

Department of Labor Final Fiduciary Regulation

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Overview

- Fiduciary Rule
 - Final Rule
 - Best Interest Contract Exemption
 - Other Exemptions
 - Litigation

ERISA Background

- ERISA § 3(21) defines “fiduciary”
 - Investment advice fiduciary is one type of fiduciary
 - *giving advice*
 - *to a plan*
 - *for a fee or other compensation*
 - In 1975, DOL established a five-part test:
 - Required “ongoing and mutual relationship”
 - Required “individualized” advice
- Why DOL re-wrote the rules

Fiduciary Investment Advice, Circa 2016

- DOL redefines Fiduciary Investment Advice
 - Investment advice fiduciary is still one type of fiduciary
 - In 2016, DOL re-defines fiduciary advice as:
 - *recommendation*
 - *to a plan or IRA*
 - *for a fee or other compensation*
 - *relating to certain financial transactions*
 - Does not require ongoing or mutual agreement
 - written or verbal “understanding”
 - Does not require individualized advice
 - “based on” or “directed to” participant’s needs

Fiduciary Investment Advice

1975 vs. 2016

1975

1. Fiduciary advice =
 - Investment advice
 - to a plan
 - for a fee
2. Advice is *individualized* to participant
3. Requires *ongoing and mutual relationship*
 - Excludes one-time advice
4. Narrow definition of covered financial transactions
 - Buy, sell or hold plan assets
 - Excludes rollovers

2016

1. Fiduciary advice =
 - Investment *recommendation*
 - to a plan *or IRA*
 - for a fee or other compensation
2. Advice is *based on or directed to* participant
3. Requires only *written or verbal understanding*
 - Includes one-time advice
4. Broad definition of covered financial transactions
 - Buy, sell, hold, rollover or transfer
 - Asset management
 - Provision of investment list
 - Includes rollovers



Recommendation

- What is a Recommendation?
 - DOL definition:
 - “A communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from a particular course of action”
 - Objective, reasonable person standard
 - The more individually tailored to a specific recipient, the more likely it will be considered a recommendation
- Examples:
 - Whether to buy, sell, or hold investments
 - Whether to roll over or transfer assets
 - How to invest following rollover
 - How to manage plan assets
 - Portfolio composition, adviser selection, investment strategy
 - Presentation of curated list of investments



Fee or Other Compensation

- What is a Fee or Other Compensation?
 - Any payment – direct or indirect – incident to the transaction in which investment advice is rendered.
 - May raise concern for existing vendors who want to pitch a new product or service to the plan
- Sales commissions
- Loads
- Finder's fees
- Revenue sharing payments
- Shareholder servicing fees
- Marketing or distribution fees
- Underwriting compensation
- Payments to brokerage firms in return for shelf space
- Recruitment compensation
- Gifts and gratuities
- Expense reimbursements

Implications for Plan Sponsors: Vendor Management

- Fiduciary Fundamentals
 - Plan Sponsor is still a fiduciary
 - Plan Sponsor is still liable for duty to select and monitor qualified service providers
- Watch Out for Updated Vendor Agreements
 - Existing vendors now may be fiduciaries
 - Potential co-fiduciary liability
 - Limitations on vendor liability
 - Seek representations, indemnifications from vendor
 - Ex: Record-keeper who provides distribution counseling
- Watch Out for New Hidden Fees
 - Vendors who are tagged as fiduciaries may seek additional fees
 - Vendors who avoid fiduciary status may seek to make up for lost downstream income

Implications for Plan Sponsors: Employee Relations

- Participant Communications
 - Review call center scripts
 - Review investment materials
 - Basic information about retirement, investments – ok
 - Widely distributed newsletters – ok
 - Avoid targeted mailings
- Distribution Counseling
 - Review what your vendors are doing
 - Election forms, counseling, etc.
- Investment Education
 - Mostly the same as IB 96-1
 - Plan info
 - General financial info
 - Asset allocation models and interactive materials
 - May face heightened liability for monitoring service provider compliance with new conditions

BIC Exemption

- A kinder, gentler BIC?
- Broader coverage
 - Available to cover both plan-level and participant/IRA holder advice
- Less onerous contract formation
- Fewer IT intensive disclosures
- Remains true to DOL's "North Star"
 - Enforceable "best interest" standard of conduct



BIC Relief Elements

- Fiduciary Acknowledgement
- Impartial Conduct Standards
 - Prudence and loyalty
 - Reasonable compensation
 - No materially misleading statements



BIC Relief Elements

- Warranties
 - Adoption of policies and procedures
 - Identification of material conflicts and BIC compliance officer
 - No use of quotas, appraisals, etc. except to the extent designed to avoid a misalignment of interests
- Disclosures
 - In writing
 - At or prior to execution of transaction
 - Good faith errors curable within 30 days



BIC Relief Elements

- Ineligible contract provisions
 - Disclaim or limit financial institution's or advisor's liability
 - Require waiver or qualification of investor's right to participate in class action
 - Require mediation of claims in unreasonable or distant venues
- Permissible limitations
 - Mandatory arbitration for non-class actions
 - Punitive damages
 - Right of rescission



BIC Web Disclosure

- Freely accessible to public
- Updated quarterly
- Discussion of business model and material conflicts
- Typical account fee schedule
- Written description of policies and procedures
- List of all product manufacturers and other parties providing third party payments
- Compensation and incentive arrangements for advisors

Good faith errors may be cured within 7 days



Pathway 1 – IRA Investors

- Bilateral contract to cover advice to IRA investors
- Requires all of the relief elements
 - Fiduciary acknowledgement
 - Impartial conduct standards
 - Warranties
 - Disclosures
 - Absence of ineligible provisions
- Manual or e-signature of client needed for new accounts
- Negative consent procedure for contracts in place prior to January 1, 2018



Pathway 2 – ERISA Plans

- Same as pathway 1
- Except no bi-lateral contract required
- Reason – ERISA already contains enforcement rights
- Significant development from 2015 proposal, which would have required contracts for advice to IRAs and ERISA plans

Pathway 3 – “BIC Lite”

- Level fee fiduciaries
 - Levelized for advisor and financial institution, i.e., based on fixed percentage of value of assets or does not vary with investment recommended
 - No indirect compensation (?)
- BIC elements required
 - Fiduciary acknowledgement
 - Impartial conduct standards
- Elements not required
 - Warranties
 - Disclosures
- Special Requirement
 - Financial institution must document why a rollover recommendation or a switch from a commission-based to a level fee arrangement is in investor’s best interest



Proprietary Products

- Investor is provided with written disclosure of restrictions
- Investor is fully informed of material conflicts
- Financial Institution reasonably concludes restrictions will not cause imprudent recommendations
- Compensation is reasonable
- Advisor's recommendation is not based on advisor's own financial interest or interests other than investment objectives, risk tolerance, financial circumstances and needs of investor



Amendments to Existing Exemptions – PTE 84-24

- Scope of relief is now significantly narrowed
- No longer covers variable or fixed indexed products for Plans or IRAs
- Now available only (including in the rollover context) for -
 - Receipt of Insurance Commissions (narrowly defined) on fixed rate annuity contracts and insurance contracts (IRAs and plans)
 - Receipt of Mutual Fund Commissions (narrowly defined) (plans)



Amendments to Existing Exemptions – PTE 84-24

- New definitions of “Insurance Commission” and “Mutual Fund Commission”
 - Only a traditional “sales commission” is covered
 - Effect: Receipt of revenue sharing, 12b-1 fees, administrative fees, or marketing fees in connection with plan investments in funds not permitted



Amendments to Existing Exemptions – PTE 84-24

- “Reasonable compensation” - now tracks standards set forth in section 408(b)(2) of ERISA
- Includes new “Impartial Conduct Standards” (see above discussion regarding “BIC exemption”)



New Exemption for Principal Transactions

- Provides ERISA section 406(a) and 406(b) relief for a principal transaction between a Retirement Investor and a Financial Institution, including –
 - The purchase by a Retirement Investor from a Financial Institution of Debt Securities, UITs and CIDs, on the recommendation of the Adviser or Financial Institution
 - The sale of “securities or other investment property” by the Retirement Investor to the Financial Institution on the recommendation of the Adviser or Financial Institution
 - Purchases and sales in riskless principal transactions



New Exemption for Principal Transactions

Conditions (BIC-like)

- Written contract for IRAs (executed prior to transaction, not advice)
 - Fiduciary status
 - Impartial Conduct Standards (including best execution)
 - Disclosures & Warranties
- No contract required for Plans (but similar conditions)



New Exemption for Principal Transactions

- Disclosure
 - Pre-transaction, as to capacity in which financial institution will act with respect to the transaction
 - Confirmations of the transactions
 - Annual lists of executed transactions, statement that Retirement Investor's consent to such transactions is terminable, right of investor to obtain details regarding assets, model contract disclosures/model notice of contractual terms, description of financial institution's policies and procedures with respect to Impartial Conduct Standards
 - on request
- Exclusions
 - Adviser or Financial Institution is discretionary fiduciary
 - Adviser or Financial Institution is sponsor or named fiduciary or ERISA section 3(16) plan administrator (certain circumstances)



Amendments to Existing Exemptions – PTE 86-128

- Historically, this PTE was used in 2 ways
 - Affiliated Brokerage: Advice or discretionary fiduciary recommended or selected affiliated broker to execute plan or IRA trades (and broker receives commissions)
 - Mutual Funds: Fiduciary recommended or selected unaffiliated mutual funds for plan or IRA, effected purchase of mutual fund shares and received revenue sharing or other third party payments



Amendments to Existing Exemptions – PTE 86-128

Now...

- Affiliated Brokerage
 - Limited for IRAs
 - Must be discretionary (and not advice) fiduciary
 - All conditions now apply
 - “Related Entities” may receive commissions
 - Narrow definition of “commission” eliminates revenue sharing
 - Commissions must be received directly from plan or IRA
- Mutual Funds
 - Adds new mutual fund exemption (replacing 75-1, Part II)
 - Not available for IRAs
 - Includes most of PTE 75-1 conditions as well as most of the PTE 86-128 conditions re “affiliated brokerage”
 - Applies only to purchase of mutual fund shares
 - Narrow definition of “commission” eliminates revenue sharing
 - Commissions may be received from plan or mutual fund



Amendments to Existing Exemptions – PTE 75-1, Part II(2)

- PTE 75-1, Part II(2) –
 - Section 2: Revoked (See amended PTE 86-128)
 - No longer available to cover revenue sharing on unaffiliated fund purchases/recommendations



Amendments to Existing Exemptions – PTE 75-1, Parts I and V

- PTE 75-1 Part I
 - Revoked Part I(b) and I(c) relating to broker's non-fiduciary advice and services
 - Duplicative of section 408(b)(2)
- PTE 75-1 (Part V)
 - Expanded to permit an advice fiduciary to receive reasonable compensation for extending credit to a Plan or IRA to avoid a failed purchase or sale of securities
 - Several conditions apply



Amendments to Other Existing PTEs

Added Impartial Conduct Standards to

- PTE 75-1(Part III)(underwritings)
- PTE 75-1 (Part IV)(market-makers)
- PTE 77-4 (purchase of affiliated mutual fund shares)
- PTE 80-83 (using proceeds from securities' sale to retire issuer's debt)
- PTE 83-1 (mortgage pool trusts)



Litigation Challenging Final Fiduciary Regulation

- Five lawsuits filed to date against DOL and Secretary of Labor, Thomas Perez
- Lawsuits challenge constitutionality and validity of Fiduciary Regulation and accompanying exemptions
- Assert claims under the Administrative Procedures Act, the Regulatory Flexibility Act, and the First and Fifth Amendments of the Federal Constitution
- Three cases in Texas, one in DC, and one in Kansas



Litigation Challenging Final Fiduciary Regulation

- *Chamber of Commerce of the U.S.A., et al. v. Thomas E. Perez et al.*, Case No. 16-cv-1476 (N.D. TX)
- *American Council of Life Insurers, et al. v. U.S. Department of Labor, et al.*, Case No. 16-cv-1530 (N.D. TX)
- *Indexed Annuity Leadership Council v. Thomas E. Perez et al.*, Case No. 16-cv-1537 (N.D. TX)
- *The National Association for Fixed Annuities v. Thomas E. Perez et al.*, Case No. 16-cv-1035 (D.D.C.)
- *Market Synergy Group Inc. v. U.S. Department of Labor, et al.*, Case No. 16-cv-40830 (D.KS)