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Department of Labor Releases the First of Three Sets of FAQs on the Fiduciary Rule and Exemptions

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The April 10, 2017, compliance date for the United Stated Department of Labor's ("DOL") new fiduciary rule (the "Fiduciary Rule")[1] is approaching quickly; even while the Fiduciary Rule's fate under the new Trump administration is uncertain. While likely to be revisited in some form, the timing and extent of modifications to the Fiduciary Rule, if any, are uncertain. Therefore, it would be prudent for market participants to continue to plan to be in full compliance by April 10, 2017, and stay informed on Fiduciary Rule developments. In that connection, below are some of our thoughts on DOL's most recent guidance.

Article By Robert L. Sichel
Kristina M. ZanottiDavid R. McCandless
K&L GatesK&L Gates HUB

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The DOL recently issued Part 1 of what we anticipate will be a three-part list of frequently asked questions ("FAQs") related to the Fiduciary Rule.[2] Part 1 provides guidance on the best interest contract exemption ("BIC Exemption"), Principal Transactions Exemption, and other Prohibited Transaction Exemptions ("PTEs") amended as part of the regulatory package released in connection with the Fiduciary Rule, as well as the types of compensation that financial institutions and their representatives may receive under the exemptions. These exemptions are key to understanding the impact of the Fiduciary Rule and how to comply, as they allow firms that have expanded fiduciary obligations under the Fiduciary Rule to continue receiving a variety of common forms of compensation as long as they meet certain conditions.

Some key takeaways from the FAQs:

- According to the FAQs, the compliance date of the Fiduciary Rule will not be delayed, as had been requested by some industry participants. The Fiduciary Rule will apply April 10, 2017.[3] The BIC Exemption and Principal Transactions Exemption will continue to be subject to a transition period during which certain conditions will not be applicable until January 1, 2018.

- The DOL provided guidance on structuring compensation regimes for advisers where financial institutions are relying on the full BIC Exemption.[4] The DOL also provided guidance on recruitment bonuses.[5] See further discussion below.

- The streamlined "level fee fiduciary" conditions of the BIC Exemption (the "Level Fee Fiduciary Exemption") will not be available if the fiduciary (at any level—adviser, financial institution, or affiliate) receives third-party payments such as 12b-1 fees and revenue-sharing payments in connection with the advisory or management program, even if such payments are the same amount or percentage for each investment offered.[6] Selling only proprietary investments for which the financial institution pays the same commission to advisers would also not be a "level fee" program.[7]

- A fiduciary relying on the Level Fee Fiduciary Exemption must document the reason why the advice that was given was considered to be in the best interest of the retirement investor. To satisfy this requirement, the adviser and financial institution must make diligent and prudent efforts to obtain information on the existing plan. If the financial institution cannot obtain the necessary information, it can rely on "alternative data sources," which may include the most recent Form 5500 for the plan or reliable benchmarks on typical fees and expenses for the type and size of plan at issue, subject to certain conditions.[8] DOL also noted that fiduciaries need to perform this same type of prudent analysis and documentation regardless of whether the fiduciary is a "level fee" fiduciary or complying with the full BIC Exemption.

- A financial institution may offer both "level fee" accounts and "commission-based" accounts and may use either the Level Fee Fiduciary Exemption or the full BIC Exemption as appropriate with respect to its recommendation into which program a retirement investor should place its assets.[9]

- While the BIC Exemption does not provide an exemption for prohibited transactions involved in operating a discretionary management program, it *can* be used to recommend that a retirement investor enter or rollover to such a program.[10] If the discretionary manager meets the definition of a "level fee fiduciary," the manager can use the Level Fee Fiduciary Exemption to recommend a rollover.[11]

- With respect to robo-advice, the full BIC Exemption does not cover advice provided solely by a computer.[12] However, a human being making a recommendation to a retirement investor to enter a robo-advisory program should be able to rely on the full BIC Exemption. Further, robo-advisers that are level fee fiduciaries may use the Level Fee Fiduciary Exemption.

- A financial institution may "discount" its prices and still rely on the full BIC Exemption, provided the starting price is itself reasonable and assuming that the discounts are not used in a manner that reintroduces conflicts of interest.[13]

- Although only explicitly addressed in the context of bank networking arrangements, the DOL offered a hint that the exclusion for "hire me" discussions may be slightly broader than previously thought. The DOL indicated that because only a recommendation of *other* persons to provide investment advice or management services constitutes fiduciary investment advice, marketing oneself or an affiliate (when it is disclosed as such), without otherwise making an investment recommendation covered by the Fiduciary Rule, does not constitute investment advice. Thus, referrals to affiliates who are providers of investment products would generally not be considered fiduciary investment advice. Because the DOL caveats this statement with the requirement that a referral must not separately contain a covered recommendation, it is difficult to know where referring entities can draw the line between marketing and advice.[14]

- Insurance companies may continue to distribute annuities through independent insurance agents and independent marketing organizations ("IMOs"). However, the DOL stated that an appropriate exemption for annuity sales (PTE 84-24 or the BIC Exemption, as applicable) would be required. The full BIC Exemption requires that a "financial institution" execute the best interest contract and exercise supervisory authority over advisers.[15] Currently, IMOs are not treated as financial institutions. Therefore, the insurance company (or other enumerated financial institution) would need to be responsible for ensuring that the exemption's conditions are met and that investment advice to buy the insurer's products is in the best interest of retirement investors.[16] IMOs may apply to be treated as financial institutions, and the DOL noted that it has several such applications under consideration.

- Under the full BIC Exemption, a financial institution must maintain an electronic copy of the retirement investor's contract on a website. The best practice is to maintain an executed copy of the retirement investor's individual contract on the website that is accessible by the retirement investor. The DOL confirmed that a financial institution may maintain a model contract on the website instead, provided it does not vary across a class of customers and includes an acknowledgement that the financial institution is bound by the terms of the model contract in its dealings with customers.[17]

- Transactional disclosures required by the full BIC Exemption are required only in connection with recommendations to purchase investment products, and not for recommendations to hold or sell.[18] Disclosures in connection with recommended transactions should generally be provided as of the date of the recommendation (and not the date of the anticipated execution), unless specifically requested by the client.[19]

- Dividend reinvestment programs are "systematic purchase programs" that are eligible for grandfathering relief under the BIC Exemption.[20] Advice to deposit additional moneys into a grandfathered plan will not be grandfathered; however, that deposit will not cause the compensation attributable to the assets that predated the Fiduciary Rule to lose its grandfathered status.[21] Similarly, advice to sell an asset that was purchased before the applicability date is grandfathered.[22]

- Purchases by plans of principal traded assets under the Principal Transactions Exemption are limited to a few enumerated classes of investments; however, advisers and financial institutions may amend the

Principal Transactions Exemption through the individual exemption process. If the DOL grants an individual exemption for a product to be traded on a principal basis, such relief will be built into the Principal Transactions Exemption and available to all.[23]

As April 10, 2017, fast approaches, the Fiduciary Rule and related exemptions and amendments to current prohibited transactions exemptions present a daunting challenge to advisers and financial institutions. Nevertheless, the DOL took an encouraging and cooperative tone in stating that its general approach to implementing the new rule and exemptions will be marked by an emphasis on assisting (rather than citing violations and imposing penalties on) plans, plan fiduciaries, financial institutions, and others who are working diligently and in good faith to understand and come into compliance with the new rule and exemptions.[24]

Compensation Grids and Recruitment Bonuses

Financial institutions planning to rely on any of the exemptions need to consider how fees and compensation structures will change. While compliance with the full BIC Exemption allows the receipt of certain variable compensation, the BIC Exemption provides that financial institutions cannot "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."[25] In the FAQ, the DOL states that financial institutions may continue to pay higher commission rates to advisers based on volume (e.g., using an escalating grid under which the percentage commission paid to the adviser increases at certain thresholds) if they are not intended or reasonably expected to cause advisers to make recommendations that are not in the best interest of retirement investors and they do not cause advisers to violate the reasonable compensation standard.[26] The DOL recommended the following factors in developing an escalating grid that conforms to the requirements:

1. to avoid incentivizing advisers to make investment recommendations that are not in the retirement investor's best interest, firms should carefully consider the amounts used as the basis for calculating adviser compensation to avoid transmitting firm-level conflicts to the adviser;

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3. grids should be designed with one or several modest or gradual increases rather than large increases, which the DOL believes might enable an adviser to disproportionately increase his or her compensation as the adviser reaches the threshold;

4. to reduce conflicts of interest, as the adviser reaches a threshold on the grid, any resulting increase in the adviser's compensation rate should generally be prospective – the new rate should apply only to new investments made once the threshold is reached;

5. firms should establish a system of oversight to monitor for conflicts and supervise adviser recommendations, both at or near compensation thresholds and at a greater distance.[27]

Similarly, the DOL stated that recruitment bonuses or awards to an adviser by a financial institution must be appropriately structured to comply with the BIC Exemption. In broad terms, the DOL stated that the full BIC Exemption permits "signing" or "front-end" awards, which are not tied to the movement of accounts or assets to the firm or on achievement of particular asset or sales targets, but rather are paid as a fixed sum contingent on the adviser's continued service in good standing at the financial institution.[28] By contrast, the DOL considers "back-end" awards, which are expressly contingent on the adviser's achievement of sales or asset targets, to create acute conflicts of interest that are inconsistent with the full BIC Exemption's impartial conduct standards.[29] The DOL will permit a limited exception for nonconforming bonus and signing regimes for agreements with advisers that predate the FAQs; however, the financial institution must engage in stringent oversight of the adviser for the remainder of the contract term and must adopt special policies and procedures reasonably and prudently designed to ensure that individual advisers adhere to the exemption's impartial conduct standards.[30]

Notes:

[1] Department of Labor, Definition of the Term "Fiduciary": Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016) (29 C.F.R. Pts. 2509, 2510, 2550).

[2] The FAQs are available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-

and-exemptions-part-1.pdf. For our earlier analysis of the Fiduciary Rule, see our client alert titled “DOL Finalizes The ERISA Fiduciary Regulation -- What It Means For Your Business”, .

[3] FAQ Q1, Q2.

[4] As it was used in the FAQs, the term “full BIC Exemption” describes the relief that is subject to the BIC Exemption’s full conditions, as distinguished from the relief provided for “level fee fiduciaries,” subject to more streamlined conditions. FAQ Q9.

[5] FAQ Q12.

[6] FAQ Q18.

[7] FAQ Q19.

[8] FAQ Q14.

[9] FAQ Q16.

[10] FAQ Q6, Q7, Q8.

[11] FAQ Q16.

[12] FAQ Q10.

[13] FAQ Q11.

[14] FAQ Q20.

[15] FAQ Q22.

[16] FAQ Q22, Q23.

[17] FAQ Q24.

[18] FAQ Q26.

[19] FAQ Q27.

[20] FAQ Q28.

[21] FAQ Q29.

[22] FAQ Q30.

[23] FAQ Q31.

[24] FAQ Q34.

[25] FAQ Q9.

[26] FAQ Q9.

[27] FAQ Q10.

[28] FAQ Q12

[29] FAQ Q12

[30] FAQ Q12

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