These are the programs available." Otherwise, those conversations – explicitly fiduciary – will have to meet the BIC exemption.

Under the DOL's proposed rule, a person would have become a fiduciary if the person either:

> (i) Represents or acknowledges that it is acting as a fiduciary within the meaning of the Act with respect to the advice or
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> (ii) Renders the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA

The final rule does not significantly change these tests. Under the final rule, a person becomes a fiduciary when the person:

> (i) Represents or acknowledges that it is acting as a fiduciary within the meaning of the Act or the Code
>
> (ii) Renders the advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the advice recipient or
>
> (iii) Directs the advice to a specific advice recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA

Thus, unless one of the exceptions to fiduciary status described below applies, anyone who makes a single, isolated investment recommendation to a plan fiduciary, participant, or IRA owner will be deemed to be a fiduciary if the client later claims to have had an understanding that the advice was specifically directed to the recipient for consideration in making an investment decision. No "meeting of the minds"

on the extent of the recipient's reliance will be required.[5]

The definition of "recommendation," which, in the proposed rule, had included any "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," has not been changed in the final rule.

The Department did provide, in the text of the rule itself, some clarification:

> The determination of whether a 'recommendation' has been made is an objective rather than subjective inquiry. In addition, the more individually tailored the communication is to a specific advice recipient or recipients about, for example, a security, investment property, or investment strategy, the more likely the communication will be viewed as a recommendation. Providing a selective list of securities to a particular advice recipient as appropriate for that investor would be a recommendation as to the advisability of acquiring securities even if no recommendation is made with respect to any one security. Furthermore, a series of actions, directly or indirectly (*e.g.,* through or together with any affiliate), that may not constitute a recommendation when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program.

This language is troublesome and demonstrates the Department's intention to cover any recommendations, regardless of the size of the group that receives them. Thus, for those firms planning to allow retail IRAs and other plans to continue as nonfiduciary brokerage accounts, the challenge will be in making sure (and being able to prove) that brokers do not make recommendations. Initial representations from the client likely will not suffice (other than in the sophisticated fiduciary exception), and broker-dealers likely will have to renew a client's understanding that no investment suggestion is being made with virtually every trade. Any solicited trade likely will be viewed as fiduciary advice. As a practical matter, broker-dealers and insurance firms likely will agree to act as a fiduciary and try to comply with an exemption rather than try to fashion a compliance program that can track the nuances of investment suggestions.

Significantly, the DOL did not substantively change the "specifically directed to" test that was the subject of so much adverse comment because the test does not require that a recommendation be "individualized to" the recipient.[6] We think the formulation in the final rule is better than the proposed, in that the final

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[5] The final rule abandons the concept of a carve-out. Instead, it has various exceptions divided into two categories.

[6] As we noted in our client alert when the proposal was first published, the preamble to the proposed rule emphasized that this "specifically directed to" language "addresses concerns that the general circulation of newsletters, television talk show commentary, or remarks in speeches and presentations at financial industry conferences would result in the person being treated as a fiduciary." But having said that, the preamble then drew a direct line between the "specifically directed to" language and *advertising*, stating that advisers could not "continue the practice of advertising advice or counseling that is one-on-one or that a reasonable person would believe would be tailored to their individual needs and then disclaim that

rule replaces "specifically directed" with "directs advice to a specific advice recipient or recipients," which arguably may be narrower. But the retention of this formulation, even as changed, is still unfortunate. Financial institutions will need to take special care when crafting marketing and advertisements to avoid invalidating any nonfiduciary education programs or factual presentation of offerings regarding rollovers by circulating marketing materials to a specific group of recipients. In an effort to clarify this issue, the Department did add a provision to the final rule called "general communications." It provides:

> General Communications. Furnishing or making available to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner general communications that a reasonable person would not view as an investment recommendation, including general circulation newsletters, commentary in publicly broadcast talk shows, remarks and presentations in widely attended speeches and conferences, research or news reports prepared for general distribution, general marketing materials, general market data, including data on market performance, market indices, or trading volumes, price quotes, performance reports, or prospectuses.

It is unclear how comforting this exception is. It repeatedly refers to general circulation, general distribution, and general marketing materials. Query whether a brochure sent to AARP members or marketing materials referring to former 401(k) plans would meet this exception. We think clarification is necessary here to make explicit that ads on television or in the press will not meet the definition of advice directed to a group of recipients.

The Exceptions

The DOL made few changes in the carve-outs, other than not referring to them in the final rule as either "exceptions" or "carve-outs." Under the final rule, platform providers for IRAs are still fiduciaries if they create a list of mutual funds from which clients can choose. Financial institutions will have to decide if they should provide a nearly universal platform of mutual funds and argue that, in merely providing the platform, they are not recommending or suggesting that any one of the mutual funds is appropriate, leaving advisers to make their own judgment on which fund to recommend, or provide a much smaller list that the institution believes can be prudently recommended to IRAs. In the case of the former carve-out for selection and monitoring assistance, it remains inapplicable to IRAs and even with respect to plans, it adds additional requirements. Thus, the exception for selection and monitoring assistance requires the person identifying the investment alternatives to disclose in writing whether the person has a financial interest in any of the identified investment alternatives and, if so, the precise nature of such interest. In addition, the following subsection was added to the final rule:

> (B) In response to a request for information, request for proposal, or similar solicitation by or on behalf of the plan, identifying a limited or sample set of investment alternatives based on only the size of the employer or plan, the current investment alternatives designated under the plan, or both, provided that the response is in writing and discloses whether the person identifying the limited or sample set of investment alternatives has a financial interest in any of the alternatives, and if so the precise nature of such interest.

This clarification does not seem helpful or practical. It misses the point of an RFP. A plan sponsor does not want responses that could be made to any plan of a similar size. A plan sponsor wants responses

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the recommendations are fiduciary investment advice in boilerplate language in the advertisement or in the paperwork provided to the client."

that fit its plan, especially when it is entirely clear to the plan sponsor that the responder is NOT providing advice, but is merely selling, trying to win the business, and competing for the work. While the sophisticated fiduciary exception will be used by plans with more than $50 million in assets, smaller plans are likely not to receive detailed responses to their RFPs because of this provision unless the plan sponsor (or IRA) gives discretionary authority to a registered advisor, bank, insurance company, etc., all of whom are independent of the persons responding to the RFP. It is hard to see how that result benefits plans.

The general communications exception is described above. The remaining exceptions are discussed below:

Education. The education exception is basically unchanged from the proposed in that IRAs can receive no examples of particular funds in an asset class. This exception replaces 29 C.F.R. § 2509.96-1 (also known as Interpretive Bulletin 96-1), which excludes general financial, investment, and retirement information from the scope of investment advice for plans. As in the proposal, the exception extends to IRAs. Commenters had urged the DOL to revise the proposal to allow asset allocation models to refer to specific investment products for plans and for IRAs. The final rule will permit such examples for plan participants but not for IRAs. The DOL specifically declined to provide a separate carve-out for call centers in the proposal and received numerous negative comments on that omission. The final rule provides no exception for call centers. There seems to be a glitch in the effective date of the withdrawal of Interpretive Bulletin 96-1 (60 days from publication) and the effective date of the new rule (April 10, 2017). Hopefully, this is merely a glitch, and not an intended hiatus in education relief for plans and IRAs. It would be helpful for the industry to seek clarification on this point.

The last three exceptions were, in the proposal, the counterparty exceptions for transactions and swaps and the exception for employees who are providing advice to the plan sponsor or plan fiduciaries. Each of these exceptions was unavailable to persons who acknowledge that they are acting as a fiduciary. Many commenters sought a clarification to the operative language that reflects ERISA's statutory qualification that a person is a fiduciary only to the extent that it is acting as a fiduciary. Commenters wanted clarity that just because an asset manager is a fiduciary with respect to one portfolio of assets does not mean it is a fiduciary when it is discussing market conditions for an unrelated asset class or recommending its affiliate to be selected as custodian or prime broker. The final rule did not make any changes in this regard.

Sophisticated Fiduciaries. The proposed rule's counterparty exception (analogous to the 2010 proposal's seller's exception) is now called "transactions with independent fiduciaries with financial expertise." This exception still does not apply to IRAs or plan participants, unless those accounts are managed by banks, investment advisers, insurance companies, or broker-dealers. The Department is even more emphatic about its reasons for excluding IRAs.

> Further, the Department is not prepared to adopt the approach suggested by some commenters that the provision be expanded to include individual retail investors through an accredited or sophisticated investor test that uses wealth as a proxy for the type of investor sophistication that was the basis for the Department proposing some relationships as non-fiduciary. The Department agrees with the commenters that argued that merely concluding someone may be wealthy enough to be able to afford to lose money by reason of bad advice should not be a reason for treating advice given to that person as non-fiduciary. [Footnote omitted]. Nor is wealth necessarily correlated with financial sophistication. Individual investors may have considerable savings as a result of

numerous factors unrelated to financial sophistication, such as a lifetime of thrift and hard work, inheritance, marriage, business successes unrelated to investment management, or simple good fortune.

The proposed rule did not allow a person to use the counterparty exception with respect to any plan with fewer than 100 participants unless the plan was managed by a fiduciary with more than $100 million of ERISA plan assets under management. The final rule changes this formulation, and eliminates the former "100 person" test, defining independent fiduciaries with financial expertise to include US or state regulated banks, insurance companies supervised under state law, investment advisers registered under US or state law, US registered broker-dealers, and any independent fiduciary that holds, or has under management or control, total assets of at least $50 million (which can be demonstrated through a written representation) so long as:

- The person knows or reasonably believes that the independent fiduciary of the plan is capable of evaluating investment risks independently (which can be demonstrated through a written representation)
- The person fairly informs the independent fiduciary that the person is not undertaking to provide impartial investment advice and fairly informs the independent fiduciary of the existence and nature of the person's financial interest in the transaction
- The person reasonably believes that the independent fiduciary is a fiduciary under ERISA or the Code with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction (which can be demonstrated through a written representation) and
- The person does not receive a fee or other compensation directly from the plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner for the provision of investment advice (as opposed to other services) in connection with the transaction

Careful attention will be needed to ensure these conditions are met, especially with respect to disclosure "of the existence and nature" of the advisor's financial interests. The DOL offered no color on the type or extent of such disclosure. Broker-dealers and others that enter into transactions without written client representations will need to consider changing their practices. It is noteworthy that the "100 person" test allowed more plans to come within the exception, since a large percentage of small plans have more than 100 participants but less than $50 million.

The terms of the exception cover the provision of advice, including the provision of asset allocation models or other financial analysis tools to a plan fiduciary with respect to an arm's length sale, purchase, loan, exchange or other "transaction" related to the investment of securities or other investment property. While Section 406(a)(1)(C) of ERISA expressly treats services as a "transaction," the DOL does not clearly indicate its intention for the exception to be equally broad. In other words, the exception does not explicitly cover advice in connection with services, such as prime brokers or futures commission merchants, which was seen as a major shortcoming of the proposal. Nor does it clearly apply to the kinds of model portfolio programs that most financial institutions provide for clients. While the Department hardly addressed that comment, the language of the regulation clearly and helpfully does not limit who may be providing that advice, so long as the terms of the exception are met.

The Department did acknowledge that at least with respect to sophisticated independent fiduciaries, a person should not be deemed to be providing a recommendation when making a pitch that the fiduciary hire him. The Department noted that the text regarding manager recommendations specifically states,

"selection of *other* persons to provide advice or investment management services." The problem with this approach in fixing a very real problem is that it leaves out other investment professionals who make pitches to be hired: brokers, futures commission merchants, prime brokers, custodians, administrators, etc. Because it seems quite clear that the Department did not mean that marketing pitches from these non-asset managers should be fiduciary advice, it may be useful for the industry to seek clarification on this point.

Another technical problem with the sophisticated fiduciary exception relates to the definition of plan fiduciary. The text of the exception and the definition are laid out below to illustrate the problem. Note that there is no definition of "independent" fiduciary, other than the fact that the independence is described as between the advisor and the plan fiduciary, and not between the plan fiduciary and the plan.

> (1) Transactions with **independent fiduciaries** with financial expertise — The provision of any advice by a person (including the provision of asset allocation models or other financial analysis tools) to a **fiduciary of the plan or IRA** (including a fiduciary to an investment contract, product, or entity that holds plan assets as determined pursuant to sections 3(42) and 401 of the Act and 29 CFR 2510.3-101) who is independent of the person providing the advice with respect to an arm's length sale, purchase, loan, exchange, or other transaction related to the investment of securities or other investment property, if, prior to entering into the transaction the person providing the advice satisfies the requirements of this paragraph (c)(1).
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> (i) The person knows or reasonably believes that **the independent fiduciary** of the plan or IRA is:
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> (A) A bank as defined in section 202 of the Investment Advisers Act of 1940 or similar institution that is regulated and supervised and subject to periodic examination by a State or Federal agency
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> (B) An insurance carrier which is qualified under the laws of more than one state to perform the services of managing, acquiring or disposing of assets of a plan
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> (C) An investment adviser registered under the Investment advisers Act of 1940 or, if not registered an as investment adviser under the Investment advisers Act by reason of paragraph (1) of section 203A of such Act, is registered as an investment adviser under the laws of the State (referred to in such paragraph (1)) in which it maintains its principal office and place of business
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> (D) A broker-dealer registered under the Securities Exchange Act of 1934
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> (E) Any independent fiduciary that holds, or has under management or control, total assets of at least $50 million (the person may rely on written representations from the **plan or independent fiduciary** to satisfy this paragraph (c)(1)(i))
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> (ii) The person knows or reasonably believes that the **independent fiduciary** of the plan or IRA is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies (the person may rely on written representations from **the plan or independent fiduciary** to satisfy this paragraph (c)(1)(ii))

> (iii) The person fairly informs the **independent fiduciary** that the person is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with the transaction and fairly informs the **independent fiduciary** of the existence and nature of the person's financial interests in the transaction
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> (iv) The person knows or reasonably believes that the **independent fiduciary** of the plan or IRA is a fiduciary under ERISA or the Code, or both, with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction (the person may rely on written representations from **the plan or independent fiduciary** to satisfy this paragraph (c)(1)(iv)) and
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> (v) The person does not receive a fee or other compensation directly from the plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner for the provision of investment advice (as opposed to other services) in connection with the transaction

The final rule defines "plan fiduciary" as follows:

> (7) The term "plan fiduciary" means a person described in section (3)(21)(A) of the Act and 4975(e)(3) of the Code. For purposes of this section, a participant or beneficiary of the plan or a relative of either is not a "plan fiduciary" with respect to the plan, and the IRA owner or a relative is not a "plan fiduciary" with respect to the IRA.
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> (8) The term "relative" means a person described in section 3(15) of the Act and section 4975(e)(6) of the Code or a brother, a sister, or a spouse of a brother or sister.

The problem with this language is that it suggests a plan fiduciary cannot be a participant in the plan, even though virtually all named fiduciaries of a plan are officers or employees of the plan sponsor who do participate in the plan. Thus, there would be no named fiduciary that could fit into this category. This is clearly another area where clarification is critical, especially for plan sponsors who want to receive the information that plan service providers generally provide. We think it likely that the Department did not intend plan committees acting as the named fiduciary to fall outside this rule, solely because they are participants in the plan.

Swap Transactions. Communications in connection with swap transactions regulated under the Securities Exchange Act or the Commodities Exchange Act will not be classified as fiduciary investment advice if the conditions of the exception are met. The exception applies only to plans, not to IRAs or individual participants, and the plan must be represented by a fiduciary independent of the swap counterparty. In addition, the swap counterparty (if a swap dealer or security-based swap dealer) cannot be acting as a trading adviser under Dodd Frank in connection the swap and must obtain a written representation that the independent fiduciary will not rely on the swap counterparty's recommendations (in addition to the representations required under the Dodd-Frank safe harbors from trading advisor status). The problem in the proposed rule – that the carve-out did not cover advice in connection with swap clearing – has been fixed. Although many commenters asked that swaps with pooled funds be included in the exception, and no one suggested that they not be included, the Department on its own determined that they should be excluded. The Department has incorrectly viewed the exclusion of pooled funds from special entity status under the Dodd-Frank Business Conduct standards as also requiring sponsors of pooled funds to be excluded from this exception. The two provisions have entirely different purposes (pooled funds are excluded from regulation as "special entities" under Dodd-Frank and thus, no safe harbor is necessary) and this is another area where clarification should be sought promptly.

Employees of the Plan Sponsor. The DOL clarified that advice given to plan fiduciaries by the sponsor's employees, as well as employees of affiliates, will not be fiduciary investment advice, unless the employee receives compensation for it beyond the employee's regular pay.

Part II – Prohibited Transaction Class Exemptions

A. <u>The Best Interest Contract Exemption</u>

The final BIC exemption[7] permits financial institutions, advisers and their affiliates to receive otherwise prohibited compensation as a result of their provision of investment advice to retirement investors, provided that the conditions of the exemption are satisfied. Significantly, the BIC exemption is the only exemption in the DOL's regulatory package that would provide relief for an investment advice fiduciary's receipt of 12b-1 fees, revenue sharing payments, marketing payments, marketing fees, administrative fees, sub-TA fees, sub-accounting fees, and other third-party payments from investment providers (with the exception of sales loads paid by mutual funds in the ERISA plan context[8] and sales commissions paid by insurance companies for purchases of insurance contracts or fixed rate annuity contracts[9]). In the IRA context, unless an investment advice fiduciary is managing an IRA on a discretionary basis,[10] the BIC exemption is also the only exemption in the regulatory package that will provide relief for an investment advice fiduciary's receipt of a commission from an IRA for executing a securities transaction.

Although the final BIC exemption differs in many respects from what was initially proposed,[11] advisers and financial institutions who intend to utilize the exemption will nonetheless have to make significant operational changes to comply with the final exemption's conditions for relief. The scope and conditions for relief under the BIC exemption are discussed in greater detail below.

Effective Date, Applicability Date, and Transition Period

As explained at the outset, although the final rule defining "investment advice" will become effective June 7, 2016, it does not become applicable until April 10, 2017. The final rule provides that the prior regulation at 29 C.F.R. § 2510.3-21(c) will continue to apply until April 10, 2017. Like the final rule, the

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[7] Best Interest Contract Exemption, 81 Fed. Reg. 21002 (April 8, 2016).

[8] *See* Amendment to and Partial Revocation of Prohibited Transaction Exemption (PTE) 86-128 for Securities Transactions Involving Employee Benefit Plans and Broker Dealers, 81 Fed. Reg. 21181, 21187, 21203 (April 8, 2016).

[9] *See* Amendment to and Partial Revocation of Prohibited Transaction Exemption (PTE) 84-24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, and Investment Company Principal Underwriters, 81 Fed. Reg. 21147, 21152, 21174 (April 8, 2016).

[10] *See* Amendment to and Partial Revocation of Prohibited Transaction Exemption (PTE) 86-128 for Securities Transactions Involving Employee Benefit Plans and Broker Dealers, 81 Fed. Reg. 21181, 21187, 21203 (April 8, 2016).

[11] *See* Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21960 (April 20, 2015) (proposed exemption).

BIC exemption becomes effective June 7, 2016, but will be applicable only to transactions occurring on or after April 10, 2017.

As explained below, the BIC exemption provides separate relief for "pre-existing transactions" that will allow continued receipt of compensation in connection with investments that were made prior to April 10, 2017. In addition, to give financial institutions and advisers more time to prepare for compliance with the conditions of the BIC exemption, the exemption provides for a "transition period" between April 10, 2017 and January 1, 2018, during which relief will be available under fewer conditions. The conditions for relief during this transition period are described further below.

Financial institutions and advisers who intend to utilize the BIC exemption and wish to take full advantage of the transition period should pay careful attention to the conditions that must be met during that period and the additional conditions that will have to be satisfied beginning January 1, 2018.

Key Differences From the Proposed Exemption

There are important differences between the BIC exemption and the proposed exemption. The key differences are summarized below:

- The BIC exemption has been revised to cover advice rendered to any "retail fiduciary," which is defined to mean a fiduciary of a plan or IRA other than an independent fiduciary with financial expertise as defined in 29 C.F.R. § 2510.3-21(c)(1)(i). The practical effect of this change is to cover advice to fiduciaries of small ERISA plans, regardless of whether the plan is participant-directed or non-participant-directed.
- The proposed exemption's list of permitted "assets" has been eliminated.
- Although the BIC exemption is generally inapplicable to principal transactions, it has been revised to provide relief for compensation received in a "riskless principal transaction." The term "riskless principal transaction" is defined to mean "a transaction in which a Financial Institution, after having received an order from a Retirement Investor to buy or sell an investment product, purchases or sells the same investment product for the Financial Institution's own account to offset the contemporaneous transaction with the Retirement Investor." Thus, for many riskless principal transactions, either the BIC exemption or the principal transactions exemption can be used.
- The BIC exemption does not require a written contract for ERISA plans.
- Although the BIC exemption still requires a written contract for IRAs and non-ERISA plans, the contract requirement applies only to the financial institution, not to the individual adviser. The BIC exemption provides that the written contract may be entered into either prior to or at the same time the recommended transaction is executed. Under the transition period rules, financial institutions have until January 1, 2018 to bring themselves into compliance with the written contract requirement for IRAs and non-ERISA plans.
- The BIC exemption limits the warranties to the financial institution and not to advisers and requires that they be incorporated in the financial institution's written contract for IRAs and non-ERISA plans. Unlike the proposed exemption, however, the financial institution must adopt and comply with "anti-conflict policies and procedures" as a condition for relief under the exemption, regardless of whether the advice concerns investments in ERISA plans, non-ERISA plans, or IRAs. This is a huge difference between the proposed and final exemptions and seems

significant enough to have required notice and comment, particularly since the preamble to the proposed exemption put so much emphasis on a breach of warranty not causing a loss of the exemption.

- The BIC exemption's pre-transaction disclosure requirements have been substantially revised. The proposed exemption would have required disclosure of an investment's projected total cost over 1-, 5-, and 10-year periods. This requirement has been eliminated in the final BIC exemption. Instead, the BIC exemption requires disclosure before or at the time of purchase of the best interest standard, material conflicts of interest, and other standardized information about the financial institution's services, fees and other compensation. More specific, customized disclosures must be provided to the retirement investor upon request and not automatically before the trade is executed.
- The annual fee and compensation disclosures and data collection requirements (quarterly investment inflows, outflows and holdings for each asset purchased, held or sold, etc.) of the proposed exemption have been eliminated.
- The final BIC exemption will require financial institutions to satisfy new web disclosure requirements that will be both time consuming and costly to implement. Under the transition period rules, financial institutions that utilize the BIC exemption will have until January 1, 2018 to comply with the web disclosure requirements.
- The final BIC exemption provides streamlined conditions for advisers and financial institutions that meet the definition of "level fee fiduciaries." Level fee fiduciaries are not required to enter into a written contract, but must provide a written acknowledgment of fiduciary status, adhere to the impartial conduct standards, and document the specific reasons why a level fee arrangement was considered to be in the retirement investor's best interest.
- The final BIC exemption expands the relief provided for pre-existing transactions. Unlike the proposed exemption, the relief for pre-existing transactions applies to compensation resulting from a recommendation after the applicability date (April 10, 2017) to hold or sell an investment made prior to the applicability date, as well as compensation that results from a systematic purchase program entered into prior to the applicability date.

Covered Transactions

As explained previously, the BIC exemption permits financial institutions, advisers, and their affiliates to receive compensation as a result of providing investment advice to a "retirement investor." The term "retirement investor" is defined to include a participant or beneficiary who has the ability to self-direct his or her account or take a distribution, an IRA owner, or a "retail fiduciary." The term "retail fiduciary" is defined to mean any fiduciary of a plan or IRA other than an independent fiduciary with financial expertise as defined in 29 C.F.R. § 2510.3-21(c)(1)(i). The preamble makes clear that the term "retail fiduciary" includes fiduciaries of simple employee pension plans (SEPs), savings incentive match plans (SIMPLEs), and Keogh plans. However, the exclusion of independent fiduciaries with financial expertise effectively precludes reliance on the exemption where the fiduciary receiving the advice holds, controls or manages $50 million or more in total assets, thus limiting the application of the exemption to smaller plans.

The BIC exemption excludes from coverage:

- An employer sponsored plan if the plan covers employees of the financial institution, adviser, or

any affiliate or if the adviser is a named fiduciary or plan administrator selected to provide advice by someone who is not independent

- Compensation received from a principal transaction with a financial institution or adviser acting for his or her own account or the account of a person directly or indirectly controlling, controlled by, or under common control with the financial institution. However, this exclusion does not apply to the sale of an insurance or annuity contract, a mutual fund transaction, or a riskless principal transaction
- Compensation received on account of robo-advice, unless the robo-advice provider is a level fee fiduciary that complies with the conditions applicable to level fee fiduciaries, as described below
- Compensation paid to an adviser who has or exercises discretionary authority or control with respect to the recommended transaction

For transactions covered by the BIC exemption, financial institutions, advisers, and their affiliates will be allowed to receive compensation that is ordinarily prohibited to fiduciaries (*e.g.,* commissions, sales charges, revenue sharing and other payments from third parties) if they comply with a series of conditions. These conditions (discussed immediately below) not only require financial institutions to state that they and their advisers will "adhere to Impartial Conduct Standards in rendering advice regarding retirement investments," but also require financial institutions to "adopt policies and procedures designed to ensure that their individual advisers adhere to the Impartial Conduct Standards; disclose important information relating to fees, compensation, and Material Conflicts of Interest; and retain records demonstrating compliance with the exemption."

Contract Requirement for IRAs and Non-ERISA Plans

With respect to IRAs and non-ERISA plans (*e.g.*, Keogh plans), the financial institution must enter into a written contract enforceable by the retirement investor that includes the contract terms required by the exemption. The exemption states that the written contact may be a "master contract covering multiple recommendations," which is curious since it seems doubtful that anyone was contemplating a new contract for each recommendation. But the opposite is also true: the contract may cover just the rollover advice and choice of program advice, and then the actual program can use robo-advice, the Frost or Country Trust advisory opinions,[12] or ERISA § 408(g) and Code § 4975(d)(17). The contract must cover advice rendered prior to its execution in order for the exemption to apply to the advice and related compensation. The exemption provides separate execution and assent requirements for new and existing contracts:

- *New Contracts.* As indicated previously, financial institutions have until January 1, 2018 to bring themselves into compliance with the written contract requirement for IRAs and non-ERISA plans. For accounts that do not have existing contracts on January 1, 2018, the financial institution must enter into a written contract with the retirement investor prior to or at the same time the recommended transaction is executed. The contract terms required by the exemption "may be incorporated into an investment advisory agreement, investment program agreement, account opening agreement, insurance or annuity contract or application, or similar document, or

[12] Adv. Op. 97-15A (May 22, 1997); Adv. Op. 2005-10A (May 11, 2005).

amendment thereto." The retirement investor's assent to the contract terms may be obtained through a handwritten or electronic signature.

- *Negative Consent for Existing Contracts.* Contracts entered into *prior to* January 1, 2018 may be amended by negative consent to include the terms required by the exemption. To amend existing contracts by negative consent, the financial institution must deliver the proposed amendment to the retirement investor (either by mail or electronically) prior to January 1, 2018, and give the investor 30 days to terminate the contract. If the retirement investor fails to terminate the contract within 30 days, the investor's silence may be treated as consent. The exemption states specifically, however, that the financial institution may not use this negative consent procedure to "impose any new contractual obligations, restrictions, or liabilities on the Retirement Investor." Because, as described below, the parties can knowingly agree to waive punitive damages and rescission, a financial institution that wishes to add such waivers to its existing contracts may not be able to take advantage of the negative consent procedure.

The exemption requires the financial institution to make an electronic copy of the retirement investor's contract accessible to the retirement investor on its website.[13] Some financial institutions do not have a website with personalized space for client account statements or contracts. Others do not have the bandwidth to put millions of contracts on their site. The Department's failure to propose this requirement for public comment is unfortunate, since financial institutions did not have an opportunity to submit information that would have allowed the Department to assess the cost of implementing it.

Conditions Common to All Retirement Investors

The following is a summary of the conditions generally applicable to all retirement investors:

- *Acknowledgment of Fiduciary Status.* The financial institution must affirmatively state that "it and the adviser(s) act as fiduciaries under ERISA or the Code, or both, with respect to any investment advice provided by the Financial Institution or the Adviser subject to the contract or, in the case of an ERISA plan, with respect to any investment recommendations regarding the Plan or participant or beneficiary account." For ERISA plans, the financial institution must provide the retirement investor with a written statement acknowledging the fiduciary status of the financial institution and its adviser prior to or at the time of the execution of the recommended transaction.
- *Impartial Conduct Standards.* The financial institution must affirmatively state that it and its advisers will adhere to, and must in fact comply with, impartial conduct standards. The impartial conduct standards require the financial institution and the adviser to provide advice that is prudent in light of the circumstances of the retirement investor, without regard to their own financial or other interests. This language has been changed to more closely track ERISA § 404(a)(1)(B). The standards also prohibit the financial institution, adviser and their affiliates from receiving more than reasonable compensation within the meaning of ERISA § 408(b)(2). In addition, the impartial conduct standards prohibit the financial institution and its advisers from making statements regarding the recommended transaction, fees and compensation, material conflicts of interest, and any other matters pertinent to the retirement investor's investment decisions that are materially misleading at the time they are made.

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[13] *See* 81 Fed. Reg. at 21077.

For IRAs and non-ERISA plans, the impartial conduct standards must be incorporated in the written contract. For advice regarding ERISA plan investments, however, the financial institution and its adviser must satisfy the impartial conduct standards as a condition for relief under the exemption.

Noncompliance with the impartial conduct standards will result in different claims and remedies against financial institutions and advisers depending on whether the advice concerns an ERISA plan, a non-ERISA plan or an IRA. If the advice concerns an ERISA plan, federal courts would have exclusive jurisdiction over any claim for violation of these standards and any resulting non-exempt prohibited transaction. In the ERISA context, the effect of the impartial conduct standards will be to shift the burden to the financial institution who acknowledged fiduciary status and the adviser to prove in any lawsuit that they acted prudently and without regard to their own interests in providing the advice covered by the exemption. If, however, the advice concerns an IRA or a non-ERISA plan, the financial institution will be exposed to breach of contract claims brought in state court and tried to a jury. Whether the advice concerns an ERISA plan, a non-ERISA plan, or an IRA, the financial institution and its adviser will be exposed to an excise tax under Section 4975 of the Code for prudence violations.

- *Sales Incentives and Anti-Conflict Policies and Procedures.* For advice concerning IRAs and non-ERISA Plans, the financial institution must warrant, and in fact comply with, the following:
  - The financial institution has adopted and will comply with written policies and procedures reasonably and prudently designed to ensure that its advisers adhere to the impartial conduct standards.
  - In formulating its policies and procedures, it has specifically identified and documented its material conflicts of interest; adopted measures reasonably and prudently designed to prevent material conflicts of interest from causing violations of the impartial conduct standards; and designated a person or persons identified by name, title or function, responsible for addressing material conflicts of interest and monitoring their advisers' adherence to the impartial conduct standards.
  - Such policies and procedures require that neither the financial institution nor (to the best of its knowledge) any affiliate or related entity use or rely upon quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that are intended or would reasonably be expected to cause advisers to make recommendations that are not in the best interest of the retirement investor.

Suffice to say, compliance with these mandated policies and procedures will require financial institutions to make significant changes in their compensation practices. Some have argued that these rules will cause financial institutions to stop selling certain products, or to level compensation or require additional monitoring in such a manner that advisers will not take the time or effort to sell certain products, simply to avoid any challenge to their compensation practices. The web disclosure requirements discussed below will exacerbate this issue by requiring financial institutions to post descriptions of their compensation and incentive arrangements with advisers and any payout or compensation grids on their websites. Under the transition period rules, financial institutions that utilize the BIC exemption will have until January 1, 2018 to bring themselves into compliance. For IRAs and non-ERISA plans, financial

institutions will have to incorporate the required policies and procedures into their written contract as warranties, and in fact comply with them or face a contractual claim and allegations that the investment transactions done under the exemption are non-exempt prohibited transactions. In the ERISA plan context, financial institutions will be required to adopt and comply with these policies and procedures as a condition for relief under the exemption. Financial institutions will also be required to provide their complete policies and procedures to the DOL upon request.

As with the impartial conduct standards, failure to maintain and comply with the required policies and procedures will result in different claims and remedies against financial institutions depending on whether the advice concerns an ERISA plan, a non-ERISA plan, or an IRA. If the advice concerns an ERISA plan, federal courts would have exclusive jurisdiction under ERISA over any claim for failure to maintain or comply with the required policies and procedures and any resulting non-exempt prohibited transaction. If, however, the advice concerns an IRA or a non-ERISA plan, the financial institution will be exposed to state court breach of warranty claims for such failures. Whether the advice concerns an ERISA plan, a non-ERISA plan, or an IRA, the financial institution also will be exposed to an excise tax under Section 4975 of the Code for any failure to maintain and comply with such policies and procedures.

- *Ineligible Contract Provisions.* For IRAs and non-ERISA plans, relief is unavailable under the exemption if the financial institution's contract with a retirement investor contains any of the following provisions:
  - An exculpatory provision disclaiming or limiting the financial institution's or adviser's liability for violating the contract
  - A provision waiving or qualifying a plan's, IRA's or retirement investor's right to participate in a class action or other representative action against the financial institution or adviser, or in which a plan, IRA, or retirement investor in an individual or class claim agrees to a liquidated damages amount for breach of contract, provided however that the final exemption does permit the parties to knowingly waive the investor's right to punitive damages (but apparently not consequential damages) and rescission[14]
  - An agreement to arbitrate or mediate individual claims in a forum that is distant or otherwise unreasonably limits a retirement investor's ability to assert a claim based on the exemption

  In the ERISA plan context, relief is similarly unavailable under the exemption if the financial institution or advisor attempts in any instrument or communication to: (a) disclaim responsibility or liability in a manner that would violate the prohibition against exculpatory provisions in ERISA § 410; (b) waive or qualify the retirement investor's right participate in a class or other representative action against the financial institution or adviser; or (c) require arbitration or mediation of individual claims in distant locations or otherwise unreasonably limit the retirement investor's ability to assert a claim based on the exemption.

[14] As noted above, this ability to obtain a waiver of punitive damages may be enough to make the use of negative consent for pre-existing contracts a mistake.

- *Contract Disclosures.* For advice concerning IRAs and non-ERISA plans, the financial institution must "clearly and prominently" provide a number of disclosures to the retirement investor in the written contract or in a "separate single written disclosure" provided with the contract. For ERISA plans, the financial institution must "clearly and prominently" provide the same information in a "single written disclosure" provided to the retirement investor prior to or at the time the recommended transaction is executed. To satisfy the "clearly and prominently" requirement, the preamble states that the financial institution "may provide a document prepared for this purpose containing only the required information, or include the information in a specific section of the contract in which the disclosure information is provided." The disclosures in the written contract or separate written disclosure document must:
  - State the best interest standard of care owed by the adviser and financial institution, inform the retirement investor of the services to be provided, and describe how the retirement investor will pay for services (*e.g.*, through direct commissions or payments from third parties)
  - Describe material conflicts of interest, disclose any fees or charges that will be imposed upon the retirement investor, and state the types of third party payments that the adviser, financial institution and its affiliates expect to receive in connection with recommended investments
  - Inform the retirement investor of the investor's right to obtain copies of the financial institution's anti-conflict policies and procedures, as well as specific disclosure of costs, fees and compensation (including third party payments) in a manner "reasonably designed to present materially accurate disclosure of their scope, magnitude, and nature in sufficient detail to permit the retirement investor to make an informed judgment about the costs of the transaction and about the significance and severity of the material conflicts of interest." The disclosure also must indicate how the investor can obtain this information free of charge. This provision is notable because, unlike the proposed exemption, the client is not entitled to this information prior to the transaction
  - Include a link to the financial institution's website and inform the retirement investor that updated model contract disclosures and a written description of the financial institution's anti-conflict policies and procedures are available free of charge on the website. The provision requires a description, and not the actual policies and procedures
  - Disclose whether the financial institution recommends proprietary products or investments that generate third party payments. To the extent the financial institution or advisor limits recommendations to proprietary products or investments that generate third party payments, the financial institution must notify the retirement investor of the limitations placed on the universe of investment recommendations
  - Provide contact information for a representative of the financial institution that the retirement investor can contact with complaints, and explain that the investor can research the financial institution and its adviser using FINRA's BrokerCheck database or the Investment Adviser Registration Depository and
  - Describe whether the adviser and financial institution will monitor the retirement investor's investments and, if so, the frequency of any such monitoring and the reasons an investor

will be alerted to a recommended change. Any agreement to undertake a monitoring obligation will likely require additional asset-based fees. Although the proposed exemption's list of permitted "assets" was eliminated in the final exemption, the Department indicated in the preamble that some investments are so risky or illiquid that no prudent fiduciary would recommend them without undertaking a monitoring obligation or without warning the retirement investor that the investor needs to find someone else to monitor the particular investment

The exemption provides a mechanism for correcting errors or omissions in the contract disclosures, without losing the exemption, as long as the financial institution acted in good faith and with reasonable diligence in making the disclosures. The correct information must be disclosed as soon as practical, but no more than 30 days after the financial institution discovers or reasonably should have discovered the error or omission.

Under the transition period rules, financial institutions that utilize the BIC exemption will have until January 1, 2018 to bring themselves into compliance with these contract disclosure requirements.

- *Pre-Transaction Disclosures.* Prior to or at the same time the recommended transaction is executed, the financial institution must "clearly and prominently" provide the following disclosures to the retirement investor in a "single written document":
  - State the best interest standard of care owed by the adviser and financial institution and describe any material conflicts of interest
  - Inform the retirement investor of the investor's right to obtain copies of the financial institution's written description of its anti-conflict policies and procedures, as well as specific disclosure of costs, fees, and compensation (including third party payments) in a manner "reasonably designed to present materially accurate disclosure of their scope, magnitude, and nature in sufficient detail to permit the Retirement Investor to make an informed judgment about the costs of the transaction and about the significance and severity of the Material Conflicts of Interest"
  - Include a link to the financial institution's website and inform the retirement investor that updated model contract disclosures and a written description of the financial institution's anti-conflict policies and procedures are available free of charge on the website

These disclosures are required only at the time the investment is made, and do not have to be repeated for subsequent recommendations of the same investment product within one year of the initial contract disclosure or a previous pre-transaction disclosure unless the subject of the disclosure has materially changed. Under the transition period rules, financial institutions that utilize the BIC exemption will have until January 1, 2018 to bring themselves into compliance with these pre-transaction disclosure requirements.

The exemption provides a mechanism for correcting errors or omissions in the pre-transaction disclosures, without losing the exemption, as long as the financial institution acted in good faith and with reasonable diligence in making the disclosures. The correct information must be disclosed as soon as practical, but no more than 30 days after the financial institution discovers or reasonably should have discovered the error or omission.

- *Web Disclosures.* The financial institution must maintain a website, freely accessible to the public and updated at least quarterly, which contains the following information:
    - A discussion of the financial institution's business model and the material conflicts of interest associated with it
    - A schedule of typical account or contract fees and service charges
    - A model contract, if applicable, and the required acknowledgement of fiduciary status and contract disclosures, which are reviewed for accuracy at least quarterly and updated within 30 days if necessary
    - A written description of the financial institution's anti-conflict policies and procedures that accurately describes the key components relating to conflict-mitigation and incentive practices in a manner that permits the retirement investor to assess the stringency of the financial institution's protections against conflicts of interest
    - A list of all parties with whom the financial institution maintains arrangements that provide third party payments to the adviser or financial institution with respect to investments recommended to retirement investors, a description of the arrangements stating whether and how they impact adviser compensation, and a statement of any benefits the financial institution provides to the product manufacturers in exchange for the payments. This provision is enormously burdensome and requires public access to proprietary arrangements between financial institutions and product manufacturers, raising serious issues of potential anti-competitive practices. It was not proposed for public comment, and thus, the Department may not have understood the effect of the requirement[15]
    - A description of the financial institution's compensation arrangements with advisers, including any cash or non-cash incentives to advisers for recommending particular product manufacturers or investments, or for advisers to move to the financial institution from another firm or to stay at the financial institution, and a description of any payout or compensation grids (excluding information specific to a particular adviser's compensation). This provision is also new, and raises significant concern regarding employment and pay practices of each financial institution. It too was not proposed for public comment

  The financial institution is not required to disclose information on its website if such disclosure is otherwise prohibited by law. In addition, to the extent the required information is provided in other public disclosures, such as a Form ADV, Part II, the financial institution may satisfy the web disclosure requirement by posting such other disclosures to its website with a link to where the required information can be found.

  The exemption states that the financial institution will not fail to satisfy the web disclosure requirements if the website is temporarily inaccessible. As with the contract disclosures and pre-transaction disclosures, the exemption provides a mechanism for correcting errors or omissions in the web disclosures, without losing the exemption, as long as the financial institution acted in

[15] See the proposed exemption, 80 Fed. Reg. at 21985.

good faith and with reasonable diligence in making the disclosures. The correct information must be disclosed as soon as practical, but no more than seven days after the financial institution discovers or reasonably should have discovered the error or omission. The preamble explains that the shorter seven-day correction period is necessary "because of the likelihood that errors or omissions on the website will have a greater impact than an error in an individual disclosure, due to the wider audience."

Under the transition period rules, financial institutions that utilize the BIC exemption will have until January 1, 2018 to bring themselves into compliance with the web disclosure requirements.

- *Notice to Department of Labor.* Financial institutions that wish to rely on the BIC exemption must give advance notice to the DOL of their intention to do so. This is the first prohibited transaction exemption to require such notification. The DOL stated in the preamble that this notice requirement "serves a valuable function by enabling the Department to determine which and which type of Financial Institutions intend to rely on the exemption, and by facilitating the Department's audit and compliance assistance programs." The notice must be provided by e-mail to e-BICE@DOL.gov.
- *Recordkeeping.* The financial institution must maintain for a period of six years records demonstrating that the conditions of the exemption have been satisfied. Such records must be made available to the DOL, the IRS, any IRA owner, any fiduciary, participant, or beneficiary of a plan that engaged in a transaction under the exemption, any contributing employer or employee organization whose members are covered by a plan that engaged in a transaction under the exemption, and any authorized representative of the above.

Proprietary Products and Third Party Payments

The BIC exemption establishes additional conditions for financial institutions that restrict their adviser's recommendations, "in whole or in part," to proprietary products or to investments that generate third party payments. What the Department means by the phrase "in whole or in part" is unclear. The term "proprietary product" is defined to mean "a product that is managed, issued or sponsored by the Financial Institution or any of its Affiliates." "Third party payments" are defined broadly to include "sales charges when not paid directly by the plan, participant or beneficiary account or IRA; gross dealer concessions; revenue sharing payments; 12b-1 fees; distribution, solicitation or referral fees; volume-based fees; fees for seminars and educational programs; and any other compensation, consideration or financial benefit provided to the Financial Institution or an Affiliate or Related Entity by a third party as a result of a transaction involving a Plan, participant or beneficiary account, or IRA."

The proposed exemption would have required financial institutions and advisers to make available a range of assets broad enough for the adviser to make recommendations with respect to every asset class necessary to serve the retirement investor's best interests. In response to comments expressing uncertainty about how this requirement would be interpreted and applied, the DOL rewrote the section dealing with restricted product offerings to, in its words, "clarify *how* a Financial Institution that limits its products in this way … can be deemed to satisfy the Best Interest standard, in light of concerns that the Financial Institutions and their Advisers would otherwise be held to violate the Best Interest standard's requirement that recommendations be made 'without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate …'" Notwithstanding the DOL's attempt to clarify how the best interest standard can be satisfied when a financial institution offers a restricted universe of products, the use of the phrase "in whole or in part" to describe the types of restricted product offerings that would

be covered by this section creates uncertainty as to its intended scope.

The final BIC exemption states that financial institutions with restricted product offerings may rely on the exemption and will be deemed to have satisfied the best interest standard if all of the applicable conditions are satisfied. Some of the conditions duplicate those that already apply to financial institutions generally, but others are specific to financial institutions with restricted product offerings. The conditions are as follows:

- Prior to or at the same time the recommended transaction is executed, the retirement investor must be "clearly and prominently informed in writing" that the financial institution offers proprietary products or receives third party payments with respect to recommended investments, and must be informed in writing of the limitations placed on the universe of investments that the advisor may recommend.
- Prior to or at the same time the recommended transaction is executed, the retirement investor must be "fully and fairly informed in writing" of any material conflicts of interest that the financial institution or adviser have with respect to the recommended transaction.
- The financial institution must document in writing its limitations on the universe of recommended investments and the material conflicts of interest associated with the limited universe; document the services it will provide to the retirement investor or any other party (including the payor) in exchange for third party payments; reasonably conclude that the limitations on the universe of recommended investments and material conflicts of interest will not cause the financial institution or its advisers to receive more than reasonable compensation within the meaning of ERISA § 408(b)(2); reasonably determine, in light of the financial institution's policies and procedures, that the limitations will not cause advisers to make imprudent recommendations; and document the bases for its conclusions. The preamble states that the purpose of this requirement is to "ensure that the Financial Institution reasonably safeguards Retirement Investors from dangerous conflicts of interest, notwithstanding its decision to provide a restricted menu of investment options." The preamble further indicates that, although the documentation required by this condition is not individualized and does not have to be provided to retirement investors, it must be maintained under the recordkeeping requirements of the exemption and made available to the DOL and to retirement investors. How both of these statements can be true is unclear, but the preamble suggests both that it does, and does not have to be provided to a retirement investor. In addition, the phrase "document the services it will provide to the retirement investor or any other party (including the payor) in exchange for third party payments" is different from the reasonable fee requirement in § 408(b)(2) and seems to contemplate some further tying of actual payments to particular services, which the DOL claimed was not what the proposed exemption required and which prompted the change in the reasonable compensation definition.
- The financial institution must adopt, monitor, implement, and adhere to policies and procedures and incentive practices that are reasonably and prudently designed to ensure that its advisers will adhere to the impartial conduct standards, and require that neither the financial institution nor (to the best of its knowledge) any affiliate or related entity use or rely upon quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other actions or incentives that are intended or would reasonably be expected to cause the adviser to make recommendations that are not in the best interest of the retirement investor.
- The compensation reasonably anticipated to be paid to the adviser and financial institution for

their services must not be in excess of "reasonable compensation" as defined in ERISA § 408(b)(2).

- The adviser's recommendation must be prudent.

Although financial institutions with restricted product offerings will satisfy the best interest standard if they meet the above conditions, they still must comply with the other requirements of the BIC exemption. Because the transition period rules condition relief on compliance with the best interest standard, there is at least a question whether financial institutions with restricted product offerings must satisfy the above conditions on the applicability date. But we think that result is unlikely given that all of the other conditions of the broader BIC exemption have been delayed during the transition period.

Limited Circumstances in Which Fewer Conditions Apply

There are two circumstances under which the BIC exemption will provide "streamlined" relief to financial institutions and advisers permitting them to receive compensation as a result of advice provided to a retirement investor based on fewer conditions. The first involves advisers and financial institutions that meet the definition of "level fee fiduciaries," and the second involves "bank networking arrangements":

- *Level Fee Fiduciaries.* This provision also was not proposed for public comment. Under it, an adviser and financial institution are "level fee fiduciaries" if the *only* fee received by the financial institution, adviser and any affiliate in connection with advisory or investment management services is a "level fee" disclosed in advance to the retirement investor. "Level fee" is defined to mean "a fee or compensation that is provided on the basis of a fixed percentage of the value of the assets or a set fee that does not vary with the particular investment recommended," and specifically excludes receipt by the adviser, financial institution or any affiliate of a commission or other transaction-based fee in excess of a level fee. Thus, unlike the broader BIC exemption, the streamlined relief will be unavailable if the either the adviser, the financial institution or any affiliate receive transaction-based compensation (*e.g.*, commissions, 12b-1 fees or revenue sharing) in connection with the advisory or investment management services rendered to the retirement investor. There is a question whether this provision permits a level fee that is based in part on third party payments, or whether the entire fee must come from the plan. It surely will not permit the use of proprietary products. If the adviser or financial institution anticipates that they or an affiliate will receive such transaction-based fees, the adviser and financial institution will have to satisfy the conditions for relief under the broader BIC exemption or use ERISA § 408(g) or Code § 4975(d)(17) which do not require a written contract or permit a private right of action or a best interest standard for non-ERISA accounts.

  The DOL acknowledges in the preamble that the receipt of a level fee "typically" would not raise prohibited transaction issues, but states that a "clear and substantial conflict" arises when an adviser recommends a rollover to an IRA that generates ongoing fees for the adviser, and that similar concerns "could be implicated" by a recommendation to switch from a "low activity" commission-based account to a fee-based account. To address these concerns, level fee fiduciaries must provide the retirement investor with a written acknowledgment of fiduciary status prior to or at the same time the recommended transaction is executed, and adhere to the impartial conduct standards. In addition, when recommending a rollover to an IRA or a switch from a commission-based to a fee-based account, level fee fiduciaries must document the specific reason or reasons why the recommendation was in the retirement investor's best interest. As explained previously, the carve-out that generally excludes robo-advice from coverage under

the BIC exemption allows robo-advice providers to rely on the relief for level fee fiduciaries if they satisfy the terms and conditions for that relief.

- *Bank Networking Arrangements.* The exemption provides relief for the receipt of referral fees by banks and bank employees in connection with the provision of investment advice to a retirement investor pursuant to a "bank networking arrangement," provided that the advice adheres to the impartial conduct standards. The term "bank networking arrangement" is defined to mean "an arrangement for the referral of retail non-deposit investment products that satisfies applicable federal banking, securities and insurance regulations, under which employees of a bank refer bank customers to an unaffiliated [registered investment adviser, insurance company or registered broker or dealer]."

Exemption for Purchases of Investment Products

The BIC exemption also provides supplemental relief from the prohibitions of ERISA §§ 406(a)(1)(A) and (D) and Code §§ 4975(c)(1)(A) and (D) for the purchase of an investment product by a plan, participant or beneficiary account, or IRA, from a financial institution that is a party in interest or disqualified person, provided that the conditions for relief are satisfied. The preamble explains that this relief is necessary in part because PTE 84-24, as amended and partially revoked, no longer provides relief for purchases of variable annuities, indexed annuities, or similar annuities. The exemption assumes that the financial institution has a pre-existing party in interest service provider relationship to the plan or IRA and that the entity causing the purchase is not the adviser or financial institution, but a fiduciary or IRA owner acting on their advice. In this situation, the entity that needs relief from the prohibitions of ERISA §§ 406(a)(1)(A) and (D) and Code §§ 4975(c)(1)(A) and (D) is the fiduciary or IRA owner that causes the purchase from the party in interest service provider.

Although the proposed exemption was limited to purchases of insurance and annuity contracts, the final exemption has been broadened to encompass the purchase of investment products generally. There appears to be some confusion in the preamble and in the exemption itself as to whether the supplemental relief extends to both purchases *and sales* of investment products, or only to purchases of investment products. As examples of transactions for which expanded relief is necessary, the preamble mentions "Proprietary Products purchased and sold" and "investments purchased or sold in Riskless Principal Transactions" with financial institutions. The title of Section VI and the introductory text in Section VI(a) also indicate that the exemption is provided for "purchases and sales." However, Section VI(b) describes the covered transaction as "the purchase of an investment product," without mentioning sales. We assume that this confusion will be clarified through a corrective amendment to the exemption.

Unlike the broader BIC exemption, the relief for purchases of investment products also has been expanded to apply to plans of all sizes (in addition to IRAs, participants, and beneficiaries). The preamble indicates that this expanded coverage was necessary to provide relief for transactions involving variable and indexed annuity contracts that is no longer available under PTE 84-24. The transaction must be effected by the financial institution in the ordinary course of its business, the compensation for any services rendered by the financial institution must be reasonable within the meaning of ERISA § 408(b)(2), and the terms of the transaction must be at least as favorable as an arm's length transaction with an unrelated party.

Like the broader BIC exemption, the supplemental relief for purchases of investment products excludes from coverage:

- An employer sponsored plan if the plan covers employees of the financial institution, the adviser, or an affiliate or if the financial institution or adviser is a named fiduciary or plan administrator selected to provide advice by someone who is not independent
- Compensation received from a principal transaction with a financial institution or adviser acting for his or her own account or the account of a person directly or indirectly controlling, controlled by or under common control with the financial institution. Notably, this exclusion does not apply to the sale of an insurance or annuity contract, a mutual fund transaction, or a riskless principal transaction, which makes it consistent with the examples in the preamble of situations in which expanded relief is necessary
- Compensation received on account of robo-advice, unless the robo-advice provider is a level fee fiduciary that complies with the conditions applicable to level fee fiduciaries
- Compensation paid to an adviser who has or exercises discretionary authority or control with respect to the recommended transaction

Since the supplemental relief encompasses only the prohibitions of ERISA §§ 406(a)(1)(A) and (D) and Code §§ 4975(c)(1)(A) and (D), the financial institution and the adviser would have to rely separately on the primary BIC exemption for relief from the self-dealing prohibitions of ERISA § 406(b) and Code §§ 4975(c)(1)(E) and (F).

Exemption for Pre-Existing Transactions

The BIC exemption provides supplemental relief from the prohibitions of ERISA §§ 406(a)(1)(A), 406(a)(1)(D), and 406(b) and Code §§ 4975(c)(1)(A), (D), (E), and (F) for investment advice involving investments acquired prior to the applicability date (*i.e.*, April 10, 2017) or based on recommendations to adhere to a systematic purchase program established before the applicability date. Unlike the broader BIC exemption, the supplemental relief for pre-existing transactions applies to the receipt by advisers, financial institutions and their affiliates of compensation as result of investment advice (including advice to hold) provided to IRA owners, participants or beneficiaries, and *all* plans, regardless of size. The conditions for relief for pre-existing transactions are as follows:

- The compensation must be received under an arrangement that was entered into prior to the applicability date and that has not expired or come up for renewal after the applicability date
- The investment transaction was not otherwise a non-exempt prohibited transaction when it occurred
- The compensation must not be received in connection with an investment of any additional amounts in the previously acquired investment vehicle. Notwithstanding this condition, the exemption states that the relief for pre-existing transactions applies to a recommendation to exchange investments within a mutual fund family or variable annuity contract pursuant to an exchange privilege or rebalancing program established prior to the applicability date, provided it does not result in the adviser, financial institution, or affiliate receiving more compensation than they were entitled to receive prior to the applicability date
- The compensation paid to the adviser, financial institution or their affiliates must be “reasonable” within the meaning of ERISA § 408(b)(2)

- Recommendations made after the applicability date must be made prudently and without regard to the financial or other interests of the adviser, financial institution or their affiliates

Transition Period Exemption

As stated previously, the BIC exemption provides for a transition period between April 10, 2017 and January 1, 2018, during which relief will be available under fewer conditions. During this transition period, the exemption permits advisers, financial institutions, and their affiliates to receive compensation as a result of their provision of investment advice to a retirement investor without violating ERISA §§ 406(a)(1)(D) or 406(b) or Code §§ 4975(c)(1)(D), (E), or (F) if the following conditions are satisfied:

- The financial institution and its advisers must comply with the impartial conduct standards in making investment recommendations.
- Prior to or at the time the recommended transaction is executed, the financial institution must provide a written notice to the retirement investor (which may cover all transactions during the transition period) acknowledging its and its adviser's fiduciary status under ERISA or the Code or both with respect to the recommended transaction, state in writing that they will comply with impartial conduct standards, and describe the financial institution's material conflicts of interest. The notice must also disclose whether the financial institution recommends proprietary products or investments that generate third party payments. To the extent the financial institution or advisor limits recommendations to proprietary products or investments that generate third party payments, the financial institution must notify the retirement investor of the limitations placed on the universe of investment recommendations. The written notice may be provided in person, electronically, or by mail, and does not have to be repeated for subsequent recommendations during the transition period. The exemption provides for the continuation of relief despite disclosure errors or omissions if the financial institution acts in good faith and with reasonable diligence; the correct information must be disclosed as soon as practical, but no more than 30 days after the financial institution discovers or reasonably should have discovered the error or omission.
- The financial institution must designate by name, title, or function, a person or persons responsible for addressing material conflicts of interest and monitoring adherence to the impartial conduct standards.
- The financial institution must maintain for a period of six years records demonstrating that the conditions of the transition period rules have been satisfied. Such records must be made available to the DOL, the IRS, any IRA owner, any fiduciary, participant or beneficiary of a plan that engaged in a transaction under the exemption, any contributing employer or employee organization whose members are covered by a plan that engaged in a transaction under the exemption, and any authorized representative of the above.

The transition period rules are subject to the same exclusions as the broader BIC exemption for advice concerning in-house plans, advice in connection with principal transactions, robo-advice, and advisers who have or exercise discretionary authority over the recommended investment.

Finally, in all of the final exemptions, the Department made several helpful changes to the access to records requirements. The changes include a provision that requires the records to be reasonably available, instead of unconditionally available, and authorizes participants to see only their own records and not those of anyone else. In addition, broker-dealers are not required to disclose privileged

commercial or financial information to anyone other than the Department or the Internal Revenue Service.

B. The Exemption for Principal Transactions in Certain Assets[16]

The final principal transaction exemption is far more usable than the proposed exemption and many issues raised by the commenters were addressed by the Department. The exemption permits certain advisers and financial institutions to sell to plans and IRAs certain debt securities, certificates of deposits, and unit investment trusts and to receive mark-ups or mark-downs (or other similar payment as applicable) for themselves or an affiliate as a result of the adviser's and financial institution's advice. Unit investment trusts and certificates of deposit are new categories added to the final rule. Municipal bonds, mortgage backed securities, foreign bonds and equities, foreign currency, and equities have not been added. Riskless principal transactions are permitted both under this exemption and the BIC exemption. The exemption would provide relief from the prohibitions of ERISA §§ 406(a)(1)(A) and (D) and 406(b)(1) and (2), and Code §§ 4975(c)(1)(A), (D), and (E) if the conditions of the exemption are satisfied.

The term "debt security" is defined for purposes of the exemption to mean a debt security under Rule 10b-10(d)(4) of the Securities Exchange Act of 1934 that is (a) dollar denominated, issued by a US corporation and offered pursuant to a registration statement under the Securities Act of 1933; (b) an agency debt security as defined in FINRA Rule 6710(1); and (c) a US Treasury security as defined in FINRA Rule 6710(p). Foreign debt is thus excluded from the exemption. More troublesome is the omission of foreign currency, now that foreign securities can be purchased under BIC. It will be very disadvantageous to plans and IRAs to have to buy small amounts of currency from an unrelated dealer in currency, and plans and IRAs will surely receive more expensive pricing of currency than had they purchased the currency from their own financial institution. The Department notes that the industry can come in for individual exemptions. We believe that course will be expensive, very time consuming, and enormously burdensome if every individual financial institution is required to seek its own individual exemption.

The term "financial institution" is defined to include only US or state registered investment advisers, US or state supervised banks, and broker-dealers registered under the US securities laws, that customarily purchase or sell the assets being traded on a principal basis (principal traded assets) for their own account in the ordinary course of business. "Adviser" is defined to mean an employee, independent contractor, agent or registered representative of a financial institution.

Like the BIC exemption, the final exemption for principal transactions does not apply if the adviser is a fiduciary for reasons other than providing investment advice for a fee, or if the plan is covered by Title I of ERISA and the adviser or financial institution or any affiliate is an employer of employees covered by the plan, or a named fiduciary or plan administrator that was selected by a fiduciary who is not independent. The exemption for principal transactions is subject to the following conditions:

Voluntary Assumption of Fiduciary Status. The financial institution must affirmatively agree that it is a fiduciary under ERISA, the Code or both. Non-ERISA plans need a signed contract; ERISA plans do not, but must nevertheless comply with the impartial conduct standards. The final rule requires that the contract between the financial institution and the non-ERISA plan be posted on a website maintained by the adviser. This seems to be a curious requirement and a technological challenge to make sure that a

[16] The title of the exemption has been changed to cover "certain assets" and not "certain debt securities" to reflect the substantive changes in the exemption.

person's contract can be seen by no one other than that person and that the volume of contracts can be accommodated on the website. The contract does not need to be executed before the provision of advice to the retirement investor to engage in a principal transaction or riskless principal transaction. However, the contract must cover any advice given prior to the contract date in order for the exemption to apply to such advice. For existing accounts, the contract can be a unilateral undertaking with deemed consent. For new accounts, a wet or electronic signature of the client is required.

Impartial Conduct Standards. Like the BIC exemption, the financial institution must affirmatively agree that it and its advisers will comply with, and in fact comply with, impartial conduct standards. The impartial conduct standards require the adviser and financial institution to provide advice that is in the investor's best interest. The proposed regulation had provided that these standards prohibit the financial institution from entering into a principal transaction if the price of the debt security (including the mark up or mark down) is unreasonable under the circumstances. That provision drew significant negative comment because the standard was so inexact and the terms "markup and markdown" were undefined. Thus, it is a welcome change that the provision has been deleted, and instead, the financial institution and the adviser must seek to obtain the best execution reasonably available under the circumstances with respect to the principal transaction or riskless principal transaction. Financial institutions that are FINRA members are deemed to satisfy this condition if they comply with the terms of FINRA rules 2121 (Fair Prices and Commissions) and 5310 (Best Execution and Interpositioning), or any successor rules in effect at the time of the transaction, as interpreted by FINRA. This change is constructive: it takes a standard that the entire industry understands and has lived under for years, and allows FINRA to interpret it. The rules allow the Department to identify specific requirements regarding best execution and/or fair prices imposed by another regulator or self-regulatory organization relating to additional assets other than securities in an individual exemption that may be satisfied as an alternative. The impartial conduct standards also prohibit misleading statements about the security or asset, the fees, the material conflicts of interest, the principal transaction, or any other matters relevant to the investor's decision. Although an investment advice fiduciary for an ERISA plan would already be subject to ERISA's fiduciary duties of loyalty and prudence, the impartial conduct standards would effectively shift the burden to the adviser and financial institution to prove in any lawsuit that they acted in the best interest of the plan in providing the advice covered by the exemption. The contract provision permits a plan or IRA to knowingly waive punitive damages and rescission.

Warranties. The financial institution must warrant the same items as in the BIC exemption regarding sales incentives and anti-conflict policies and procedures, and no use of incentives that would tend to encourage advisers to make recommendations that are not in the investor's best interest. The financial institution also must warrant that its policies and procedures on principal transactions address how credit risk and liquidity assessments on debt securities will be made. It appears that the incentives rules apply to the client-facing adviser and not to the traders on the fixed income desk. The final exemption contains language different from the proposed which may provide some leeway for financial institutions in compensating employees. The final exemption provides:

> Notwithstanding the foregoing, the requirement of this Section II(d)(3) does not prevent the financial institution or its affiliates from providing advisers with differential compensation (whether in type or amount, and including, but not limited to, commissions) based on investment decisions by Plans, participant or beneficiary accounts, or IRAs, to the extent that the policies and procedures and incentive practices, when viewed as a

> whole, are reasonably and prudently designed to avoid a misalignment of the interests of advisers with the interests of the Retirement Investors they serve as fiduciaries.[17]

The practical question is how to permit differential compensation and yet be able to defend a class action alleging inappropriate incentives. That challenge will be faced by all financial institutions in the coming months. As with the BIC exemption, the impartial conduct standards and warranties will give IRA owners and non-ERISA plans a private state cause of action for breach of contract and an arbitration claim under the contract. For ERISA plans, those requirements will give plan fiduciaries, participants, and the Secretary of Labor a federal cause of action under ERISA § 502(a) for engaging in a non-exempt prohibited transaction. Financial institutions also will be subject to an excise tax if they engage in a non-exempt prohibited transaction with an IRA or an ERISA plan. In the proposed exemption, violation of the warranties led to a contract claim, not a prohibited transaction. In the final exemption, a warranty violation causes a loss of the exemption, leading to reversal of the transaction and the imposition of excise taxes. That change makes the exemption less likely to be used, when an adviser can trade away from his own financial institution just as readily with no risk. In the event of a non-exempt prohibited transaction involving the purchase or sale of an asset, the excise tax would be imposed on the entire principal amount of the security.

Transaction Disclosures. The written disclosures provided to clients before execution of the trade must set forth in writing the circumstances under which the adviser and financial institution may engage in principal transactions. What the DOL has in mind here is unclear. Since the exemption excludes discretionary control and purchases and sales will only be at the investor's direction, it is difficult to understand what the written disclosure would cover. The contract with a non-ERISA account also must identify and disclose material conflicts associated with the principal transactions, obtain the investor's written consent to principal transactions, notify the investor that the consent is terminable at will at any time without penalty, and notify the investor of the right to obtain complete information about all fees and other payments currently associated with its investments, apparently not limited to principal transactions. The client also must be informed, orally or in writing, of the capacity in which the financial institution may act with respect to the transaction, and must receive a confirmation with all of the information required by the securities laws.

The financial institution must state that model contract disclosures or other model notice of the contractual terms are reviewed for accuracy no less than quarterly and updated within 30 days as necessary and are maintained on the financial institution's website, and that the financial institution's written description of its policies and procedures is available free of charge on the website. Finally, and significantly, the disclosure must describe whether or not the adviser and financial institution will monitor the retirement investor's investments that are acquired through principal transactions and alert the retirement investor to any recommended change to those investments and, if applicable, the frequency with which the monitoring will occur and the reasons for which the client will be alerted.

The final exemption also contains an inadvertent failure provision that makes a lot of sense and is found in the BIC exemption as well, thus preventing a foot-fault from leading to an excise tax and guarantee of the economics of the trade. Under that provision, the financial institution will not fail to satisfy the disclosure provisions or a contractual provision, solely because it, acting in good faith and with reasonable diligence, makes an error or omission in disclosing the required information, or if the website

[17] Similar language is included in the BIC exemption, 81 Fed. Reg. at 21077.

is temporarily inaccessible, provided that in the case of an error or omission on the web, the financial institution discloses the correct information as soon as practicable, but not later than seven days after the date on which it discovers or reasonably should have discovered the error or omission, and in the case of other disclosures, the financial institution discloses the correct information as soon as practicable, but not later than 30 days after the date on which it discovers or reasonably should have discovered the error or omission.

Prohibited Contract Provisions. As with the proposed BIC exemption, exculpatory provisions and waivers of the right to bring or participate in a class action are prohibited. Two changes were made in the final exemption in this area. The first is that parties may knowingly agree to waive the client's right to obtain punitive damages or rescission of recommended transactions to the extent such a waiver is permissible under applicable state or federal law. The second is that the contract cannot contain agreements to arbitrate or mediate individual claims in venues that are distant or that otherwise unreasonably limit the ability of the client to assert the claims safeguarded by this exemption.

Asset Requirements. The debt security may not have been issued by the financial institution or any affiliate. This exclusion applies regardless of the size and sophistication of the plan, and regardless of how highly rated the debt is, how liquid the debt is, or the depth of other dealers making a market in the security. The exemption also precludes purchases of new issues where the financial institution or an affiliate is in an underwriting syndicate, although presumably PTE 75-1, Part III still could be used in that situation if the financial institution is a member and not a manager of the syndicate. The debt security also must possess no greater than moderate credit risk, although "moderate" is undefined. In addition, the debt security must be "sufficiently liquid" that it could be sold at or near its carrying value within a reasonably short period of time. The proposed exemption had required that the debt security be able to be sold at or near its fair market value which made no sense. The current formulation is more readily understood by the industry.

Prohibited Arrangement. The transaction must not be part of an agreement to evade compliance with ERISA or the Code or to otherwise impact the value of the principal traded asset.

Cash Consideration. The purchase or sale of the principal traded asset must be for cash.

Transaction Pricing. In the proposed exemption, the transaction price was required to be at least as favorable as the price available in a transaction that is not a principal transaction – presumably the price from any other dealer plus a commission and the markup and markdown needed to be independently reasonable. In response to considerable adverse comments, the Department significantly changed this rule. The final exemption references the FINRA best execution standard as the appropriate condition, which will make compliance and surveillance much more efficient and effective since most financial institutions have these rules in place currently. The provision reads as follows:

> (2) The adviser and financial institution seek to obtain the best execution reasonably available under the circumstances with respect to the Principal Transaction or Riskless Principal Transaction.
>
> > (i) financial institutions that are FINRA members shall satisfy this Section II(c)(2) if they comply with the terms of FINRA rules 2121 (Fair Prices and Commissions) and 5310 (Best Execution and Interpositioning), or any successor rules in effect at the time of the transaction, as interpreted by FINRA, with respect to the Principal Transaction or Riskless Principal Transaction.

(ii) The Department may identify specific requirements regarding best execution and/or fair prices imposed by another regulator or self-regulatory organization relating to additional Principal Traded Assets pursuant to Section VI(j)(1)(iv) in an individual exemption that may be satisfied as an alternative to the standard set forth in Section II(c)(2) above.

Annual and Upon Request Disclosures. The adviser or the financial institution is required to send to the client annually written disclosure in a single disclosure that contains a list identifying each principal transaction and riskless principal transaction executed in the retirement investor's account in reliance on this exemption during the applicable period and the date and price at which the transaction occurred, and a statement that the consent required for principal transactions is terminable at will upon written notice, and that the client has the right to obtain, free of charge, information about the asset, including its salient attributes. The preamble suggests that the salient attributes are as follows: the credit quality of the issuer; the effective yield; the call provisions; and the duration of the instrument. The client must be advised that, model contract disclosures or other model notice of the contractual terms, which are reviewed for accuracy no less frequently than quarterly and updated within 30 days if necessary, are maintained on the financial institution's website, and the financial institution's written description of its policies and procedures are available free of charge on the financial institution's website.

Recordkeeping. The financial institution must maintain for a period of six years records demonstrating that the conditions of the exemption have been satisfied.

C. <u>Amendments to and Partial Revocation of PTE 84-24</u>

In its final form, PTE 84-24 provides relief from the prohibitions of ERISA §§ 406(a)(1)(A) through (D) and 406(b) and parallel Code provisions for certain transactions relating to purchases by ERISA plans and IRAs of insurance and fixed annuity contracts and for the receipt by an insurance agent or broker or pension consultant of an "insurance commission" (specifically defined within the exemption) in connection with such purchases, provided that the conditions of the exemption are satisfied. It also provides similar relief for purchases by ERISA plans of investment company securities and for the related receipt by principal underwriters of a "mutual fund commission" (again, strictly defined) if the exemption's conditions are met.

Under the final exemption, PTE 84-24 does not apply to the purchase by a plan or IRA of a variable annuity contract, indexed annuity contract, or similar contract. Further, the exemption does not apply to the purchase by an IRA of investment company securities. Investment advice fiduciaries (including insurance agents, brokers, pension consultants and insurance companies) engaging in such transactions will have to rely on the BIC exemption (including the supplemental exemption within the BIC for purchases of insurance and annuity contracts).

PTE 84-24 continues to apply to plan and IRA purchases of fixed rate annuity contracts, which are defined under the final exemption as annuity contracts issued by insurance companies that, among other requirements, have benefits that do not vary, in part or in whole, based on the investment experience of a separate account or accounts maintained by the insurer or the investment experience of an index or investment model. Additionally, PTE 84-24 continues to apply to purchase by plans of investment company securities from principal underwriters. Care should be taken if the securities are purchased from an affiliate other than the principal underwriter. The compensation relief for such securities sales, however, remains limited to commissions paid to principal underwriters.

As with the proposed exemption, final PTE 84-24's conditions require anyone providing fiduciary investment advice to an ERISA plan or IRA in reliance on the exemption to satisfy impartial conduct standards, which require the adviser to act in the investor's best interest, disclose material conflicts of interest, and not make misleading statements about recommended investments, fees, material conflicts of interest, and any other matters relevant to the investor's decision. As explained previously, these impartial conduct standards would effectively shift the burden to the adviser to prove that it acted in the investor's best interest in providing the advice.

In addition, like the proposed exemption, the final exemption requires that the transaction be effected in the investment advice fiduciary's ordinary course of business, be on terms at least as favorable to the Plan or IRA as an arm's length transaction with an unrelated party would be, and result in combined total compensation that is reasonable.

Compared to the proposed exemption, the final exemption calls for more transparency in compensation disclosures by insurance agents and brokers, pension consultants, and principal underwriters (*i.e.*, to the extent feasible, as an absolute dollar figure). Additionally, under the final exemption, certain disclosures must be repeated if more than one year has passed since the initial disclosure was made with respect to the purchase, as opposed to after three years under the proposed exemption.

As noted above, the final exemption includes definitions for "insurance commissions" and "mutual fund commissions" that are covered by PTE 84-24. The term "insurance commission" is defined to mean "a sales commission paid by the insurance company to the insurance agent or broker or pension consultant for the service of effecting the purchase of a Fixed Rate Annuity Contract or insurance contract, including renewal fees and trailers, but not revenue sharing payments, administrative fees, or marketing payments." The term "mutual fund commission" is defined to mean "a commission or sales load paid either by the plan or the investment company for the service of effecting or executing the purchase of investment company securities, but does not include a 12b-1 fee, revenue sharing payment, administrative fee, or marketing fee." Under these narrow definitions, insurance agents, brokers, and pension consultants selling fixed annuities to plans or IRAs would have to limit their compensation to a sales commission, and principal underwriters selling investment company securities to ERISA plans would have to limit their compensation to a sales load. To receive any other compensation from a third party, the party effectuating the sale would have to satisfy a different exemption (*e.g.*, the BIC exemption) or be compensated under a wrap fee arrangement that allows for an offset of any third-party payments against the wrap fee.

D. <u>Amendments to and Partial Revocation of PTE 86-128 and PTE 75-1, Parts I and II</u>

PTE 86-128 provides relief from the self-dealing prohibitions of ERISA § 406(b) and Code §§ 4975(c)(1)(E) and (F) for a fiduciary to receive commissions for effecting and executing securities transactions as agent for ERISA plans and IRAs, provided that the conditions of the exemption are met. PTE 86-128 also allows the fiduciary of an ERISA plan or an IRA to engage in an "agency cross transaction" as an agent both for the plan or IRA and for another party and receive reasonable compensation from the other party, provided that it does not act as a fiduciary on both sides of the transaction and that the conditions of the exemption are otherwise met.

The DOL has amended and partially revoked PTE 86-128. The changes in PTE 86-128 will have a significant impact on broker-dealers, reporting dealers, and banks who engage in securities transactions with ERISA plans and IRAs. In the IRA setting, the amendments to PTE 86-128 provide relief only for IRA fiduciaries who have discretionary authority or control over the management of the IRA's assets, and

not for IRA fiduciaries who provide fiduciary investment advice for a fee. Advisers to IRAs will have to rely on the BIC exemption for relief, effectively requiring level commissions for advised IRAs. The exemption revokes the exception for IRAs from many of the exemption's conditions.

The DOL has simultaneously revoked Parts I(b) and (c) of PTE 75-1 so that all relief from the self-dealing prohibitions of ERISA § 406(b) for these agency securities transactions is in either PTE 86-128 for ERISA plans and managed IRAs or in the BIC exemption for IRAs and non-participant-directed small plans. Because the BIC exemption provides relief from the prohibitions of ERISA § 406(b)(3), advisers to IRAs and non-participant-directed small plans presumably can rely on the BIC exemption for the receipt of a commission from the counterparty to an agency cross transaction. Fiduciaries of managed IRAs and participant-directed small plans apparently will be able to rely on either PTE 86-128 or the BIC exemption for relief from the prohibitions of ERISA § 406(b). However, neither PTE 86-128 nor the BIC exemption provide ERISA § 406(a) relief, which means that advisers seeking 406(a) relief for these transactions must in the future rely on only the statutory exemption for services in ERISA § 408(b)(2) (unless QPAM, INHAM or one of the pooled fund exemptions is available).

In addition, PTE 86-128 has been amended to require all fiduciaries relying on the exemption to comply with impartial conduct standards. As with the BIC exemption, these impartial conduct standards generally require the fiduciary to act in the investor's best interest, limit compensation to what is reasonable, disclose material conflicts of interest, and not make misleading statements about the transaction, fees and compensation, material conflicts of interest and any other matters relevant to the investor's decision

The amendments to PTE 86-128 also incorporate and modify the exemption previously contained in PTE 75-1, Part II(2), which allowed a fiduciary to act as principal in selling mutual fund shares to plans and IRAs.[18] As amended, PTE 86-128 provides relief from the prohibitions of ERISA §§ 406(a)(1)(A) and (D), and 406(b) and Code §§ 4975(c)(1)(A), (D), (E), and (F) for a fiduciary to cause an ERISA plan to purchase mutual fund shares from the fiduciary (regardless of whether the purchase is confirmed on an agency or principal basis), and to receive a commission from the plan or mutual fund. The fiduciary for purposes of this transaction must be a registered broker-dealer acting as such and cannot be the principal underwriter for or an affiliate of the mutual fund. The preamble confirms that the exemption for mutual fund purchases does not require a principal transaction confirmation; purchases confirmed as agent are also covered. The exemption omits sales *to* the fiduciary from the relief because in the DOL's view, a sale to the fiduciary is "unnecessary." The exemption also excludes relief for IRAs, whether managed or advised, thus requiring use of the BIC exemption for all IRA mutual fund purchases from a fiduciary.

The securities transaction section of the amended PTE 86-128 covers only "[a] plan fiduciary's using its authority *to cause a plan* to pay a Commission *directly* to [a fiduciary or related entity] . . . ." Although the new mutual fund transaction section of the exemption (unlike the securities transaction section) covers the receipt of such a "Commission" from a third party, the term "Commission" is narrowly defined to include "a brokerage commission or sales load paid for the service of effecting or executing the transaction, but not a 12b-1 fee, revenue sharing payment, marketing fee, administration fee, sub-TA fee or sub-accounting fee." The exemption thus limits commission relief for executing mutual fund transactions to sales loads paid either by the plan or the mutual fund, thereby forcing advisers into wrap fee arrangements if they wish to receive revenue sharing, 12b-1 fees, and other payments from mutual

[18] PTE 75-1, Part II(2) has been revoked.

funds or other third parties in connection with ERISA plans that are not self-directed and have more than 100 participants.

E. Amendments to PTE 75-1, Part V

Part V of PTE 75-1 permits covered broker-dealers to provide extensions of credit to plans and IRAs in connection with various transactions where an extension of credit is intrinsic to the transaction, such as settlement failures, options, short sales, margin transactions, and other transactions. Under this exemption, if the broker is a fiduciary, the extension of credit must be without charge. The proposed change to Part V of PTE 75-1 provided relief for investment advice fiduciaries to receive a fee, but only for settlement failures. The Department clarified the basic rule in the final exemption to condition the relief on the failure not having been caused by the fiduciary or an affiliate. The proposed language had said that the fail could not have been the result of action or inaction by such fiduciary or affiliate. The final rule did not expand relief beyond settlement failures. It is unclear how any plan or IRA will be permitted to do short sales, option trades, margin transactions, and a variety of other trades unless the transactions are covered by the QPAM, INHAM, or pooled fund exemptions.

F. Amendments to PTE 75-1, Parts III and IV, PTEs 77-4, 80-83, and 83-1

As outlined in our advisory on the proposed regulations, the DOL also requires adherence to impartial conduct standards as a condition for obtaining relief for transactions covered by the following exemptions:

- **PTE 75-1**, Part III permits a fiduciary to cause a plan or IRA to purchase securities from a member of an underwriting syndicate other than the fiduciary, when the fiduciary is also a member of the syndicate
- **PTE 75-1**, Part IV permits a plan or IRA to purchase securities in a principal transaction from a fiduciary that is a market maker with respect to such securities
- **PTE 77-4** provides relief for a plan's or IRA's purchase or sale of open-end investment company shares where the investment adviser for the open-end investment company is also a fiduciary to the plan or IRA
- **PTE 80-83** provides relief for a fiduciary causing a plan or IRA to purchase a security when the proceeds of the securities issuance may be used by the issuer to retire or reduce indebtedness to the fiduciary or an affiliate
- **PTE 83-1** provides relief for the sale of certificates in an initial issuance of certificates by the sponsor of a mortgage pool to a plan or IRA, when the sponsor, trustee or insurer of the mortgage pool is a fiduciary with respect to the plan or IRA assets invested in such certificates.

The proposed exemptions added the impartial conduct standards to each of the exemptions, which generally require the adviser to act in the investor's best interest, limit compensation to what is reasonable, disclose material conflicts of interest, and not make misleading statements about recommended investments, fees, material conflicts of interest, and any other matters relevant to the investor's decision. The final amendments do not materially alter the proposed amendments to these exemptions.

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Questions about the final regulation redefining the term “fiduciary,” the new exemptions and the amendments to existing exemptions may be directed to Melanie Nussdorf at +1 202 429 3009, Eric Serron at +1 202 429 6470, Patrick Menasco at +1 202 429 6215, Joni Andrioff at +1 202 429 8064, Scott Sinder at +1 202 429 6289, Tom Veal at +1 312 577 1234, Kate Jensen at +1 202 429 6259, Raisa Daigneault at +1 202 429 8187, Osvaldo Vazquez at +1 202 429 3914, and Bibek Pandey at +1 202 429 6417.