Client Update
Final DOL Fiduciary Rules Simplify Some Mechanics, but Retain Core Principles . . . and Flaws

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Last week, the U.S. Department of Labor (the "DOL") finalized its much anticipated regulations expanding the definition of fiduciary investment advice with respect to pension plans covered by the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and individual retirement accounts ("IRAs"). Despite extensive comments expressing serious concerns over the potential impact of the 2015 proposal on the ability of broker-dealers, banks, investment advisors and other financial services firms to continue providing advice to retirement investors and the lack of a viable path to preserving commission-based business models common in many aspects of the retirement investor marketplace, the final rules and the new and amended prohibited transaction exemptions have largely the same structure and breadth as the 2015 proposal.

While several significant improvements were made on procedural and technical aspects of the rules and compliance with the available exemptions, the final rules fail to provide any specific guidance or direction regarding how to comply with the demanding conditions of the Best Interest Contract Exemption ("BIC Exemption"). Indeed, despite stating that it provided specific operational advice on how institutions offering proprietary products could comply with the BIC Exemption, the DOL failed to offer any guidance on how such institutions could meet the stringent "best interest" condition of the "Impartial Conduct Standards" of the BIC Exemption (which is discussed in greater detail below). Without that guidance and direction, it is likely that the BIC Exemption, a purported centerpiece of this regulatory initiative, will be unworkable for many of the entities who will require the relief purported to be available thereunder to continue to operate within their existing business models.

Set forth below is our summary of the key changes from the proposal and the aspects of the final rule and revised proposed exemptions that we believe will have the biggest impact on institutions providing services to retirement

investors. It does not purport to be a complete summary of the final rule. For an in-depth analysis of the DOL's proposed regulation, including a detailed discussion of the core Impartial Conduct Standards, please refer to our April 21, 2015 client update.

EFFECTIVE DATE

The effective date of the final regulation has been extended to April 10, 2017, nearly a full year after its publication. While this is four months longer than the proposed rule's eight-month implementation period, it is still a very short period of time for entities that have not previously been deemed fiduciaries to make the necessary adjustments to their business practices. The DOL also offered a transition period, running from the April 10, 2017 effective date to January 1, 2018, for complying with a number of the arduous contract, disclosure and other mechanical requirements of the BIC Exemption. However, since the Impartial Conduct Standards will have to be satisfied as of the April 10, 2017 effective date, this transition period will likely not provide any material relief for institutions that will have to significantly restructure their business practices, including the manner in which they compensate their representatives who directly interface with retirement investors.

INVESTMENT ADVICE

The proposed regulation's definition of "investment advice" cast a deliberately wide net, and treated as a fiduciary anyone who makes an investment-related recommendation to an ERISA-covered pension plan, an IRA, a plan participant or IRA owner or beneficiary (a "Retirement Investor") for a fee or other compensation. The final regulation provides substantially the same definition with some key clarifications and changes regarding the limits of the rule's reach.

Seller's Carve-Out

Most significantly, the DOL expanded what was referred to under the proposal as the "seller's carve-out." Under that carve-out, communications made in connection with arm's length transactions with parties that the DOL deemed sophisticated would not give rise to fiduciary status. The seller's carve-out was only available for recommendations made to plans with at least 100 participants or that are represented by an independent fiduciary (including a named fiduciary of the plan) with at least $100 million in employee benefit plan assets under management. The final rule has dropped the 100-participant prong of the carve-out, reduced the assets under management threshold for the independent fiduciary to $50 million and no longer limits the required assets solely to employee benefit plan assets. It also adds a category of relief where the plan is represented by an independent fiduciary that is a bank, broker-dealer, insurance

company or registered investment adviser regardless of assets under management. This should provide broad relief to counterparties (such as private equity firms and other sponsors of alternative asset vehicles) that generally deal with large institutional plan investors. Of course, this relief is likely not available with respect to most IRA investors because IRAs are rarely professionally managed by one of the foregoing parties, and the DOL specifically declined to extend the seller's carve-out to situations where an IRA owner otherwise meets certain securities law suitability requirements (e.g., accredited investor or qualified purchaser status), finding that wealth is not an appropriate proxy for financial sophistication.

"Hire Me" Marketing Activities

When dealing with Retirement Investors that are not eligible for the seller's carve-out, the final rule provides far more limited relief with respect to sales pitches and certain types of counterparty communications. In response to commenter concerns that the proposed rule could capture marketing and self-promotion of services to a Retirement Investor, the final rule purports to make clear that only a recommendation of a third party to provide investment advice could give rise to fiduciary duties, and that it is not the DOL's intent to make people fiduciaries for merely engaging in sales pitches to Retirement Investors. However, if an adviser makes specific investment recommendations as part of its pitch, it would not be able to rely on this exception. This is a fine distinction to make and advisors will need to take care to stay on the right side of it in their marketing activities. Additionally, it is not clear to us that an advisor marketing its services through an investment in a specific fund or group of funds would be able to avail itself of this exception, which could create a particular pitfall for fund managers that wish to accept IRA investments.

BEST INTEREST CONTRACT EXEMPTION

The BIC Exemption purports to provide relief for certain common industry compensation practices such as commissions, revenue sharing, sales loads, 12b-1 fees, etc. Under the final rule, absent an exemption such as the BIC Exemption, any individual or entity acting as an investment advice fiduciary to a Retirement Investor would be deemed to have violated the self-dealing prohibitions of ERISA and the provisions of the Internal Revenue Code of 1986, as amended (the "Code") applicable to IRAs upon the receipt of such fees in connection with the recommendation of financial products, because the amount of the fiduciary's compensation would be affected by such recommendations.

Both the proposed BIC Exemption and its final counterpart are conditioned on adherence to an "Impartial Conduct Standard" and specific, detailed disclosure

requirements. Like the investment advice definition, the final BIC Exemption provides a number of changes from the 2015 proposal that clarify and simplify certain mechanical aspects to qualifying for the available relief, but ultimately the exemption has largely the same structure, the same requirements and many of the same flaws. The two most significant changes relate to the general applicability of the exemption and the terms of the written contract requirement.

Applicability

The 2015 proposal limited relief to certain types of Retirement Investors. With respect to participant-directed plans, the BIC Exemption was only available for recommendations made to participants or beneficiaries and not to the fiduciaries responsible for establishing the menu of plan investment options. The proposed exemption was also not available for recommendations made to non-participant-directed plans that had 100 or more participants. The final rule eliminates both of these restrictions and dovetails BIC Exemption applicability with the seller's carve-out described above by making relief available to any plan fiduciary that would not be eligible for seller's carve-out relief.

The 2015 proposal was also only applicable to a narrow, plain vanilla list of investments. The DOL eliminated the "approved" list in the final rule, making the BIC Exemption applicable on its face to all forms of investments as long as the other conditions are met. However, in the preamble to the BIC Exemption, the DOL indicated that assets outside the scope of the original approved list would merit special attention and care, and would be subjected to special scrutiny. Thus, it is apparent that the DOL still believes that there are "appropriate" assets for recommendations, and another class of illiquid and riskier investment classes that are generally considered unadvisable for Retirement Investors. It is not clear why this extra attention and care are necessary given that reliance on the BIC Exemption is otherwise predicated on adherence to ERISA's fiduciary duties, including the best interest standard.

Contract Requirement

The DOL has also made substantial changes to the written contract and disclosure requirements. The proposal required a written contract with a Retirement Investor prior to the provision of any investment advice. The final rule has eliminated the contract requirement for ERISA plans (though it still requires written fiduciary status acknowledgement) and provided some guidance and flexibility for IRAs and other non-ERISA plans. Under the final rule, an investment advice fiduciary to an IRA investor can incorporate the contract requirements into the investment advisory agreement, account opening

agreement or similar document with the Retirement Investor and the contract can be executed at the time the actual investment is made as long as the required provisions apply retroactively to pre-contract investment advice. The final rule also provides a negative consent mechanism for client relationships already in place on the effective date. Perhaps most significantly, the contract no longer requires a warranty that the fiduciary will comply with all applicable laws and regulations, though other meaningful warranties are still mandatory. However, Retirement Investors expressly continue to have the right to pursue recourse for violations of the BIC Exemption as part of a class action litigation, a feature that the DOL identifies as critical to assuring compliance with the Impartial Conduct Standards.

Impartial Conduct Standards

Despite the technical changes described above and certain other refinements to the BIC Exemption, the final rule has not departed from the core conditions of the proposal: adherence to "Impartial Conduct Standards," adoption of specific policies and procedures to address conflicts of interest and specific and lengthy disclosure to Retirement Investors. As noted above, the final rule also continues to impose a written contract requirement for IRA and non-ERISA plan advice, providing a direct avenue for seeking redress of any purported failure to comply with the contractual undertakings, including through a class action litigation.

The Impartial Conduct Standards have two primary components: a requirement to act in accordance with ERISA's duties of prudence and loyalty and a requirement that compensation received in connection with a recommendation be reasonable within the meaning of Section 408(b)(2) of ERISA and Section 4975(d)(2) of the Code.

The duty of loyalty is expressed in the BIC Exemption as follows:

> [T]he Adviser's recommendation is not based on the financial or other interests of the Adviser or on the Adviser's consideration of any factors or interests other than the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor.

This is significant not just because it effectively imposes ERISA's standard of care, including the duty of loyalty, on certain IRA fiduciaries that are not subject to such duties under the statute, but also for the quagmire that it creates for an investment advice fiduciary that operates on anything other than a level fee (i.e., fixed percentage of assets or flat rate) basis. Historically, the DOL has granted exemptions from the self-dealing prohibitions of ERISA and the Code by first acknowledging that a conflict of interest exists and then conditioning relief on

specific procedural safeguards that were designed to assure that the plan or other Retirement Investor was not disadvantaged due to the presence of such conflict. With the BIC Exemption, however, the DOL conditions relief on an Adviser somehow acting without regard to the underlying conflict of interest—and of course being able to prove that its advice was given with an eye solely on the interest of the Retirement Investor when confronted with a class action challenge. Despite pleas from the industry for further guidance on how to meet this condition in light of the stringent requirements imposed under ERISA, the final rule failed to provide any meaningful guidance on how an investment fiduciary could comply with this quandary. Instead, the DOL repeatedly stated that this "duty of loyalty" has been part of the duties imposed on fiduciaries under ERISA since its enactment, and was generally developed from long-standing common law principles. The so-called specific guidance with respect to proprietary products and products that generate third-party fees merely added additional disclosure requirements and mandated documentation, without offering any insight into how to comply with the key requirement of the BIC Exemption.

The DOL also attempted to bring clarity to the reasonable compensation standard by directly incorporating the statutory standard under Section 408(b)(2) of ERISA. The DOL stated that this is "[u]ltimately, a market based standard," but specifically rejected the invitation to embrace "customary" compensation arrangements as satisfying that standard. Unless institutions can refer to customary arrangements to determine market prices and practices, assuring compliance with this portion of the Impartial Conduct Standards will be exceedingly difficult. The DOL suggested that institutions could commission an independent third-party review of their compensation structures, perhaps reflecting its own implicit view that judgments regarding reasonable compensation cannot be made by the person receiving the compensation.

The lack of clear guidance on two of the cornerstone requirements of the BIC Exemption will present significant challenges to institutions that look to rely on this Exemption. Investment advice fiduciaries that receive any compensation that varies based on their recommendations are likely to face significant challenges in proving that they have complied with the Impartial Conduct Standards, and the BIC Exemption will place them in the position of having to do so. The DOL has made clear that the burden of proof will fall to fiduciaries relying on the exemption, and given the exemption's contractual enforcement mechanisms, the litigation risk and expense are likely going to be significant.

NEW AND AMENDED EXEMPTIONS

As part of this rulemaking, the DOL also granted a new exemption for principal transactions in debt securities and amended several existing Prohibited Transaction Exemptions. The key features and changes for each of these are summarized below.

PTE 84-24

Prohibited Transaction Exemption ("PTE") 84-24 historically provided relief from Section 406(a) and 406(b) of ERISA and Section 4975(a)(1)(A)-(F) of the Code for purchases by all Retirement Investors of insurance contracts, annuity contracts and investment company securities. The amendment significantly scales back the scope of this relief by excluding variable rate and indexed annuities, which the DOL has determined must comply with the BIC Exemption to be exempt from the prohibited transaction rules and by limiting the types of compensation that may be received under the exemption. With regard to fixed annuity products, rather than providing an exemption based principally on the plan or other Retirement Investor paying no more than reasonable compensation for the annuity, the exemption will now be conditioned upon satisfying the Impartial Conduct Standards described above (although there is no written contract requirement). The exemption also no longer applies to IRA purchases of mutual fund shares, which must look to the BIC Exemption for relief. These changes represent significant shifts in an established exemption that has been relied upon by the insurance industry and Retirement Investors for over 30 years, and will likely require major internal policy and procedure changes within that industry.

PTE 86-128

PTE 86-128 provides relief for executing securities transactions for a Retirement Investor and receiving a fee or commission in connection with the transaction. Prior to the amendment, it was available for IRA transactions subject only to the condition that the transactions were not excessive (i.e., there was no churning). The amended PTE 86-128 is only available if the IRA fiduciary is a discretionary advisor; investment advice fiduciaries that execute securities transactions will need to comply with the BIC Exemption. The amended PTE imposes the same conditions for IRA transactions as it historically imposed on ERISA plans, requiring specific advance authorization from an independent fiduciary to execute the transactions and periodic disclosures to affected Retirement Investors. It also requires adherence to the same Impartial Conduct Standards as the BIC Exemption and PTE 84-24. Finally, PTE 86-128 has been revised for certain mutual fund transactions that were previously exempt under PTE 75-1

Part II. Like the amendments to PTE 84-24, these are major changes to a well-established exemption that will require affected parties to make substantial changes to certain business practices, policies and procedures.

Principal Transactions in Debt Securities

The DOL granted relief in the proposed rules for a limited set of principal transactions entered into with, and at the recommendation of, an investment advice fiduciary. The proposed exemption was largely the same as the proposed BIC Exemption, and the final exemption's changes tracked the corresponding changes made to the final BIC Exemption.

One notable difference from the BIC Exemption is that the principal transaction exemption's Impartial Conduct Standards require best execution rather than reasonable compensation, and this is deemed satisfied if certain FINRA execution rules are complied with. Additionally, the exemption only applies to purchases of certain specified debt securities, unit investment trusts and certificates of deposit (sales have no such restriction). Eligible debt securities purchased in a principal transaction must "possess no more than moderate credit risk," which the DOL suggested could be read as "investment grade" (though this was done with a wink in the preamble because the Dodd-Frank Act prohibits references to credit ratings in an exemption). The security must also be "sufficiently liquid" so that it may be sold at or near "carrying value within a reasonably short period of time." These credit risk and liquidity conditions mirror language used in a rule promulgated by the U.S. Securities Exchange Commission, which is helpful, but the best interest requirements of the Impartial Conduct Standards pose the same problems with this exemption as discussed above in the context of the BIC Exemption.

Other PTEs

Parts of PTE 75-1, providing relief for a number of common brokerage practices, PTE 77-4, providing relief for investments in affiliated mutual funds, PTE 80-83, providing relief for the purchase of security where the proceeds are used to relieve the debt owed to a party in interest and PTE 83-1, providing relief for the sale of certain mortgage pool certificates, were all amended to impose the Impartial Conduct Standards where the transaction involves potential self-dealing on the part of the fiduciary. The changes to these exemptions will primarily affect IRA fiduciaries by imposing ERISA's fiduciary duties on them with respect to the otherwise prohibited conflicted transactions. While not as seismic as the new BIC Exemption or the changes to PTE 84-24 or 86-128, these amendments are nonetheless significant for the higher standard of care imposed by them.

Recordkeeping requirements for several PTEs, which were previously the responsibility of the plan or IRA involved in the transaction, has been shifted to the plan's counterparty/fiduciary. Additionally, parts of PTE 75-1 have been revoked. Parts I(b) and (c), which provided an exemption for certain agency transactions and non-fiduciary advice were deemed redundant in light of Section 408(b)(2) of ERISA. Part II(2), which provided an exemption for certain mutual fund share purchases, has been moved to PTE 86-128 with respect to ERISA plans, as noted above, and to the BIC Exemption with respect to IRAs (and therefore only applies to investment advice fiduciaries). Those that currently rely on these exemptions will need to review existing agreements and procedures to ensure that they are in compliance with this new regulatory framework.

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Please do not hesitate to contact us with any questions.