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BENEFITS BRIEF

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DOL Releases Guidance on Best Interest Contract and other Exemptions

On October 27, 2016, the Department of Labor ("DOL") issued a series of Frequently Asked Questions ("FAQs") providing much needed guidance concerning the Fiduciary Rule and related prohibited transaction exemptions ("PTEs"), including the Best Interest Contract Exemption ("BIC Exemption"), PTE 84-24, and the Principal Transactions Exemption.

Although many of the FAQs merely restate positions DOL articulated in the preambles to the final exemptions issued in April 2016, the FAQs also provide important new clarifications of a number of core issues. Most notably, the FAQs –

- Address the adaptation of broker-dealer compensation grids and recruitment programs to the BIC Exemption conditions;
- Clarify the narrow scope of the BIC Exemption for "level fee" fiduciaries ("BIC Lite") by reiterating that BIC Lite is not available where an Adviser[1] receives third-party compensation or commission in connection with proprietary products; and
- Provide guidance on the application of the exemptions to insurance products, including a potential role for independent marketing organizations ("IMOs") as part of a "segmented BIC" exemption strategy.

For purposes of summarizing the FAQ guidance, we have grouped our analysis by topic in the following order: (i) the BIC Exemption, (ii) BIC Lite, (iii) PTE 84-24, (iv) IMOs, and (v) other topics (*e.g.*, the Principal Transactions Exemption). We also note that this initial set of FAQs does not address many critical and time sensitive interpretive questions related to the Fiduciary Rule itself. DOL has indicated that subsequent sets of FAQs will follow this initial release; FAQs still in progress at DOL may address some of those issues. DOL also noted (in FAQ 34) that it intends to focus its efforts on assisting with compliance, rather than citing violations and imposing penalties.

I. BIC Exemption

A. Financial Adviser Recruiting Payments

In FAQ 12, DOL addressed broker-dealer adviser recruitment practices and raised significant concerns related to back-end recruitment compensation. In DOL's view, "all or nothing" back-end compensation arrangements that would account for a large portion of an Adviser's total annual compensation contingent upon meeting a production or assets under management target are not consistent with the warranty conditions under the BIC. DOL distinguishes such impermissible arrangements from front-end payments not tied to production or assets. Firms that intend to rely on the BIC Exemption may wish to examine their recruitment arrangements and adapt them to the DOL guidance.

[1] Capitalized terms not defined herein shall have the meanings assigned to them in the final exemptions.

Importantly, the FAQ extends beneficial "grandfathering-type" relief to existing recruitment arrangements that are based on binding, written recruitment agreements between Financial Institutions and Advisers and that were entered into before October 27, 2016. Accordingly, such agreements may provide for the types of back-end payments that DOL has now expressly prohibited in FAQ 12. That said, DOL has cautioned that grandfathered back-end recruitment compensation will require "stringent oversight" by Financial Institutions with increasing supervision as Advisers approach their target production thresholds. The grandfathered relief will allow the run-out of recruitment compensation packages for the standard length typically offered by the financial services industry.

FAQ 12 also provides some insight as to the types of supervision practices and policies a firm may consider for both legacy and future recruitment arrangements. In addition to supervision of Advisers approaching compensation thresholds, these may include: following FINRA Rule 2273 regarding recruitment practices; providing training and education on the impartial conduct standards; reviewing new hires for past misconduct and disciplinary actions; and disciplinary action including potential nullification of awards when wrongdoing is found.

B. Escalating Compensation Grids

The BIC Exemption and its warranty provisions raised questions as to whether a financial services firm could continue to compensate Advisers based on revenue production, and whether the firm could provide a greater proportion of revenue to Advisers that were more productive overall. With important guardrails, DOL answered both questions in the affirmative. Going forward, this should provide important certainty for broker-dealers that utilize this traditional method of commission-based compensation.

FAQ 9 makes clear, however, that firms must avoid disproportionate Adviser compensation in connection with plan transactions. DOL provides several key guideposts for escalating grids:

- Firms must take care not to transfer the firm's financial interest in products to the Adviser. As such, the starting point is that all revenue fed into the Adviser's compensation grid must be the same within a product category and compensation differentials must be justified by neutral factors between the product categories. Compensation differences between product categories must not be based upon how lucrative a product is for the firm. Importantly, DOL emphasized that if a firm justifies a higher payment for one category of investments over another, the firm must ensure that the justifications "are borne out in practice." This means that firms should document the basis for commission differentials, and then monitor the neutral factors analysis over time.
- Grids should generally provide a gradual increase in compensation. DOL did not specify what level of gradual and total increases would be permissible, but it emphasized that firms should avoid "dramatic" increases that could misalign interests.
- Increases should not be retroactive. In DOL's view, retroactive grids that increase the percentage of compensation paid out on prior recommendations are likely to be considered disproportionate and to create "acute conflicts of interest." This means that grids which increase payout levels back to the beginning of the compensation year are likely out of step with the BIC Exemption.
- As with grandfathered recruitment deals, DOL again emphasized the importance of firm supervision and oversight.

In light of DOL's guidance, firms with traditional commission-based compensation models may wish to closely review their compensation pay-out grids.

C. Financial Adviser Discretionary Discounting on Product Prices

In FAQ 11, DOL addressed the common practice of discounting services fees by firms and their Advisers and indicated that such practices are generally permitted. The FAQ clarifies that offering a discount does not in and of itself create a misalignment of interests between an Adviser and Retirement Investor. It is also clear that firms need not provide discounts consistently between different Retirement Investors. In this respect, DOL acknowledged that there are many reasons that firms may engage in discounting, including the size of the transaction, the desire to attract a new client, the level of service agreed upon between the client and Adviser, and finally as a way to express appreciation to long-standing clients. There are two important caveats: (1) the starting point of compensation must always be reasonable, and (2) the discounts must not re-introduce a conflict of interest.

D. Robo-Advice

In FAQ 10, DOL reiterated that the Full BIC Exemption is not available for robo-advice (*i.e.*, advice provided solely through an interactive website that does not involve any personal interaction or advice from an individual Adviser). DOL explained that this was due to its view that the marketplace for robo-advice is still "evolving" in ways that appear to avoid conflicts of interest that would raise prohibited transaction issues. Further, DOL cited ERISA sections 408(b)(14) and 408(g) as existing avenues for relief for robo-advice. DOL also reiterated that, if eligible, robo-advice providers could rely on the streamlined conditions under BIC Lite.

E. Bank Networking Arrangements

In FAQ 20, DOL provided a helpful clarification regarding referrals to affiliates using the "hire me" exception. The FAQ addresses the relief provided within the BIC Exemption for Bank Networking Arrangements involving referrals by banks and bank employees to *non-affiliated* Financial Institutions. In explaining why the BIC Exemption's relief for Bank Networking Arrangements do not extend to referrals to affiliates, DOL advised that it did not consider referrals to affiliates who are providers of retail non-deposit investment products as fiduciary investment advice because such referrals are not recommendations of *another* person to provide investment advisory or management services. As a result, DOL confirmed that such referrals fall within the "hire me" exception, provided the referrals are not coupled with recommendations related to particular investments or strategies.

F. Grandfathering

DOL made the following clarifications related to grandfathering:

- FAQ 28 provides that a dividend reinvestment program (*i.e.*, a program that provides for the reinvestment of dividends with respect to specific shares to purchase additional shares) constitutes a "systematic purchase program" within the meaning of Section VII(b)(ii) of the BIC Exemption and is eligible for grandfathering relief.
- FAQ 29 addresses the situation where an Adviser receives compensation in connection with an investment of additional amounts in a previously acquired investment vehicle and compensation for the earlier investment is subject to grandfathering relief. DOL takes the position that the "new money" (*i.e.*, the Adviser compensation relating to the additional investment) is not eligible for grandfathering relief but that the receipt of compensation on the investment of "new money" would not affect the grandfathered status of the compensation received on amounts invested before the applicability date of the Fiduciary Rule.
- In FAQ 30, DOL reaffirmed that grandfathering relief applies to compensation received in connection with investment advice to sell an investment product (as stated in Section VII of the BIC Exemption). However, DOL also advised that compensation received in connection with investment advice relating to the "proceeds of the sale" would not be subject to grandfathering relief.

G. Disclosures

DOL made the following clarifications regarding the BIC Exemption's disclosure requirements:

- As to the requirement that a Financial Institution make available an electronic copy of a Retirement Investor's best interest contract on the Financial Institution's website, DOL stated that a Financial Institution may make available a model contract only if the model contract contains all contractual terms applicable to the Retirement Investor. FAQ 24.
- Where an existing contract is amended to add BIC Exemption required terms through a negative consent process, a Financial Institution may make available on its website a model amendment (rather than the actual amendment mailed to the Retirement Investor) only if the model amendment contains all amendment terms applicable to the Retirement Investor. FAQ 25. DOL does not appear to require the existing contract to be provided on the Financial Institution's website. FAQ 25.
- The transaction disclosures are only required for a recommendation to purchase an investment product; no disclosures are required for a hold or sell recommendation. FAQ 26.
- Information provided pursuant to a request made by a Retirement Investor must be accurate as of the date of the recommendation made by the Adviser (rather than the date of the request). FAQ 27.

II. BIC Lite

A. Definition of "Level Fee"

In FAQ 18, DOL clarified that Financial Institutions and Advisers that receive third party payments – including 12b-1 fees and revenue sharing payments – in connection with the furnishing of advisory or investment management services may not rely on BIC Lite, even if the amount of third party payments are the same for each investment offered. In reaching this conclusion, DOL observed that "[t]hird party payments . . . even if they provide the same amount or percentage for each investment offered, are transaction-based fees and vary on the basis of a particular investment because they are paid only for the particular investments that are included in the arrangement."

DOL's answer clearly suggests that DOL intends to narrowly interpret the definition of "level fee." For example, including any investment options that pay third party payments in connection with investment advisory or management services appears to preclude the use of BIC Lite. The fact that third party payments are "level" does not appear to be helpful in demonstrating a "level fee."

This narrow interpretation of the level fee definition suggests that other types of payment arrangements not directly addressed in this first set of FAQs may also not be permitted under BIC Lite. For example, DOL has long held that a prohibited transaction does not occur if third party payments are offset against an account level management fee or are contributed to an investor's account (*i.e.*, a so-called "Frost Bank" arrangement). However, FAQ 18 indicates that the mere inclusion of funds that make the third party payments eliminates the availability of BIC Lite even if the payments do not give rise to a prohibited transaction pursuant to DOL's prior guidance. Similarly, DOL's regulations have long permitted fiduciaries to be reimbursed for direct, out-of-pocket costs such as "ticket charges" on advisory account trading. However, to the extent that these charges are transaction-based they would appear to run afoul of the level fee definition. DOL's narrow interpretation also casts doubt on whether the receipt of soft dollars would preclude reliance on BIC Lite. Arguably, however, "soft dollars" and possibly other revenue streams paid to a Financial Institution or its affiliates in many cases should not be viewed as compensation paid "in connection with advisory or investment management services" provided to the account.

In FAQ 19, DOL confirmed that level fee programs do not include programs that utilize commission- or transaction-based compensation arrangements, or "compensation structures that are limited to the sale of proprietary products." DOL noted that the compensation paid in connection with such arrangements is not level because "[t]he availability of the compensation depends on the recommendation of a product (and acceptance of that recommendation by the advice recipient)." It is not clear whether DOL's answer in the FAQ was intended to address all programs that include just proprietary products or only arrangements that include only proprietary products and pay commissions. However, the FAQ appears to address all arrangements that include only proprietary products. Further, this FAQ calls into question whether BIC Lite is available if an arrangement limits the investment options in part to proprietary options.

B. Rollover and Transfer Recommendations Covered by BIC Lite

In FAQ 15, DOL clarified that a Financial Institution that offers both level fee accounts and commission-based accounts may rely on BIC Lite for recommendations with respect to its level fee accounts. DOL further noted that any recommendation as to account type must adhere to the impartial conduct standards and should not be made with the intent to evade the requirements of the Full BIC Exemption. This FAQ appears to affirm the view that compliance with the Full BIC Exemption, including the requirement that the Financial Institution enter into a contract with the Retirement Investor, is not necessary to recommend a level fee account in lieu of a commission-based account, or in lieu of an account for which the Financial Institution relies on another PTE.

DOL confirmed in FAQ 16 that a Financial Institution and Adviser may rely on BIC Lite to recommend a rollover from an ERISA-covered plan to an IRA for which the Adviser will serve as a discretionary asset manager. However, DOL noted that any conflicts which arise in connection with the management of the account once the rollover transaction is completed in accordance with the requirements of BIC Lite must be addressed via another exemption or must be eliminated. DOL did not explain what types of conflicts of interest could arise if the Financial Institution, the Adviser and their respective affiliates receive only a level fee in connection with the furnishing of investment management services.

In FAQ 17, DOL confirmed that a Financial Institution and Adviser may rely on BIC Lite to recommend that a Retirement Investor transfer assets from a commission-based account to a level fee account. DOL cautioned, however, that in making such recommendations, Financial Institutions and Advisers must adhere to the impartial conduct standards, and, in doing so, should consider whether the type of account is appropriate in light of the services provided, the projected cost to the Retirement Investor, alternative fee structures that are available, and the Retirement Investor's fee structure preferences. DOL further noted that there may be "circumstances in which advisers may recommend inappropriate commission- or fee-based accounts as a means of promoting the Adviser's compensation as the expense of the customer," such as "recommending a fee-based account to an investor with low trading activity and no need for ongoing monitoring or advice." Such recommendations, DOL observed, would separately violate prohibitions against fiduciary self-dealing and would not be covered by the BIC Exemption.

FAQs 15 through 17 also seem to support the position – though they do not clearly address it – that BIC Lite can be used to recommend a partial rollover into a level fee program, while at the same time using a different exemption strategy (*e.g.*, PTE 84-24 or the Full BIC Exemption) for the remaining assets.

C. Rollover Recommendations in the Absence of Plan Information

A Financial Institution that relies on BIC Lite for a rollover recommendation is required to document the specific reason(s) why the recommendation was considered to be in the best interest of the Retirement Investor. The exemption expressly requires that the documentation include consideration of (i) the Retirement Investor's alternatives to a rollover, including leaving the assets in the investor's current plan, if permitted, (ii) the fees and

expenses associated with both the current plan and the offered IRA, (iii) whether the investor's employer pays for some or all of the current plan's expenses and (iv) the different level of services and investments available under the current plan and the offered IRA. In FAQ 14, DOL confirmed that a Financial Institution and Adviser can, under certain conditions, rely on BIC Lite for a rollover recommendation if the Adviser does not have reliable information about the current plan's expenses and features.

DOL noted that the Financial Institution and Adviser must first "make diligent and prudent efforts to obtain information on the existing plan." In this regard, DOL observed that such information should be readily available as a result of disclosures to plan participants required by regulations issued under ERISA and codified at 29 C.F.R. § 2550.404a-5. DOL added, however, that if, despite an Adviser's efforts, the Financial Institution is unable to obtain the necessary information, or the Retirement Investor is unwilling to provide such information, the Financial Institution could rely on alternative data sources. Such sources would include "the most recent Form 5500 or reliable benchmarks on typical fees and expenses for the type and size of plan at issue." Any Financial Institution that seeks to rely on such alternative data should explain the data's limitations and include in its documentation an explanation of how the Financial Institution determined that the alternative data was reliable.

Additionally, DOL stated in FAQ 14 that although the documentation requirement only appears in the provisions of the BIC Exemption relating to level fee fiduciaries, the factors to be considered under the requirement are "integral to a prudent analysis of whether a rollover is appropriate." Accordingly, a fiduciary relying on the Full BIC Exemption for a rollover recommendation would also need to consider those factors before making the recommendation.

III. PTE 84-24

A. Definition of Fixed Rate Annuity Contract

DOL clarified in FAQ 21 that the basic definition of "fixed rate annuity contract" is "intended to describe the types of annuities commonly referred to as immediate annuities, traditional annuities, declared rate annuities and fixed rate annuities." However, DOL did not address a number of important questions about whether certain insurance or annuity products contain "investment components."

B. Reasonable Compensation

DOL stated in FAQ 33 that it views the "reasonable compensation" conditions of the BIC Exemption and PTE 84-24 as substantively similar and that it will interpret the conditions the same way. DOL also took the opportunity to provide guidance on how a service provider may determine whether its compensation is reasonable, stating this can be done —

> *"by being attentive to market prices and benchmarks for the services; providing the investor proper disclosure of relevant costs, charges, and conflicts of interest; prudently evaluating the customer's need for the services, and avoiding fraudulent or abusive practices with respect to the service arrangement."*

DOL had not previously stated that benchmarking can help assure that the compensation one receives is reasonable.

C. Rollover Recommendations

In FAQ 32, DOL reiterated that PTE 84-24 provides relief for a recommendation to make a rollover or take a distribution from a plan to purchase a fixed rate annuity or an insurance product.

IV. IMO-specific Issues

A. Segmented BIC Exemption

Some annuity and insurance product manufacturers maintain distribution relationships with "life licensed-only" producers (*i.e.*, producers who are licensed as insurance agents but who are not representatives of a Financial Institution). A number of such companies have expressed interest in exploring the feasibility of serving as the Financial Institution under a "segmented BIC," as described below.

Under a "segmented BIC Exemption" approach, each annuity provider that has authorized a life licensed-only producer to recommend its proprietary products would serve as the supervising Financial Institution for purposes of the provider's recommendation of that company's products. Since an independent producer may maintain relationships with multiple, unrelated providers, this would mean that the producer would effectively be supervised by each of those multiple provider entities, in each case, solely with respect to the producer's recommendation of that provider's own products.

A major question concerning the viability of a segmented BIC Exemption approach is whether the notion of segmented supervision can be reconciled with one of the BIC Exemption's fundamental principles – namely, that the financial incentives for a fiduciary Adviser to recommend any one product from the Adviser's "shelf" of products available for recommendation should be neutralized to the greatest extent possible.

In FAQ 22, DOL confirms the availability of the segmented BIC approach, while leaving open some level of uncertainty as to how segmented supervision would operate in practice. DOL notes that –

> *"If an insurer chooses to act as the supervisory Financial Institution for purposes of the exemption, its obligation is simply to ensure that the insurer, its affiliates and related parties meet the exemption's terms with respect to the insurer's annuity which is the subject of the transaction. . . . In other words, its responsibility is to oversee the recommendation and sale of its products, not recommendations and transactions involving other insurers."*

Notwithstanding the permissibility of such a limitation on the scope of a Financial Institution's segmented BIC oversight responsibilities, FAQ 22 suggests that the Financial Institution may need to acquire some level of knowledge about the competing products of other companies available for recommendation by the producer. In this regard, the guidance notes that each supervising Financial Institution would need to "adopt and implement prudent supervisory and review mechanisms" that would, among other things, "avoid improper incentives to preferentially push the products . . . that are most lucrative for the insurer." A reasonable question to ask would be how a Financial Institution under a segmented BIC might permissibly restrict the scope of its oversight to its own products while at the same time avoiding the provision of preferential compensation incentives to the producer.

DOL suggests that a potential solution to this issue could be contracting with an intermediary entity, such as an IMO to implement supervisory procedures on behalf of the Financial Institution using the segmented BIC. DOL notes that an IMO may be positioned to "eliminate potentially troubling compensation incentives across all the insurance companies that work with the IMO."

DOL's suggestion about the potential utility of IMOs to orchestrate and synchronize segmented BIC compliance efforts on behalf of multiple insurers is significant. Many in the IMO industry have expressed frustration over their non-Financial Institution status under the BIC Exemption.

B. Compliance Options

The FAQs contain an extended discussion about how IMOs can continue to operate after the April 10, 2017 applicability date. In short, IMOs can use PTE 84-24, operate under the supervision of a Financial Institution, or seek to be added to the definition of Financial Institution. In FAQ 23, DOL reiterated that IMOs were not treated as Financial Institutions and thus could not execute the best interest contract. However, DOL advised that the BIC Exemption provides relief for compensation paid to "affiliates" and "related entities," and that IMOs would typically fall within such categories. DOL further reiterated that the BIC Exemption provided a mechanism for IMOs to apply for Financial Institution status. DOL has received several IMO applications, and if it grants one application, other IMOs that satisfy the conditions of the individual exemption may be able to rely on it to become Financial Institutions themselves.

V. Other Exemptions

A. Principal Transactions Exemption

In FAQ 31, DOL reiterated that parties can apply for an individual or class exemption to expand the scope of assets covered by the Principal Transactions Exemption. In other words, if DOL grants an individual exemption for a product to be sold by an investment advice fiduciary to a plan or IRA on a principal or riskless principal basis in compliance with the terms of the exemption, that asset will be added to the definition of Principal Traded Asset in the class exemption.

B. Effective Dates

In FAQ 2, DOL reaffirmed that (i) the new restrictions on the availability of relief under the recently amended PTEs 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128 are effective April 10, 2017, and (ii) under a transition rule set forth in PTE 86-128, fiduciaries relying on the exemption may, in lieu of obtaining affirmative written consent to engage in covered transactions from IRA and non-ERISA plans that are customers of the Financial Institution as of April 10, 2017, instead rely on negative consent, provided that the required disclosures and consent termination form are furnished to such customers by such date.