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The Department of Labor's Final Fiduciary Rule is Here – A First Look for Plan Sponsors

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Outline

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- ✦ Implementation deadlines

Background – Why the need for a new rule?

♦ 40 years of change

- > A landscape once dominated by defined benefit plans where participants had no investment control has been increasingly replaced by 401(k)-type defined contribution plans and IRAs
- > Financial products are increasingly marketed directly to retail investors, plan participants and IRA owners.
- > Plan participants and IRA owners often do not have investment expertise and must rely on experts even though they may be unable to assess the quality of the expert's advice or to adequately take into account conflicts of interest

Background – Why the need for a new rule?

- ✦ Financial products have become increasingly varied and complex over the last 40 years, with new products and features, including:
 - > Target date funds;
 - > Exchange traded funds (ETFs);
 - > Hedge funds;
 - > Private equity funds;
 - > Real estate investment trusts;
 - > Various structured debt instruments;
 - > Insurance products that offer menus of direct or formulaic market exposures and guarantees from which consumers can choose;
 - > Extensive array of derivatives; and
 - > Other alternative investments

Background – Who is a Fiduciary?

- ✦ When ERISA was enacted in 1974, Congress wanted to ensure individuals with discretionary authority **or influence over the investment and management of plan assets** would put participant's retirement needs first. The result was a set of fundamental duties imposed on these individuals, known as "fiduciaries."
- ✦ An individual who serves as a fiduciary is subject to heightened standards of care, must act impartially, and act in the best interest of participants.
- ✦ An ***expert standard*** applies

Background – Who is a Fiduciary?

- ✦ In carrying out their duties, fiduciaries are not permitted to receive payments creating conflicts of interest unless they comply with conditions (“prohibited transaction exemptions”) designed to minimize the potential effects of a conflict
- ✦ Fiduciaries who do not meet fiduciary standards or who enter into prohibited transactions without meeting exemption requirements may be *personally* liable to restore any losses and/or return any profits made through improper use of plan assets

Background – Who is a Fiduciary?

♦ ERISA Section 3(21)(A) provides:

- > A person is a fiduciary with respect to a plan to the extent he or she
 - (i) exercises any discretionary authority or discretionary control with respect to management of such plan or exercises any authority or control with respect to management or disposition of its assets;
 - (ii) 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
 - (iii) has any discretionary authority or discretionary responsibility in the administration of such plan

Background – 1975 Implementing Regulations

- ✦ The 1975 regulation (the “1975 Rule”) applied a somewhat narrow interpretation of the statutory definition of an investment advice fiduciary by creating a five-part test under which advice is considered investment advice if the adviser ***does not have discretionary authority or control*** over the purchase or sale of securities or other property for the plan, and renders advice to the Plan:
 - > 1. as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property;
 - > 2. on a regular basis;

Background – 1975 Implementing Regulations

- > 3. pursuant to a mutual agreement, arrangement or understanding with the plan or a plan fiduciary;
 - > 4. that will serve as a primary basis for investment decisions with respect to plan assets; and
 - > 5. that will be individualized based on the particular needs of the plan
- ★ The 1975 Rule excluded, for example, people who gave one-time advice, or advisors whose advice was not a primary basis for an investment decision

Background – Rulemaking process and the Proposed Rule

- ✦ The DOL first proposed a new conflict of interest fiduciary rule in 2010; it was withdrawn in 2011 for further development
- ✦ A second proposed rule was issued on April 20, 2015
- ✦ Over 3,000 comment letters were filed with the DOL with respect to the 2015 proposal
- ✦ 300,000 submissions were made as part of 30 separate petitions submitted in reaction to the proposal
- ✦ The Final Rule was published on April 8, 2016

Background – Why plan sponsors should pay attention

- ✦ Direct impact on financial advisors with whom plan sponsors regularly work
- ✦ Relationships and some agreements are likely to undergo changes
- ✦ Fiduciary status could lead to possible prohibited transactions (PTs). Plan fiduciaries should understand the changed rules regarding who is an investment advice fiduciary, the key exceptions, and PT exemptions in order to avoid the potential of inadvertently being involved in a PT

The Final Rule: A broad approach

- ✦ The Final Rule eliminates and replaces the “5 part test” in place since 1975 to more broadly determine when someone is acting as a fiduciary by providing investment advice for a fee or other compensation
- ✦ First, in order to be treated as a fiduciary providing investment advice, a person, either directly or indirectly (*e.g.*, through or together with any affiliate), must do one of three things:
 - > (1) Represent or acknowledge that such person is acting as a fiduciary within the meaning of ERISA or the Code with respect to rendering investment advice;

The Final Rule: A broad approach

- > (2) Render investment advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is based on the particular investment needs of the advice recipient; or
- > (3) Direct investment advice to a specific advice recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA

The Final Rule: Definition of Investment Advice

- ★ The Final Rule also broadens the definition of investment advice. The determination as to whether a communication constitutes investment advice involves three steps:
 - > (1) Determining whether the communication is in a category that would constitute investment advice;
 - > (2) Determining whether the communication is a “recommendation”; and
 - > (3) Determining whether the “recommendation” falls under a safe-harbor “exception” to being considered investment advice

The Final Rule: Definition of Investment Advice

A communication constitutes investment advice if a person provides directly to a plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner:

- ★ (i) A “recommendation” as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, or a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred or distributed from the plan or IRA; or

The Final Rule: Definition of Investment Advice

- ✦ (ii) A recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, types of investment account arrangements (brokerage versus advisory), or recommendations with respect to rollovers, transfers or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer or distribution should be made

The Final Rule: “Recommendations” constituting Investment Advice

- ✦ “Recommendation” means 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 taking a particular course of action
- ✦ This determination is an objective inquiry
 - > The more individually tailored the communication is to a specific advice recipient, the more likely it is to be viewed as a recommendation
 - > A series of actions may constitute a recommendation in the aggregate even if they would not when viewed individually
 - > Does not matter if the communication was initiated by a person or computer software program

The Final Rule: “Recommendations” constituting Investment Advice: Non-Recommendations

- ✦ The following types of communications do not rise to the level of being a “recommendation” and therefore, do not constitute investment advice:
 - > (1) Marketing or making available a platform
 - > (2) Selection and monitoring assistance
 - > (3) General communications
 - > (4) Investment education

The Final Rule: “Recommendations” constituting Investment Advice: Non-Recommendations

✦ Platform Providers:

- > The marketing or making available to a plan fiduciary of a plan (without regard to the individualized needs of the plan, its participants, or beneficiaries) a platform or similar mechanism from which a plan fiduciary may select or monitor investment alternatives, into which plan participants or beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts will not be considered a recommendation provided that:

The Final Rule: “Recommendations” constituting Investment Advice: Non-Recommendations

✦ Platform Providers (cont.):

- 1) the plan fiduciary is independent of the person who markets or makes available the platform or similar mechanism, and
- 2) the person discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity

The Final Rule: “Recommendations” constituting Investment Advice: Non-Recommendations

✦ Selection and monitoring assistance:

- > Identifying investment alternatives that meet objective criteria by the plan fiduciary, provided that the person identifying the investment alternatives discloses in writing whether the person has a financial interest in any of the identified investment alternatives, and if so the precise nature of such interest
- > Providing objective financial data and comparisons with independent benchmarks to the plan fiduciary

The Final Rule: “Recommendations” constituting Investment Advice: Non-Recommendations

★ General Communications

- > Furnishing or making available general communications that a reasonable person would not view as an investment recommendation, including:
 - General circulation newsletters;
 - Commentary in public broadcast talk shows;
 - Remarks and presentations in widely attended speeches and conferences;
 - Research or news reports prepared for general distribution;
 - General marketing materials;
 - General market data, including data on market performance, market indices, or trading volumes;
 - Price quotes;
 - Performance reports; or
 - Prospectuses

The Final Rule: “Recommendations” constituting Investment Advice: Non-Recommendations

♦ Investment Education

> Plan information

- Without reference to appropriateness of investment alternative, describing terms or operation of plan or IRA, informing about benefits of participation or increasing contributions, describing the impact of preretirement withdrawals, advantages, disadvantages and risks of different forms of distributions, or describing product features, investor rights and obligations, fee and expense information, etc.

The Final Rule: “Recommendations” constituting Investment Advice: Non-Recommendations

★ Investment Education

- > General financial, investment, and retirement information
 - Information and materials that do not address specific investment products, specific investment alternatives (offered under the plan or IRA or offered outside the plan or IRA) or distribution options and which inform the plan fiduciary, plan participant or beneficiary, or IRA owner about:

The Final Rule: “Recommendations” constituting Investment Advice: Non-Recommendations

- > General financial, investment, and retirement information (cont.)
 - General financial and investment concepts;
 - Historic differences in rates of return between different asset classes based on standard market indices;
 - Effects of fees and expenses on rates of return;
 - Effects of inflation;
 - Estimating future retirement income needs;
 - Determining investment time horizons;
 - Assessing risk tolerance;
 - Retirement-related risks; and
 - General methods and strategies for managing assets in retirement (including those outside the plan or IRA)

The Final Rule: “Recommendations” constituting Investment Advice: Non-Recommendations

✦ Investment Education

> Asset allocation models

- A model must be based on generally accepted investment theory taking into account historic returns of different asset classes, and must include a statement to consider other assets, income and investments in addition to those considered by the model
- Strict requirements surrounding identification of specific investment products

> Interactive Materials

- Questionnaires, worksheets etc. provided to plan participant or IRA owner to assist them in estimating income needs or retirement income streams, that take into account generally accepted theories, and use an objective correlation between asset allocation and income stream
- Material facts and assumptions must be provided by the participant or IRA owner, or accompany the materials.
- Use of specific investment alternatives must be provided by participant or IRA owner

The Final Rule: Safe-harbor “exceptions” to Investment Advice

- ✦ The final rule exempts from being classified as investment advice the following activities and communications that might otherwise meet the definition:
 - > A “seller’s” exception
 - > Swap and security-based transactions, and
 - > Certain activities by employees of the plan sponsor

The Final Rule: Safe-harbor “exceptions” to Investment Advice

- ✦ The seller’s exception applies to advice provided to state and federally supervised banks, insurance carriers qualified under the laws of more than one state, state and federally registered investment advisers, federally registered broker-dealers, and any plan fiduciary independent of the seller with at least \$50 million in total assets under management (generally, these are all “sophisticated” investors)

The Final Rule: Safe-harbor “exceptions” to Investment Advice

- ✦ The sellers must know or reasonably believe that the independent fiduciary is capable of evaluating investment risks and may rely on a written representation from the plan or fiduciary
- ✦ The seller must “fairly inform” the independent fiduciary:
 - > That the seller is not undertaking to provide impartial investment advice
 - > Of the existence and nature of the seller’s financial interest in the transaction, and
 - > That the seller is not giving advice in a fiduciary capacity

The Final Rule: Safe-harbor “exceptions” to Investment Advice

- > The seller may not receive a fee from the plan, independent fiduciary, plan participant, beneficiary, IRA or IRA holder for the provision of investment advice in connection with the transaction
- > These requirements generally have to be met before entering into the transaction

The Final Rule: Safe-harbor “exceptions” to Investment Advice

- ✦ The provision of any advice to an ERISA plan (and not an IRA) by a person who is a swap dealer or swap participant in connection with a swap transaction will be exempt if:
 - > The plan is represented by an independent fiduciary
 - > The swap dealer is not acting as an advisor to the plan
 - > The swap dealer ahead of the transaction obtains from the independent fiduciary a representation that the fiduciary understands the dealer is not undertaking to provide impartial investment advice or give advice in a fiduciary capacity, and
 - > No additional fee for investment advice is received

The Final Rule: Safe-harbor “exceptions” to Investment Advice

- ✦ Investment advice is exempted to the extent an employee of the plan sponsor, acting in their capacity as an employee, gives advice to a plan fiduciary or to another employee or independent contractor
- ✦ The employee must not receive any fee or other compensation in connection with the advice other than their normal compensation for work performed for the employer
- ✦ Advice given to a fellow employee in that employee’s capacity as a plan participant or beneficiary is also exempted as long as the advice giver’s job responsibilities do not involve giving investment advice and they are not otherwise registered under securities or insurance laws

The Final Rule: Investment Advice must involve compensation

- ✦ In order to be considered fiduciary investment advice, the advice must be “for a fee or other compensation, direct or indirect,” which means
 - > Any explicit fee or compensation for the advice received by the person (or by an affiliate) from any source and
 - > Any other fee or compensation received from any source in connection with or as a result of the recommended purchase or sale of a security or the provision of investment advice services

The Final Rule: Investment Advice must involve compensation

- > This includes, but is not limited to:
 - 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 paid in connection with transfers of accounts to a registered representative's new broker-dealer firm, gifts and gratuities, and expense reimbursement

The Final Rule: Investment Advice must involve compensation

♦ But-For Test

- > The Final Rule also expressly provides that a fee or compensation is paid “in connection with or as a result of” advice if the fee or compensation would not have been paid **but for** the recommended transaction or advisory service or if eligibility for or the amount of the fee or compensation is based in whole or in part on the transaction or service.

Hypotheticals

- ✦ Tom TPA suggests you hire Ina Investment Advisor
- ✦ Ina Investment Advisor provides an overview of her services and suggests you hire her
- ✦ Ina Investment Advisor provides an overview of her services, includes thoughts on the Plan's existing investment strategies, and suggests you hire her
- ✦ Ina Investment Advisor provides an overview of her services, including the platform of investments Ina is able to offer, and suggests you hire her

BIC Exemption and Prohibited Transaction Rules

- ✦ Fiduciary asset managers and fiduciary advisers must act prudently and with undivided loyalty to the plans and their participants and beneficiaries. They must also refrain from engaging in prohibited transactions
- ✦ The prohibited transaction rules generally prohibit fiduciaries from engaging in self-dealing and receiving third-party compensation for transactions involving plan or IRA assets

The Best Interest Contract (BIC) Exemption

- ✦ The BIC Exemption allows for receipt by fiduciaries of common forms of variable rate compensation which would typically violate the prohibited transaction rules (since compensation would be affected by the investment advice) including:
 - ✦ Commissions paid by the plan, participant or beneficiary, or IRA; or
 - ✦ Sales loads, 12b-1 fees, revenue sharing and other payments/commissions from third parties that provide investment products

BIC Exemption – Eligible Users

- ✦ BIC Exemption can only be used by “financial institutions” and their employees, contractors, agents and representatives, affiliates and related entities.
- ✦ “Financial institutions” generally include:
 - > Registered investment advisers
 - > Banks
 - > Insurance companies
 - > Broker/dealers

BIC Exemption – Eligible Counterparties

- ✦ BIC Exemption is available with respect to advice rendered to the following retail “retirement investors”
 - > Plan participants and beneficiaries;
 - > IRA owners; and
 - > Plan or IRA fiduciaries who are not eligible for the sophisticated “counterparty” exception described in the Regulation

BIC Exemption – Impartial Conduct Standards

- ✦ All financial institutions relying on the BIC Exemption must:
 - > Adhere to a standard similar to ERISA's fiduciary duty standard;
 - > Not recommend transactions that will result in the receipt of unreasonable compensation; or
 - > Make materially misleading statements

BIC Exemption – Contract Requirement

- ✦ In certain cases (for advice to certain retirement investors – specifically, advice regarding investments in IRAs, and non-ERISA plans), the BIC Exemption requires that investment advice be given pursuant to an enforceable written contract, which must be available through the financial institution’s website
 - > This most stringent requirement of this Exemption applies when advice is given with respect to IRAs and non-ERISA plans, which lack the enhanced protections afforded by ERISA
 - > For ERISA plans, no contract necessary for recommendations to retirement investors

BIC Exemption – Contract Requirement

- ✦ Where a “best interest contract” is required, the financial institution must:
 - > acknowledge its fiduciary status in writing;
 - > commit to adhere to the “impartial conduct standards”; and
 - > give certain warranties regarding conflicts of interest
- ✦ A “best interest contract” may not limit the financial institution’s liability for a violation of contract terms, force arbitration of individual claims in remote venues or in a manner that unreasonably limits enforcement of the contract, or limit the retirement investor’s ability to bring class action claims in court

BIC Exemption – Anti-Conflict Policies and Procedures

- ✦ Financial institutions must adopt policies and procedures designed to prevent material conflicts of interest from causing the adviser to violate the “impartial conduct standards” or use compensation, personnel or other actions that would incentivize advisers to make recommendations not in the best interest of retirement investors

BIC Exemption – Required Disclosures

♦ Three levels of disclosures:

> Pre-transaction disclosures

- Stating best interest standard of care; describing any material conflicts of interest with respect to transaction; disclosing the recommendation of proprietary products and products that generate third party payments; and informing retirement investor that the investor may receive specific disclosure of the costs, fees, and other compensation associated with the transaction

> Transaction-based disclosures

- A disclosure, on request, describing in detail the costs, fees, and other compensation associated with the transaction

> More extensive web-based disclosure

Level to Level Transactions

- ✦ Applies if the only fee received by the financial institution, the advisor, or affiliate in connection with advice or management of Plan or IRA assets is a pre-disclosed level fee, i.e., a fee that is a fixed percentage of plan assets or a set fee that does not vary based on the investments that are made
- ✦ Level-fee arrangements are generally considered less prone to conflicts of interest, accordingly for level-fee only arrangements, the financial institution does not have to enter into a contract with retirement investors or make the other required disclosures

Level to Level Transactions

- ✦ For level-fee only arrangements, to satisfy the BIC exemption, the financial institution does not have to enter into a contract with the retirement investor or make the other required disclosures. The level-fee fiduciary, however, must provide:
 - > A written statement of fiduciary status;
 - > Adhere to the Impartial Conduct Standards; and
 - > Prepare a written documentation of the reasons for the recommendation(s) to roll from an ERISA Plan to an IRA, rollover from an IRA, or switch from commission to a level-fee arrangement

BIC Exemption – Disclosure to the DOL

♦ Notification to the DOL

- > A financial institution generally must provide notice to the DOL of its reliance on the BIC Exemption
- > This notice need not identify any plan or IRA
- > Notice must be provided by email to e-BICE@dol.gov

BIC Exemption – Recordkeeping

- ♦ A financial institution must maintain records sufficient to enable an examination of compliance with the requirements of the BIC Exemption for a period of six years

Hypotheticals

- ✦ Terminated 401(k) Plan participant Paula contacts Ike Investment Advisor to discuss rollover options.
 - > How would various compensation structures impact Ike's obligations?
 - > What if Ike is a fiduciary investment advisor to the 401(k) Plan?

Hypotheticals

- ✦ Plan fiduciaries contact an IRA provider, and provide the IRA provider with a list of terminated participants with account balances, and request IRA provider discuss rollover options with terminated participants

Implementation of the Final Rule

♦ Phased Implementation:

- > Final Regulation officially effective on June 7, 2016
- > Final Regulation will generally become applicable (the "Applicability Date") on April 10, 2017
- > The BIC Exemption is subject to a slower phase-in, with full compliance with its requirements not needed until January 1, 2018 if the adviser complies with the impartial conduct standards, acknowledges fiduciary status in writing and meets certain other disclosure requirements

Questions?

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