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The US Department of Labor's Final "Fiduciary" Rule Incorporates Concessions to Financial Service Industry but Still Poses Key Challenges

The Rule Will Require Restructuring of Pay and Compliance Policies at Financial Institutions Serving Retail Retirement Clients

The Rule Also Increases the Litigation Risks to Financial Institutions Associated with Providing Investment Advice to IRAs and IRA Beneficiaries

On April 6th, the US Department of Labor issued its final "fiduciary" rule. Over 800 pages in length and more than 15 years and three iterations in the offing, the rule and its related prohibited transaction exemptions ("PTEs") will, for the first time since the passage of ERISA,¹ subject many of the investment and asset management recommendations from broker dealers, banks and other financial organizations to individual retirement accounts ("IRAs") and other retail retirement clients² to ERISA's fiduciary standards and remedies.³

The most immediate impact of the rule will be on the compensation practices at broker-dealers and other financial institutions and on the fee and revenue sharing arrangements among funds, fund sponsors and the financial institutions that offer investment advice to retail retirement clients. The rule and related exemptions require new client contracts, new internal "best interest" or "impartial conduct" policies and procedures, new websites and additional disclosures to both investors and the DOL. For fund and other product sponsors, there may be new demands for investment vehicles with low, no or level broker compensation – and potentially a "stuck in the middle" quandary for some as they try to accommodate competing or even conflicting approaches to the rule from different financial institution partners. The rule also increases the litigation risks to financial institutions in providing investment and other services to retail

¹ ERISA means the Employee Retirement Income Security Act of 1974, as amended.

² While the rulemaking and this publication focuses on retail retirement clients, the rule will, in certain instances, apply to large plans, and the fiduciaries of those plans, as well. The rule, and the related PTEs, define "plan" as "any employee benefit plan described in § 3(3) of ERISA and any plan described in § 4975(e)(1)(A) of the Code." The rule, and the related PTEs, defines "IRA" as any account or annuity described in Code § 4975(e)(1)(B) through (F)..."

³ The rule and the prohibited transaction exemptions promulgated along with the rule can be found at:

<http://www.dol.gov/ebsa/regs/conflictsofinterest.html>.

retirement clients, because the rule subjects advice to IRA and other non-ERISA plan clients to ERISA's remedial provisions, and does so in a context that emphasizes subjective fair treatment in a complex environment.

The rule will be applicable to financial institutions and the financial advisers employed by them⁴ on April 10, 2017, which is one year after its effective date. However, in response to implementation and feasibility concerns raised by the financial services industry, the DOL has delayed full compliance with certain provisions of the "best interest contract" and "principal transaction" exemptions until January 2018.

This publication describes the main provisions of the rule, as well as the key terms of the new and amended PTEs promulgated by the DOL.

Re-defining Who is an "Investment Advice Fiduciary"

In General

Under both ERISA and the Internal Revenue Code,⁵ a so-called "investment advice fiduciary" is a person who renders investment advice for a fee or other compensation with respect to moneys or other property of an employee benefit plan or a tax-favored retirement savings account such as an IRA.⁶ Since 1975, regulations promulgated by the DOL have provided that a person will be an investment advice fiduciary only if (1) the advice is rendered as to the value of securities or property or as to the advisability of investing in securities or property, (2) on a regular basis, (3) pursuant to a mutual agreement or understanding between the adviser and the client, (4) that the advice will serve as the primary basis for investment decisions and (5) that it will be particularized to the individual needs of the retirement investor. The narrow focus of this five-part test allowed advisers comfortably to conclude that they were not acting as ERISA fiduciaries when making most investment recommendations to retail retirement clients.

The rule abandons the five-part test and replaces it with a principles-based approach that focuses on whether or not a "recommendation" has been made that constitutes "investment advice." At the heart of the rule is an examination of (1) the relationship between the adviser and the client and (2) the type of advice being given, and the rule provides a detailed explanation of the types of communications that will and will not rise to the level of being a "recommendation."

⁴ The "best interest contract exemption" and the "principal transaction exemption" (both of which are described, below) contain specific definitions of "financial institutions" and "advisers" for purposes of determining who can take advantage of each exemption.

⁵ Internal Revenue Code means the US Internal Revenue Code of 1986, as amended.

⁶ ERISA § 3(21)(A)(ii) and Internal Revenue Code § 4975(e)(3). In 1978 the Department of Labor was provided with the authority to promulgate rules under § 4975 of the Code and, therefore, the rule applies to the identical definitions of "fiduciary" found in ERISA and the Code.

Significantly, the rule no longer requires the investment advice be provided to the client on a regular basis or with the understanding that it will be used as the primary basis for the client's decision. As a result, the rule broadly captures "recommendations" made pursuant to any written or oral understanding that the advice is being tailored to the specific needs of the retail retirement client.

Advisers who are fiduciaries for purposes of ERISA or the Code are subject to a broad prohibition against conflicts of interest transactions. That, in turn, requires an adviser to cast about for available exemptions to continue compensation and other commercial practices that would have been permissible absent fiduciary status—a process that under the rule will, in many cases, lead to the so-called "best interest contract" or "BIC" exemption described later in this publication.

Types of Relationships

For a "recommendation" to be subject to the rule, it must be made by one of the following persons (or their affiliates):

- Persons who represent or acknowledge that they are acting as fiduciaries with respect to the advice;
- Persons who render the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is based on the particular needs of the recipient; or
- Persons who direct the advice to a specific advice recipient(s) regarding the advisability of a particular investment or management decision.⁷

Types of Recommendations

Recommendations as to either the investment or management of the securities or investment property⁸ constitute "investment advice" under the rule.⁹ These include recommendations as to the advisability of acquiring, holding,

⁷ The rule was initially proposed in 2015 (along with the proposed exemptions, the "2015 proposal"). The 2015 proposal provided that unless the adviser represented that he or she is a fiduciary with respect to advice, the advice had to be provided 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 recipient for consideration in making investment or management decisions with respect to investment of the plan or IRA. In the preamble to the rule, the DOL explains that this provision was revised for two reasons. First, the phrase "for consideration" was removed because that clause was largely redundant with the description of investment advice set forth in Section 2510.3-21(a)(1) of the rule, which addresses the subject matter areas to which a recommendation must relate to constitute investment advice. Accordingly, the rule revises the condition to require that advice be "directed to" a specific advice recipient or recipients regarding the advisability of a particular investment or management decision. Second, the DOL determined that requiring that there be an agreement, arrangement or understanding that advice was specifically directed to the recipient for both the "individualized advice" prong and the "specifically directed to" prong served no useful purpose for defining fiduciary investment advice because the point of the language concerning advice "specifically directed to" an individual was to distinguish specific investment recommendations to an individual from recommendations made to the general public, or to no one in particular. The DOL believes that a showing that an adviser directed a specific investment recommendation to a specific person carries with it a reasonable basis for both parties to understand what the adviser was doing.

disposing of or exchanging securities or other investment property or recommendations as to how such securities or investment property should be invested after being rolled over, transferred or distributed from the plan or IRA. The rule clarifies that the management of the securities or investment property include recommendations as to: (1) investment policies or strategies, (2) proxy voting, (3) portfolio composition, (4) other persons to provide investment advice or management services,¹⁰ (5) types of investment account arrangements (e.g., brokerage vs. advisory), (6) transitions to fee-based arrangements¹¹ or (7) rollovers, transfers or distributions (including whether, in what amount, in what form and to what destination a transfer or rollover is directed).¹²

Communications That Are “Recommendations”

Under the rule, a “recommendation” is a communication (whether initiated by a person or computer software program), 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.¹³ Under this standard, the determination as to whether a “recommendation” has been made is not dependent on the intentions of advisers when they make the communication, or the interpretation of the communication by advice recipients.

In its 2015 proposal, the DOL solicited comments on whether it should adopt some or all of the standards developed by FINRA in defining communications that rise to the level of a “recommendation” for purposes of distinguishing between investment education and investment advice under ERISA. The NASD Notice to Members 01 – 23¹⁴ provides guidelines to assist brokers in evaluating whether a particular communication could be viewed as a “recommendation,” triggering application of FINRA’s Rule 2111, which requires that a firm or associated person have a reasonable basis to believe that a recommended transaction or investment strategy involving securities is suitable for the customer. The rule mirrors the FINRA guidance in stating that the more individually

⁸ The definition of “investment property” excludes health insurance policies, disability insurance policies, term life insurance policies and other property to the extent the policies or property do not contain an investment component. In discussing the type of recommendations that constitute investment advice, the DOL uses the term “investment component” several times, but does not define the term. It appears that the term is shorthand for “investment advice component.” (See § A(1) of the preamble to the rule, stating “The Department believes it would depart from a plain and natural reading of the term “investment advice” to conclude that recommendations to purchase group health and disability insurance constitute investment advice.”)

⁹ Although the 2015 proposal included appraisals and valuation reports, the DOL stated that it is reserving that coverage for a future rulemaking.

¹⁰ In the preamble to the rule, the DOL states that communications with respect to marketing oneself or an affiliate would not give rise to “investment advice.”

¹¹ Communications of this type to sophisticated or large money managers will generally be excluded under the “seller’s carve-out,” discussed below.

¹² The rule therefore supersedes Advisory Opinion 2005-23A (Dec. 7, 2005), which provided that it is not fiduciary advice to make a “recommendation” as to distribution options even if accompanied by a recommendation as to where the distribution would be invested.

¹³ A series of actions (including actions taken by an affiliate) that may not constitute a “recommendation” when viewed individually may amount to a “recommendation” when considered in the aggregate.

¹⁴ The NASD Notice to Members 01 – 23 is available at: <http://www.finra.org/sites/default/files/NoticeDocument/p003887.pdf>.

tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a “recommendation.” However, the rule does not adopt the FINRA standard for “recommendation.” In the view of the DOL, FINRA guidance does not specifically define the term “recommendation” in a way that could be directly incorporated into the rule. Moreover, according to the DOL, strictly adopting FINRA guidance would mean that the rule could be subject to changes in FINRA interpretations announced in the future and not reviewed or separately adopted by the DOL.

As noted above, the rule states that the more individually tailored a communication is to a specific advice recipient or recipients, the more likely the communication will be viewed as a “recommendation.” Further, the rule clarifies that offering a selective list of securities to a retail retirement client would be a “recommendation” as to the advisability of acquiring securities, even if no “recommendation” is made with respect to any one security.

The rule provides that the following provisions of services or information do not constitute “recommendations”:

- **Platform Providers and Related Activities.** Marketing or making available to a plan fiduciary, without regard to the individualized needs of the plan¹⁵ or its participants, a platform or similar mechanism to select or monitor investments is not a “recommendation,” so long as the plan fiduciary at whom the marketing is directed is independent of the person marketing the platform, and the adviser discloses in writing to the plan fiduciary that the adviser is not undertaking to provide impartial investment advice or give advice in a fiduciary capacity. For purposes of this exception, plan fiduciaries do not include plan participants, IRA owners or IRA beneficiaries.

In addition, certain activities carried out by platform advisers to assist plan fiduciaries in selecting and monitoring investment alternatives are not “recommendations” under the rule. These activities are: (1) identifying investment alternatives that meet objective criteria specified by the plan fiduciary,¹⁶ (2) responding to a request for information or proposal with information of a limited or sample set of investment alternatives based only on size of the plan and/or the current investment alternatives designated under the plan and (3) providing the plan fiduciary with objective financial data and comparisons with independent benchmarks.¹⁷

- **Investment Education.** The provision of general investment information and educational materials is not a “recommendation” on how to invest plan assets and therefore is not “investment advice.” The new rule incorporates most of the DOL’s Interpretive Bulletin from 1996 on investment education, a notable exception for references to specific investment options.¹⁸ The rule provides and discusses four categories of education

¹⁵ The rule permits “segmentation,” or the marketing of platforms based on objective criteria (e.g., size of plan).

¹⁶ Examples of objective criteria include: stated parameters concerning expense ratios, size of fund, type of asset or credit quality.

¹⁷ In order to take advantage of the activities in (1) and (2), the adviser (or other person identifying the investment alternatives) must identify whether he has a financial interest in any of the identified investments alternatives, and the precise nature of that interest.

¹⁸ See 29 CFR 2509.96-1 (“IB 96-1”) which is superseded by the rule. The one substantive change from IB 96-1 is that asset allocation models and interactive investment materials may not identify specific investment alternatives and distribution options unless: (1) the alternative is a designated investment alternative under the plan covered by ERISA, (2) the alternative is subject to fiduciary oversight by a plan fiduciary independent of the person who developed or marketed the alternative or distribution option, (3) the asset allocation model and interactive

information: (1) plan investment information, (2) general financial, investment and retirement information, (3) asset allocation models and (4) interactive investment materials.

Seller’s Carve-Out and Other “Recommendations” That Do Not Constitute Investment Advice

The rule provides that the following “recommendations” do not constitute “investment advice” subject to the rule:¹⁹

- Transactions with Independent Fiduciaries with Financial Expertise (the “Seller’s Carve-Out”). This exception provides that an adviser will not be considered an investment advice fiduciary by providing advice to an independent fiduciary of a plan with respect to an arm’s length sale, purchase, loan, exchange or other transaction involving the investment of securities or other property. In order to fall within this exception, the adviser must: (1) not receive a fee or other compensation from the plan for the investment advice in connection with the transaction, (2) inform the independent fiduciary of the existence and nature of the adviser’s financial interest in the transaction and (3) know or reasonably believe that the independent fiduciary is a bank, registered investment adviser, insurance carrier qualified in more than one state, or manager with at least \$50 million in assets under management²⁰ which is acting independently for the plan and is capable of evaluating the risks of the transaction.
- Swap Transactions. Providing advice to an employee benefit plan covered by ERISA in connection with a swap or security-based swap²¹ will not be investment advice if the financial institution giving the advice is a swap dealer, security-based swap dealer, major swap participant, major security-based swap participant or a swap clearing firm and:
 - The fiduciary of the ERISA plan is independent of the financial institution;
 - The swap dealer or security-based swap dealer is not an adviser to the plan under § 4s(h) of the Commodity Exchange Act or § 15F(h) of the 1934 Act;
 - The financial institution does not receive a fee or other compensation directly from the plan or plan fiduciary for the advice in connection with the transaction; and
 - Before providing any “recommendation” with respect to a swap or security-based swap transaction, the financial institution obtains a written representation from the fiduciary that the fiduciary understands that the advice-provider is not undertaking to provide impartial investment advice, and the fiduciary is exercising independent judgment.
- Employees of Plan Sponsors. Employees of plan sponsors generally will not become fiduciaries by providing advice to plan fiduciaries or another employee of the plan sponsor. In addition, employees will not become

materials identify all the other designated investment alternatives that have similar risk and return characteristics and (4) the models and materials are accompanied by a statement that identifies where information on those investment alternatives may be obtained.

¹⁹ The 2015 proposal referred to these exceptions as “carve-outs” but the rule drops this term.

²⁰ A fiduciary that does not meet these qualifications is a “retail fiduciary” for purposes of the BIC Exemption. (See fn. 23, below.)

²¹ As defined in § 1a of the Commodity Exchange Act and § 3(a) of the Securities Exchange Act of 1934 (the “1934 Act”).

fiduciaries by providing advice to plan participants if the employee's job responsibilities do not involve providing investment advice or recommendations, the employee is not registered or licensed under federal or state securities laws, and the advice does not require the employee to be so registered or licensed. Under no circumstances may the employee receive any fees or other compensation in connection with the advice beyond the employee's normal compensation.

These exemptions apply only in limited circumstances and will not typically apply to most of the dealings with retail retirement clients that are the focus of the rule.

Consequences of Being a Fiduciary

There are many implications of ERISA fiduciary status, including being subject to ERISA's prudence and exclusive benefit rules, being restricted by ERISA's prohibited transaction rules, being subject to a remedial framework that allows claims for violations of fiduciary duty to be brought by the DOL, other fiduciaries and participants, and, in certain circumstances, being potentially liable as a co-fiduciary. ERISA also prohibits a fiduciary from exercising its discretion in a manner that will directly or indirectly benefit the fiduciary or its affiliates. One direct consequence of this limitation is that a fiduciary may not exercise its discretion in any manner that results in the compensation paid to the fiduciary and its affiliates to vary based upon the advice given or the securities recommended. As a result, absent the BIC Exemption discussed below, financial institutions and advisers would be precluded under the rule from receiving third party payments, commissions and other forms of variable remuneration and payments related to products recommended or purchased by their retail retirement clients.

The Best Interest Contract Exemption

In General

At the heart of this regulatory initiative by the DOL is the Best Interest Contract Exemption, or "BIC Exemption." The BIC Exemption allows financial institutions and advisers²² to retail retirement clients²³ to receive forms of compensation that would otherwise be prohibited by ERISA and the Code, subject to compliance with a number of conditions.

²² The BIC Exemption is only available to advisers that became fiduciaries by providing "investment advice for a fee," work for a financial institution and satisfied the federal and state regulatory and licensing requirements of insurance, banking and securities laws with respect to the covered transaction. A financial institution is defined in the BIC Exemption as any entity that is (1) registered as an investment adviser under the Investment Advisers Act, (2) a bank, similar financial institution or savings association, (3) an insurance company that meets certain qualifications, (4) a broker or dealer registered under the 1934 Act or (5) any entity that the DOL determines is a financial institution in a future exemption.

²³ For purposes of the BIC Exemption, a retail retirement client is referred to as a "retirement investor." A "retirement investor" is (1) a participant or beneficiary of a plan subject to Title I of ERISA or described in § 4975(e)(1)(A) of the Code with authority to direct the investment of assets in his or her plan or take a distribution, (2) the beneficial owner of an IRA acting on behalf of the IRA or (3) a fiduciary of a plan that is a "retail fiduciary" (as defined in fn. 20, above).

As noted above, ERISA and the Internal Revenue Code broadly prohibit fiduciaries from receiving any compensation that could create a conflict of interest, in particular, any compensation paid by a third party, or fees that vary based on the particular investment product recommended. Without the BIC Exemption, many existing types of compensation—including commissions, 12b-1 fees and revenue sharing payments—would be prohibited when received in connection with a recommendation to a retail retirement client.

Changes from 2015 Proposal

The BIC Exemption included in the 2015 proposal was heavily criticized by the financial services industry as being unworkable and overly rigid. In response to these criticisms, the DOL made a number of changes to the BIC Exemption that lessen the compliance burdens imposed by the exemption. These include:

- The requirement to enter into a contract with the retail retirement client has been eliminated for plans covered by Title I of ERISA.
- The procedure for entering into a contract has been streamlined. A contract must be entered into prior to execution of the recommended transaction, rather than prior to making a recommendation, and can be incorporated into account opening documents or agreements.
- A negative consent process is permitted for existing retail retirement clients that eliminates the need for a signed contract but that does not otherwise eliminate the obligations on the financial institution and the adviser to comply with the requirements of the BIC Exemption.
- The BIC Exemption applies to recommendations to invest in any investment product, rather than a specified list of approved assets.²⁴
- Certain required disclosures to the retail retirement client have been eliminated.
- Mechanisms for correcting good faith violations of disclosure conditions were introduced.
- The scope of grandfathering relief has been expanded with respect to advice regarding some investments entered into prior to April 10, 2017.

Despite these concessions by the DOL, as noted below, the BIC Exemption will place substantial recordkeeping and disclosure burdens on financial institutions and change fundamental aspects of the relationship between financial institutions and advisers and retail retirement clients.

Conditions of the BIC Exemption

Broadly, the BIC Exemption allows financial institutions and advisers to receive otherwise prohibited forms of compensation resulting from recommendations made to a retail retirement client as long as:

²⁴ Under the 2015 proposal, only the following assets were covered by the BIC Exemption: bank deposits, certificates of deposit, shares or interests in registered investment companies, bank collective funds, insurance company separate accounts, exchange-traded REITs, exchange-traded funds, corporate bonds offered pursuant to a registration statement under the Securities Act of 1933, agency debt securities, US Treasury securities, insurance and annuity contracts, guaranteed investment contracts and exchange-traded equity securities.

- The financial institution and its advisers adhere to Impartial Conduct Standards, as described below;
- The financial institution adopts and complies with policies and procedures designed to ensure that advisers adhere to the Impartial Conduct Standards; and
- The financial institution complies with certain disclosure and recordkeeping requirements.

With respect to retail retirement clients that are not covered by Title I of ERISA, there is also a requirement that the financial institution enter into an enforceable contract with the retail retirement client in which the financial institution agrees to adhere to Impartial Conduct Standards. An electronic copy of the retail retirement client's contract must be maintained on the financial institution's website and be accessible by the retail retirement client.

The BIC Exemption applies differently to IRAs than it does to plans subject to ERISA, and different procedural requirements apply to new clients and clients of a financial institution that already have an "existing contract" (i.e., an investment advisory agreement, investment program agreement, account opening agreement, insurance contract, annuity contract, or similar agreement or contract that was executed before January 1, 2018, and remains in effect). The differences are highlighted below.

- IRA clients without an existing contract:
 - The financial institution and retail retirement client must enter into an enforceable contract.
 - The contract must include the financial institution's (1) acknowledgement of fiduciary status for both the financial institution and its advisers, (2) agreement that it and its advisers will adhere to Impartial Conduct Standards, (3) warranty of adoption of and compliance with anti-conflict policies and procedures designed to ensure advisers adhere to Impartial Conduct Standards and (4) required disclosures related to services, fees and compensation, and conflicts of interest (which may be provided in the contract or in a separate document).
 - The contract must NOT include any provisions (1) that disclaim or limit the liability of the adviser or financial institution, (2) under which the retail retirement client waives or qualifies the right to bring a class action or other representative action or agrees to liquidated damages (except that a waiver of the retail retirement client's right to punitive damages or rescission of recommended transaction is permissible) or (3) under which the retail retirement client agrees to arbitrate or mediate individual claims in a venue that is distant or that limits the rights of the retail retirement client to assert claims.
 - The contract must be signed (in writing or electronically) prior to or at the same time as execution of the first recommended transaction and may be included with standard account opening documents.
 - The financial Institution must comply with recordkeeping requirements and must notify the DOL of its intention to rely on the BIC Exemption before receiving any compensation in reliance on the BIC Exemption.
- IRA clients with an existing contract:
 - The same requirements set forth above apply, except that the required BIC Exemption contract need not be physically signed by the retail retirement client. A "negative consent procedure" is permitted, allowing the financial institution to deliver a proposed contract amendment, adding the required provisions and removing

any impermissible provisions to the retail retirement client prior to January 1, 2018. Under this procedure, the amended contract may be considered effective if the retail retirement client does not terminate the amended contract within 30 days. Negative consent eliminates the need for a signature from an existing client but does not eliminate the need to comply with the requirements of the BIC Exemption with respect to advice given to existing clients.

▪ Plan clients subject to Title I of ERISA:

- A BIC Exemption contract between the financial institution and the ERISA client is NOT required.
- The financial institution and the adviser must comply with the Impartial Conduct Standards. In addition, the financial institution must (1) provide to the ERISA client a written statement of its and its advisers' fiduciary status, (2) adopt and comply with anti-conflict policies and procedures designed to ensure advisers adhere to Impartial Conduct Standards and (3) provide required disclosures related to services, fees and compensation and conflicts of interest.
- The financial institution and adviser must not, in any contract, instrument or communication, (1) disclaim or limit the liability of the adviser or financial institution if the disclaimer would be prohibited under ERISA, (2) waive or qualify the right of the ERISA client to bring a class action or other representative action or (3) require arbitration or mediation of individual claims in a venue that is distant or that limits the rights of the ERISA client to assert claims. To the extent that an existing agreement with the ERISA client contains such provisions, it would likely have to be amended to comply with the BIC Exemption.
- The financial institution must comply with recordkeeping requirements and must notify the DOL of its intention to rely on the BIC Exemption before receiving any compensation in reliance on the BIC Exemption.

▪ Level Fee:

- Generally, an adviser or financial institution will not be required to rely on the BIC Exemption when fees are level, because neither the financial institution nor the adviser would be exercising discretion in a manner that varies fee income or compensation. In the DOL's view, however, the potential for a conflict of interest exists when an adviser recommends that a participant roll money out of a plan into a fee-based account that will generate ongoing fees (including level fees). When a fiduciary that earns only level fees must rely on the BIC Exemption (generally, in connection with a rollover recommendation), the BIC Exemption provides for streamlined conditions. Under this streamlined approach, the financial institution must give the retail retirement client a written statement of its and its advisers' fiduciary status, and the financial institution and the adviser must comply with the Impartial Conduct Standards. In addition:
 - If the level fee fiduciary recommends a rollover from an ERISA plan to an IRA, the financial institution must document the specific reasons why the recommendation was considered to be in the Best Interest of the retail retirement client. This documentation must include consideration of alternatives to the rollover, the fees and expenses associated with both the plan and the IRA, whether the employer pays for some or all of the plan's administrative expenses and the different levels of services and investments available under each option.

- If the level fee fiduciary recommends a rollover from another IRA or a switch from a commission-based account to a level fee arrangement, the level fee fiduciary must document the reasons why that arrangement is considered to be in the Best Interest of the retail retirement client.

Impartial Conduct Standards and “Best Interest”

As noted above, the BIC exemption requires compliance with the Impartial Conduct Standards. Adherence to the Impartial Conduct Standards means that (1) the financial institution and adviser will provide investment advice that is in the Best Interest of the retail retirement client, (2) the compensation received in connection with the recommended transaction is not in excess of reasonable compensation (within the meaning of ERISA and the Code) and (3) the financial institution and the adviser do not make materially misleading statements to the retail retirement client regarding the recommended transaction, fees and compensation, material conflicts of interest²⁵ and any other matters relevant to a retail retirement client’s investment decisions.

Echoing the provisions of ERISA, the BIC Exemption states that advice is in the Best Interest of the retail retirement client:

“when the adviser and financial institution providing the advice act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person 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, based on the investment objectives, risk tolerance, financial circumstances, and needs of the retail retirement client, without regard to the financial or other interests of the adviser, financial institution or any affiliate, related entity or other party.”²⁶

Additional requirements apply when the financial institution limits investment recommendations based on whether the investments are proprietary products or generate third-party payments.

Policies and Procedures

Each financial institution (other than level fee fiduciaries) must prepare a written document containing policies and procedures designed to ensure compliance with the Impartial Conduct Standards. In formulating its policies and procedures, the financial institution must identify the material conflicts of interest and include measures designed to prevent these conflicts from causing violations of the Impartial Conduct Standards. In addition, the financial institution must designate at least one individual responsible for addressing material conflicts of interest. Finally, the policies and procedures may not require the financial institution to use or rely upon quotas, appraisals, performance or personnel actions, bonuses, contests or other awards or differential compensation that would reasonably be expected to cause advisers to make recommendations that are not in the Best Interest of the retail retirement client.

²⁵ A “material conflict of interest” exists when an adviser or financial institution has a financial interest that a reasonable person would conclude could affect the exercise of its best judgment as a fiduciary in rendering advice to a retail retirement client.

²⁶ The BIC Exemption § VIII, (d).

What Compensation is Permissible

One of the most challenging aspects of applying the BIC Exemption will be determining which compensation practices are impermissible. While the preamble to the BIC Exemption states that the BIC Exemption is “designed to cover a wide variety of current compensation practices that would otherwise be prohibited,” the language of the BIC Exemption itself, and elsewhere in the preamble, implies that certain compensation arrangements may not be allowed. These are significant questions for both the financial institutions involved and the sponsors of funds and other products handled by them and are likely to drive change and innovation in the coming months and years.

The BIC Exemption states that it does not prevent:

“differential compensation (whether in type or amount, and including, but not limited to, commissions)... to the extent that the Financial Institution’s 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 (such compensation practices can include differential compensation based on neutral factors tied to the differences in the services delivered to the Retirement Investor with respect to the different types of investments, as opposed to the differences in the amounts of Third Party Payments the Financial Institution receives in connection with particular investment recommendations).”²⁷

While differential payments are permissible, any compensation arrangements under which the amount paid to advisers is directly based on the amount received by the financial institution as a result of the adviser’s recommendations would likely be impermissible.²⁸

²⁷ The BIC Exemption § II, (d)(3).

²⁸ As the preamble to the BIC Exemption explains in § II, (B)(5)(c)(ii): “While differential payments are permitted, the differentials must reflect neutral factors, not the higher compensation the financial institution stands to gain by recommending one investment rather than another.”

Compensation:

What Will Likely Work; What Likely Will Not

Assuming that the amount of resulting compensation to the financial institution is reasonable and, to the extent the BIC Exemption is required, the appropriate policies and disclosures required by the BIC Exemption are in place, then financial institution fee income and remuneration and adviser compensation will likely sort into the following categories:

<u>What is likely permitted in reliance on the BIC Exemption</u>	<u>What is likely unworkable under the BIC Exemption</u>
<ul style="list-style-type: none"> ▪ Level fees ▪ Asset-based compensation ▪ Level commissions ▪ A set fee schedule, based on the services provided to the retail retirement client, which may be satisfied by payments directly from the retail retirement client or from third-parties ▪ Commissions that vary based on different asset classes and products, assuming an objective basis is available to justify the distinction between the commission rates ▪ Variable compensation based on the difficulty in evaluating and delivering differing products ▪ Variable compensation that rewards advisers based on their adherence to Impartial Conduct Standards ▪ Investment recommendations based entirely on an unbiased computer model created by an independent third party 	<ul style="list-style-type: none"> ▪ Variable pay based solely on the amount of third-party payments ▪ Increased pay based on selecting an investment product that provides the highest third-party payment (e.g., selecting a mutual fund that provides a third-party payment instead of a collective investment trust managed by the same manager that does not provide third-party payments) ▪ Increased pay resulting from the selection of a mutual fund share class that provides the most favorable third-party payments (assuming no other objective basis for selection of the share class) ▪ 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 retail retirement client

Transition Period

As noted above, full compliance with the BIC Exemption is not required until January 1, 2018. From April 10, 2017 to January 1, 2018, the availability of the BIC Exemption is subject to fewer conditions. These conditions are: (1) the financial institution and adviser must comply with the Impartial Conduct Standards, (2) the financial institution must provide a written notice acknowledging its and its advisers' fiduciary status and stating that it and its advisers will comply with the Impartial Conduct Standards and disclose its material conflicts of interest, and (3) the financial institution must disclose any material conflict of interest and whether it receives third-party payments or recommends proprietary products.

Pre-Existing Investments

Compliance with the BIC Exemption is generally required prospectively, i.e., to fiduciary investment advice provided on or after April 10, 2017. In addition, there are fewer conditions for compliance with the BIC Exemption for compensation resulting from advice provided to a retail retirement client after April 10, 2017, if the advice is with respect to an investment acquired prior to April 10, 2017, or acquired pursuant to a recommendation to adhere to a systemic purchase program established prior to that date. The exemption for pre-existing investments is subject to

the following conditions: (1) the compensation received is pursuant to an arrangement entered into prior to April 10, 2017, which has not expired or come up for renewal after April 10, 2017; (2) the transaction was not otherwise prohibited under ERISA or the Code when it was entered into; (3) the compensation is not received in connection with a recommendation to acquire additional amounts in the pre-existing investment (except for certain exchange privileges); (4) the amount of compensation received by the adviser is reasonable; and (5) investment advice provided after April 10, 2017 is in the Best Interest of the retail retirement client.

The Principal Transaction Exemption

In General

The Principal Transaction Exemption (the “PT Exemption”) allows a financial institution to purchase or sell certain assets in “principal transactions” or “riskless principal transactions” with plans, plan accounts or IRAs, and to receive a mark-up, mark-down or other similar payments as a result of the advice of the financial institution or one of its advisers regarding the transaction. This exemption does not apply if (1) the financial institution or one of its advisers has or exercises discretionary authority over the assets of, or administers, the relevant plan, plan account or IRA or (2) the plan is covered by ERISA and the financial institution is the employer of covered employees or a named fiduciary or plan administrator of the plan.²⁹

For purposes of the PT Exemption:

- A “principal transaction” occurs when a financial institution is purchasing from or selling to a plan, plan account or IRA “principal traded assets” for its own account.
- A “riskless principal transaction” occurs when a financial institution, having received an order from a retirement investor to buy or sell a “principal traded asset,” purchases or sells the asset for the financial institution’s own account to offset the contemporaneous transaction with the retirement investor.³⁰
- “Principal traded assets” are (1) for purposes of a purchase by a plan, plan account or IRA limited to: (i) a debt security,³¹ (ii) a certificate of deposit, (iii) interests in a unit investment trust or (iv) an investment that is permitted

²⁹ Like the BIC Exemption, the PT Exemption is only available to advisers that became fiduciaries by providing “investment advice for a fee,” work for a financial institution and satisfied the federal and state regulatory and licensing requirements of insurance, banking and securities laws with respect to the covered transaction. A financial institution is defined in the PT Exemption as the entity that employs the adviser or otherwise retains such individual as an independent contractor, agent or registered representative and customarily purchases or sells principal traded assets for its own account in the ordinary course of its business, and that is: (1) registered as an investment adviser under the Investment Advisers Act, (2) a bank, similar financial institution or savings association or (3) a broker or dealer registered under the 1934 Act.

³⁰ For purposes of the PT Exemption, a “retirement investor” means (1) a fiduciary of a non-participant directed plan subject to Title I of ERISA or described in § 4975(c)(1)(A) of the Code with authority to make investment decisions for the plan, (2) a participant or beneficiary of a plan subject to Title I of ERISA or described in § 4975(c)(1)(A) of the Code with authority to direct the investment assets in his or her account or to take a distribution or (3) the beneficial owner of an IRA acting on behalf of the IRA.

³¹ The PT Exemption defines “debt security” as a “debt security” under Rule 10b-10(d)(4) of the 1934 Act, that is: (1) US dollar denominated, issued by a US corporation and offered pursuant to a registration statement under the Securities Act of 1933, as amended; (2) an “Agency Debt

to be purchased under an individual prohibited transaction exemption granted by the DOL after the effective date of this exemption, that permits investment advice fiduciaries to engage in a transaction with a plan or IRA under the same conditions as the PT Exemption and (2) for purposes of a sale by a plan, plan account or IRA, securities or other investment property.

Changes from the 2015 Proposal and Exemption Conditions

As with the BIC Exemption, the DOL revised the requirements of the PT Exemption contained in the 2015 proposal to ease implementation and make compliance less burdensome. Specifically, the following notable changes were made:

- The PT Exemption's scope was expanded to cover interests in unit investment trusts and certificates of deposit.
- The requirements to obtain two quotes in connection with best execution and to disclose mark-ups and mark-downs were eliminated.

The conditions required to satisfy the PT Exemption mirror the conditions required to satisfy the BIC Exemption, with the following differences:

- The Impartial Conduct Standards require the financial institution seek to obtain the best execution reasonably available under the circumstances with respect to the transaction. Financial institutions that are FINRA³² members may satisfy the best execution requirements by complying with FINRA's rule on Fair Prices and Commissions (Rule 2121) and on Best Execution and Inter-positioning (Rule 5310).
- The PT Exemption does not require any disclosure of a covered transaction to the DOL.
- The financial institution must warrant to the retirement investor that the financial institution's written policies and procedures regarding transactions address how credit risk and liquidity assessments for debt securities will be made.
- Disclosures: Financial institutions must make various disclosures to retirement investors to satisfy the PT Exemption.
 - Contract Disclosures: For each transaction, the PT Exemption requires that financial institutions make specific disclosures to retirement investors to ensure that they appropriately authorize the transaction. The disclosures may be contained in the contract or in a separate single written disclosure provided to the retirement investor prior to, or at the same time as, the execution of the transaction. Unlike the pre-transaction disclosure discussed below, the contract disclosure may cover multiple recommendations. These disclosures include a description of (1) the circumstances when the adviser or financial institution may engage in transactions, (2)

Security" as defined in FINRA rule 6710(l) or its successor; (3) an "Asset Backed Security" as defined in FINRA rule 6710(m) or its successor, that is guaranteed by an Agency as defined in FINRA rule 6710(k) or its successor, or a Government Sponsored Enterprise as defined in FINRA rule 6710(n) or its successor; or (4) a "US Treasury Security" as defined in FINRA rule 6710(p) or its successor.

³² FINRA means the Financial Industry Regulatory Authority.

the compensation received in connection with transactions and (3) conflicts of interest associated with transactions. The disclosures must also note that consent to the transaction is terminable at will upon written notice and without penalty and state that the retirement investor may obtain copies of the financial institution's policies and procedures with respect to transactions, as well as information about the principal traded assets, free of charge. Finally, retirement investors must be informed that the financial institution will review model disclosures no less frequently than quarterly, that the disclosures will be maintained on the financial institution's website and as to the degree to which the financial institution will monitor the retirement investor's investments acquired through transactions, alert the retirement investor as to recommended investments and if so, how often monitoring will occur and reasons for which retirement investors will be alerted.

- Pre-Transaction Disclosure: Prior to or concurrently with the execution of each transaction, the financial institution must inform the retirement investor (orally or in writing) of the capacity in which the financial institution may act with respect to the transaction.
- Confirmation: The financial institution must provide written confirmation of the transaction.
- Annual Disclosure: Financial institutions must send retirement investors disclosure at least annually that lists the covered transactions executed for the retirement investor. This disclosure must state that (1) the contractual consent required is terminable at will upon written notice and without penalty, (2) the retirement investor may obtain information about the covered transactions free of charge, (3) model disclosures are reviewed by the financial institution no less than quarterly, updated within 30 days, if necessary, and maintained on the financial institution's website and (4) the financial institution maintains a description of its policies and procedures designed to ensure compliance with the Impartial Conduct Standards which are available on its website free of charge.

Additional General Conditions

The PT Exemption explicitly states that a covered transaction may not be part of an arrangement designed to evade compliance with ERISA or the Code or to otherwise impact the value of the principal traded asset. Records of transactions must be maintained by financial institutions for six years, and purchases or sales of a principal traded asset must be made for cash.

With respect to purchases of debt securities by a plan, plan account or IRA, the debt security being purchased cannot have been issued by the financial institution or its affiliate and cannot be purchased by the plan, plan account or IRA in an underwriting or underwriting syndicate in which the financial institution or an affiliate is an underwriter or member. Using information reasonably available to the financial institution at the time of the transaction, the financial institution must determine that the debt security being purchased possesses no greater than moderate credit risk and is sufficiently liquid so that it could be sold at or near its carrying value within a reasonable period of time.

Transition Period

As with the BIC Exemption, full compliance with the PT Exemption is not required until January 1, 2018.

Amendments to Pre-Existing Prohibited Transaction Exemptions

The DOL has revised certain long-standing PTEs in consideration of the changes to the industry that will result from the rule. The revisions to these PTEs are described in Appendix A.

Risk of Increased Litigation

Reliance on the BIC Exemption or other exemptions that incorporate the Best Interest and Impartial Conduct Standards will likely increase the risk of litigation to financial institutions and advisers who provide investment advice to retail retirement clients. There are a number of reasons for this increased risk:

- Advisers who were previously unaccustomed to ERISA compliance will need to retool certain of their commercial practices to comply with the rule and the requirements of each applicable exemption.
- Exculpatory language in contracts with retail retirement clients must be eliminated.
- Remote arbitration venues are not allowed.
- The right to participate in class-action lawsuits cannot be waived by contract.
- Compliance with the BIC Exemption is principles-based, and the workability of certain pay practices may ultimately be determined only through litigation.
- The requirement to disclose fee arrangements and compliance policies on a web site may make it more likely that practices will be targeted by plaintiff's lawyers.
- The process of moving from the "old" regime to the "new" one may engender complaints by retail retirement clients.

Over the longer term, these litigation risks may affect the pricing of services and may limit the range of services offered to retail retirement clients by financial institutions for which the retail market is not a core part of their business.

Conclusion

The DOL's revisions to the final rule reduced a number of the transition and implementation burdens on financial institutions, particularly for compliance with the BIC and PT Exemptions. However, the rule will still have a profound and, if it survives any ensuing court challenges, lasting effect on the retail retirement market and the business of many financial institutions. The rule dramatically extends the scope of ERISA to vast segments of the retirement market that did not exist at the time of ERISA's adoption. In this respect, the rule represents a paradigm shift that is akin to the passage of ERISA itself.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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Amendments to Pre-Existing Prohibited Transaction Exemptions

These amendments (and partial revocations) to long-standing PTEs are applicable to transactions occurring after April 10, 2017.

Amendment to PTE 75-1, Part V

PTE 75-1 permits the extension of credit to a plan or an IRA by a broker-dealer in connection with the purchase or sale of securities. Currently, PTE 75-1 does not permit the receipt of compensation for an extension of credit by broker-dealers that are fiduciaries of the assets involved in transaction. The amendment to PTE 75-1, Part V permits broker-dealers that are investment advice fiduciaries to receive reasonable compensation when they extend credit to plans and IRAs solely for the purpose of avoiding a failed securities transaction.

To rely on the amendment to PTE 75-1, Part V:

- The potential failure of the purchase or sale of the securities may not be caused by broker-dealer or its affiliates;
- The terms of the extension of credit must be at least as favorable to the plan or IRA as the terms available in an arm's length transaction between unaffiliated parties; and
- The plan or IRA must receive written disclosure of certain terms prior to the extension of credit.

Amendment to and Partial Revocation of PTE 86-128; Amendment to and Partial Revocation of PTE 75-1

- PTE 86-128 allows fiduciaries to receive compensation from plans and IRAs in connection with certain securities transactions (under Part 1(a) of PTE 86-128) and mutual fund transactions (under Part 1(b) of PTE 86-128). Under the amended PTE, investment advice fiduciaries to IRAs will not be able to rely on Part 1(a) of PTE 86-128 and no fiduciary to an IRA will be able to rely on Part 1(b) of PTE 86-128. Going forward, these fiduciaries will have to rely on the BIC Exemption. Further, those fiduciaries that are permitted to rely on the amended PTE 86-128 will have to comply with its new conditions, which include the Impartial Conduct Standards.
- The amendment provides that the compensation permitted under PTE 86-128 is limited to "commissions," which is defined as a brokerage commission or sales load paid for the service of effecting or executing the transaction, but not 12b-1 fees, revenue sharing payments, marketing fees, administrative fees, sub-TA fees or sub-accounting fees. For Section 1(a) transactions, commissions must be paid directly from the plan or IRA. For Section 1(b) transactions, commissions may also be paid by the mutual fund.
- Revocation of Parts I(b) and I(c) and Part II(2) of PTE 75-1.
 - Part I(b) provided relief under § 406 of ERISA for the effecting of securities transactions by parties in interest.
 - Part I(c) provided relief under § 406 of ERISA for the furnishing of advice regarding securities to a plan or IRA by a party in interest under circumstances that do not make the party in interest a fiduciary.

- Part II(2) provided relief for the purchase or sale by a plan of securities issued by an open-end investment company, as long as the fiduciary of the plan who made the decision is not a principal underwriter or affiliated with the investment company.

Amendment to and Partial Revocation of PTE 84-24

- As amended, PTE 84-24 provides relief for certain transactions that occur when investment advice fiduciaries and other service providers receive compensation for recommendations that plans or IRAs purchase fixed rate annuity contracts and insurance contracts. The exemption permits investment company principal underwriters and certain other persons that are parties in interest or fiduciaries with respect to plans or IRAs to effect these purchases and receive a commission.
- Fiduciaries relying on PTE 84-24 must adhere to certain Impartial Conduct Standards, including acting in the Best Interest of the plans and IRAs. The amendment also defines the types of payments that are permitted and revises the recordkeeping and disclosure requirements of PTE 84-24.