

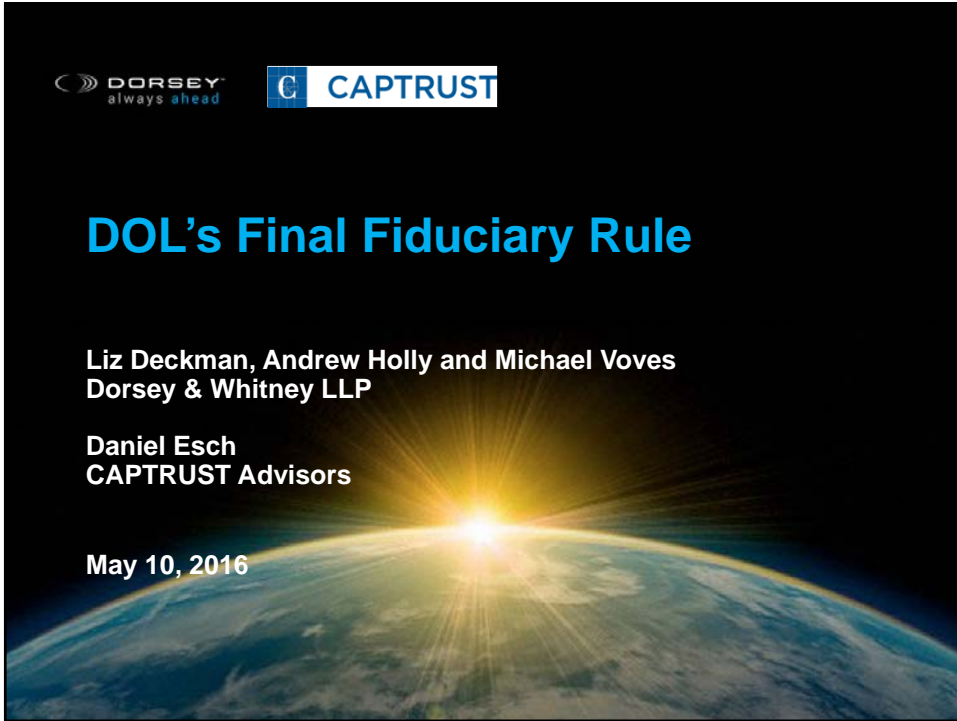


DOL's Final Fiduciary Rule

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May 10, 2016



Overview

Background

Investment Advice Overview

Prohibited Transactions Overview



When Will the Fiduciary Rule Be Effective?

- The regulation does not become effective until April 10, 2017
- Some provisions do not become effective until January 1, 2018

Background

- **Employee Retirement Income Security Act (ERISA)**
 - Enacted in 1974
 - Amended the Labor laws to add provisions governing employee benefit plans
 - Amended the Internal Revenue Code to add provisions governing employee benefit plans, but scope of certain rules also applies to IRAs
 - ERISA imposes fiduciary standards and prohibited transaction rules
 - ERISA violations trigger monetary penalties and personal liability

Background

- **NOTE!**
 - **Internal Revenue Code (Code)**
 - Contains a similar, but not identical set of prohibited transaction rules
 - Presidential order gives DOL authority to issue regulations and exemptions under both ERISA and Code
 - IRS enforces excise taxes due under the Code
 - **IRAs**
 - In general, IRAs are not ERISA plans (they are not established by an employer)
 - IRAs, however, are benefit plans under the Code, including section 4975 (the Code's prohibited transaction rules)

Background

- **Fiduciary Standards – ERISA Section 404(a)**
 - A fiduciary is to discharge duties to a plan solely in the interests of the participants and beneficiaries, and:
 - for the exclusive purpose of providing benefits and paying reasonable expenses,
 - with the care, skill, and prudence of a prudent person familiar with such matters,
 - by diversifying investments, and
 - following the plan documents

Background

- **Fiduciary Prohibited Transactions – ERISA Section 406(b)**
 - Prevents fiduciaries from:
 - Self-dealing
 - Receiving compensation from third parties
- **In the DOL's view, performance fees and variable compensation paid to fiduciaries create 406(b) problems; fiduciaries cannot influence their own compensation for investment services**
 - See DOL Frost/Aetna letters: requires fee leveling
- **Does ability to influence pay matter so long as pay is reasonable? Yes, says DOL; no, says 8th Circuit (see Harley vs. 3M)**

Background

- **A fiduciary who receives variable compensation would (in the DOL's view) commit a 406(b) prohibited transaction unless the fiduciary conducts itself in accordance with new impartial conduct / best interest standards adopted as part of the new fiduciary rule.**

Background

- **A person is an ERISA fiduciary to the extent the person:**
 - Exercises any discretionary authority or control respecting management of such plan,
 - Exercises any authority or control respecting management or disposition of its assets,
 - Renders investment **advice** for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or
 - Has any discretionary authority or responsibility for plan administration

What Is Investment Advice?

- **1975 Regulation:**
 - Recommendation rendered on a regular basis,
 - Pursuant to a mutual understanding,
 - For a fee or other compensation from any source (including incidental fees),
 - Individualized to particular client's needs, AND
 - Serves as a primary basis for investment decisions

What Is Investment Advice?

- **2016 Regulation:**
 - Advice need only be rendered by a person who acknowledges his or her status as fiduciary, OR
 - Advice need only be rendered pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular needs of the recipient, OR
 - Advice need only be directed to a specific recipient or set of recipients,
- Advice still must be rendered for a fee or other compensation, direct or indirect
- Advice must be rendered to a plan, plan fiduciary, participant, beneficiary, IRA or IRA owner



What Is Investment Advice?

- **“Investment advice” covers:**
 - Recommendations as to advisability of acquiring, holding, disposing or exchanging securities or other investment property
 - Covers recommendations regarding IRA rollovers, even absent a recommendation as to how to invest the rolled assets
 - Recommendations regarding HSAs, MSAs and other products potentially covered where there is an investment component
 - Excludes recommendations to purchase insurance without an investment component
 - Excludes appraisals and fairness opinions concerning the value of securities or other property
 - Recommendations as to management of securities or other property
 - Recommendations of a person who provides services described above



What Is a Recommendation?

- Any “communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action”
- DOL rejected suggestions that recommendations be “clear and affirmative” endorsements
- Final rule tracks FINRA and SEC guidance (communications that require the adviser to comply with suitability requirements under applicable securities or insurance laws will be viewed as a recommendation)

What Is a Recommendation?

- The more individualized the communication, the more likely to be a recommendation
- Providing a list of securities deemed “appropriate” is a recommendation, even if none is individually recommended – BUT SEE platform provider exception

What Is NOT A Recommendation?

- **Certain activities are not recommendations:**
 - Marketing investment platform to be selected by plan fiduciary for any participant-directed ERISA Title I plan
 - Does not apply to brokerage window products
 - Certain selection and monitoring activities provided by platform providers, such as identifying investment alternatives using objective criteria
 - Marketing cannot be based on individualized needs of the plan participants
 - But segmenting products to small, medium or large plans is okay
 - Sample line-ups used in RFPs are not recommendations, so long as advice disclaimer and disclosure of financial interests is included



What Is NOT A Recommendation?

- **Certain activities are not recommendations:**
 - Investment education: descriptions of investment alternatives, explanation of investment concepts, asset allocation models and interactive materials that do not recommend specific products
 - Some differentiation between plans and IRAs vis-à-vis “designated investment alternatives”
 - DOL also acknowledged employers generally do not receive a fee or other compensation for providing education, and incidental economic advantages that may benefit an employer (such as when plan pays fees from revenue sharing dollars rather than employer) would not constitute fees or compensation to the employer
 - General communications: television, radio, prospectuses and material for general circulation



Can I Recommend Myself?

- **Marketing oneself as a potential fiduciary is not a recommendation. . . unless it is coupled with an investment recommendation**
- **Can one sell an advisory or investment management service without making an investment recommendation?**
- **Example: prospective advisor recommends switching from commission-based fee arrangement to level fee-based arrangement**
- **Is the only solution for the advisor to satisfy the DOL's best interest/impartial conduct standards?**



Additional exceptions:

- **“Seller” (counterparty) exception:**
 - **Seller must deal with plan represented by independent sophisticated fiduciary (bank, RIA, broker/dealer, insurer) with at least \$50 million under management or control**
 - **No longer limited to large ERISA plans; applies to IRAs as well**
- **Swap transaction exception**



Prohibited Transaction Rules

- **As noted earlier, ERISA and the Code contain prohibited transaction rules**
 - Receipt of third party or variable compensation can raise prohibited transaction concerns
- **Current exemptions applicable to investment professionals:**
 - PTE 75-1
 - PTE 77-4, 77-3 (proprietary funds)
 - PTE 84-24 (insurance and annuity products)
 - PTE 86-128 (brokerage commissions)
 - All have specific conditions and only exempt certain compensation types

Prohibited Transaction Rules

- **2016 Regulations radically alter the current DOL exemption regime:**
 - Changes the existing exemptions
 - Add a new exemption to cover compensation received by brokers who are not fiduciaries
- **Changes to existing exemptions:**
 - Conditions for some were changed from easy-to-assess objective standards to “standards based” exemptions
 - Example: PTE 86-128, brokerage commissions paid by a plan to a fiduciary for “effecting or executing” securities transactions
 - Others were essentially eliminated, now covered by the Best Interests Contract Exemption (discussed below)
 - Example: PTE 84-24 no longer covers IRA transactions involving variable annuities or indexed annuities

Prohibited Transaction Rules: Impartial Conduct Standards

- **DOL's revisions require fiduciaries to satisfy "Impartial Conduct Standards" in various contexts**
 - Fiduciary must act in the best interests of the plan or IRA
 - The fiduciary's compensation in connection with the transaction must be "reasonable" in connection with the total services provided to the Plan or IRA
 - Communications must not be misleading
 - This standard does not require that the fiduciary warrant compliance with applicable law

Prohibited Transaction Rules: Best Interests Contract Exemption

- **The Problem: DOL believes ERISA's and the IRS's prohibited transaction rules preclude a fiduciary from receiving variable compensation/compensation from third parties**
- **Now, a whole series of brokers/dealers are fiduciaries – and receive potentially prohibited compensation**
- **The BIC exemption is supposed to address this problem – but may drastically change how the prohibited transaction rules are enforced**

Prohibited Transaction Rules: Best Interests Contract Exemption

- **Exemption allows:**
 - “Advisors”, “Financial Institutions”, “Affiliates”, and “Related Entities” to “receive compensation as a result of their provision of investment advice”
 - When they provide advice to a “Retirement Investor”
 - ERISA plan participant
 - IRA plan participant, or participant in a section 4975(e)(1)(A) plan (e.g., 403(b) plans).
 - A “Retail Fiduciary”
 - Several important changes
 - No limit on what “assets” are covered
 - Covers broader class of investors
 - Several exemptions, including employers and fiduciaries with discretionary authority



Prohibited Transaction Rules: Best Interests Contract Exemption

- **There are two separate BIC exemptions**
- **First, the “streamlined exemption”**
 - Applies only where the advisor receives “Level Fee,” i.e., Compensation that is provided on the basis of a fixed percentage of the value of the assets, or does not vary with the particular investment recommended.”
 - Must acknowledge being a fiduciary
 - Comply with Impartial Conduct Standards
 - If there is a roll over to an IRA, switch to another IRA, or move from commission-based to level fee account, must document why this was in the best interests of participants



Prohibited Transaction Rules: Best Interests Contract Exemption

- **Second, the “full” exemption**
- **Conditions of relief:**
 - **Written contract (only for IRAs)**
 - **Acknowledge fiduciary status**
 - **“Impartial conduct standards” must be in the contract**
 - **The Financial Institution must warrant:**
 - **That its policies are “prudently” designed to ensure compliance with Impartial Conduct Standards**
 - **That it has no compensation practices that might encourage recommendations not in participants’ best interests**
 - **Identified and presented Material Conflicts of Interest**
 - **Very complex disclosure, data retention, and recordkeeping requirements**
 - **Prohibited contract terms:**
 - **Can’t disclaim or limit liability**
 - **Can’t require a class action waiver or impose liquidated damages**
 - **But you can require arbitration and a punitive damages waiver**



Initial Assessment: Impact to Financial Industry

- **Bringing all IRA assets into realm of ERISA – substantially increasing risk exposure to firms and advisors that deal with IRA assets**
- **Direct assault on advisor business models that utilize commissions or variable compensation programs, or receive indirect compensation from asset managers and vendors that they recommend to their clients**
- **Recordkeepers that provide services as loss leader in order to obtain rollovers may seek recordkeeping fee increases**
- **Recordkeeper “investment liaisons” likely to disappear as associated fiduciary status undesirable**
- **Smaller advisory firms will be consolidated into larger specialized firms**



Initial Assessment: Impact to Plan Sponsors

- Review and analyze investment education material provided to participants
- Undertake fiduciary training with focus on selection and monitoring duties
- Watch for investment advice fiduciaries to request revised service agreements and contract terms
- Assess how providers or advisors interact with participants in rollover / distribution process
- Evaluate plan distribution options for more participant-friendly provisions
- Review and renegotiate recordkeeper agreements for contract terms and longer term fee guarantees



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