GROOM LAW GROUP

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Proposed "Best Interest Contract" Exemption

1) Rationale for Exemption

a. In the absence of an exemption, receipt by a fiduciary adviser of commissions paid by the plan, participant or beneficiary, or IRA, or its receipt of commissions, sales loads, 12b-1 fees, revenue sharing or other payments from third parties that provide investment products would violate the prohibited transaction provisions of ERISA section 406(b) because the amount or timing of the fiduciary's compensation would be affected by the investment advice it provides.

b. According to EBSA, the exemption is designed to (1) promote the provision of investment advice that is untainted by conflicts of interest and is in the best interest of retail investors such as plan participants and beneficiaries, IRA owners, and small plans; and (2) facilitate the continued provision of advice to such retail investors by permitting advisers to receive brokerage or insurance commissions, 12b-1 fees and revenue sharing payments.

c. In general, fiduciary advisers wishing to rely on the exemption must contractually agree to adhere to Impartial Conduct Standards in rendering advice, warrant that they have adopted policies and procedures designed to mitigate the dangers posed by material conflicts of interest, disclose important information relating to fees, compensation, and those conflicts, and retain documents and data relating to investment recommendations. DOL has described this approach as a "standards-based approach":

> "As noted above, the exemption proposed in this notice provides relief for some of the same compensation payments as the existing exemptions .... It is intended, however, to flexibly accommodate a wide range of current business practices, while minimizing the harmful impact of conflicts of interest on the quality of advice. The exemption permits fiduciaries to continue to receive a wide variety of types of compensation that would otherwise be prohibited. It seeks to preserve beneficial business models by taking a standards-based approach that will broadly permit firms to continue to rely on common fee practices, as long as they are willing to adhere to basic standards aimed at ensuring that their advice is in the best interest of their customers. This standards-based approach stands in marked contrast to existing class exemptions that generally focus on very specific types of investments or compensation and take a highly prescriptive approach to specifying conditions. The proposed exemption would provide relief for common investments of retirement investors under the umbrella of one exemption. It is intended that this updated approach will ease compliance costs and reduce complexity while promoting the provision of investment advice that is in the best interest of retirement investors."

2) Covered Transactions and Relief Provided

The exemption would provide relief from the restrictions of sections 406(a)(1)(D) and 406(b) and Code sections 4975(c)(1)(D), (E), and (F) for the following:

a. The receipt of compensation by “Advisers,” “Financial Institutions,” “Affiliates” and “Related Entities” for services provided in connection with a purchase, sale or holding of an “Asset” by a Plan, participant or beneficiary account, or IRA, or as a result of an Adviser’s and Financial Institution’s investment advice to a “Retirement Investor.” (*Note: terms in quotation marks are defined below.)*

> i. “Assets” are bank deposits, CDs, shares or interests in registered investment companies, bank collective funds, insurance company separate accounts, exchange-traded REITs, exchange-traded funds, corporate bonds offered pursuant to a registration statement under the Securities Act of 1933, agency debt securities as defined in FINRA Rule 6710(p) or its successor, U.S. Treasury Securities as defined in FINRA Rule 6710(p) or its successor, insurance and annuity contracts (both securities and non-securities), guaranteed investment contracts, and equity securities within the meaning of 17 CFR section 230.405 that are exchange-traded securities within the meaning of 17 CFR section 242.600.
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> ii. An equity security future or a put, call, straddle, or any other option or privilege of buying an equity security from or selling an equity security to another without being bound to do so is *not* an “Asset.”

b. DOL contemplates that the exemption would cover commissions paid directly by the plan or IRA, as well as commissions, trailing commissions, sales loads, 12b-1 fees, and revenue sharing payments paid by the investment providers or other third parties to Advisers and Financial Institutions. It would also cover other compensation received by the fiduciary as a result of the Retirement Investor’s investment, such as investment management fees or administrative services fees from an investment vehicle in which the Retirement Investor invests.

3) Covered Recipient of Advice

A “Retirement Investor” is a plan participant or beneficiary of a plan subject to Title I of ERISA with authority to direct the investment of assets in his or her plan account or to take a distribution; in the case of an IRA, the beneficial owner of an IRA; or a plan sponsor (or an employee, officer or director thereof) of a non-participant-directed ERISA plan that has fewer than 100 participants. Welfare benefit plans can be Retirement Investors. *Note: A DOL comment in the Fiduciary Regulation Preamble states that it considers ERISA-governed 403(b) plans to be participant-directed plans, and thus subject to this exemption.*

4) Covered Providers of Advice

Investment advice fiduciaries – both individual "Advisers" and the "Financial Institutions" that employ or otherwise contract with them – and their "Affiliates" and "Related Entities" may obtain relief under the exemption.

a. An "Adviser" is an employee, independent contractor, agent, or registered representative of a "Financial Institution" who satisfies applicable law and licensing with respect to the receipt of the compensation.

b. A "Financial Institution" is a registered investment adviser, bank, insurance company or registered broker-dealer that employs an Adviser or otherwise retains the Adviser as an independent contractor, agent or registered representative.

c. An "Affiliate" is (i) any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the Adviser or Financial Institution; (ii) any officer, director, employee, agent, registered representative, relative, member of family, or partner in, the Adviser or Financial Institution; and (iii) any corporation or partnership of which the Adviser or Financial Institution is an officer, director or employee or in which the Adviser or Financial Institution is a partner.

d. A "Related Entity" is any entity other than an Affiliate in which an Adviser or Financial Institution has an interest that may affect the exercise of its best judgment as a fiduciary.

5) Exclusions

The exemption does not cover the receipt of prohibited compensation in the following circumstances:

a. if the Adviser, Financial Institution or Affiliate is the employer of employees covered by the ERISA plan.

b. if the Adviser or Financial Institution is a named fiduciary or plan administrator with respect to an ERISA plan.

c. if the compensation is received as a result of when the Adviser engages in a principal transaction with the ERISA plan, participant or beneficiary account, or IRA.

d. if the compensation is received by an Adviser or Financial Institution as a result of investment advice that is generated solely by an interactive website in which the computer software-based models or applications provide investment advice to Retirement Investors based on personal information each investor supplies through the website without any personal interaction or advice from an individual Adviser.

e. if the compensation is received by Advisers who have full investment discretion with respect to plan or IRA assets or who have discretionary authority over the administration of the plan or IRA.

6) Conditions of Relief

a. Written Contract. The Adviser and Financial Institution must enter into a contract with the Retirement Investor prior to recommending the purchase, sale, or holding of an Asset.

b. Acknowledge Fiduciary Status**.** Both the Adviser and Financial Institution must acknowledge fiduciary status with respect to any recommendations to the Retirement Investor to purchase, sell or hold an Asset.

c. Impartial Conduct Standards. Both the Adviser and the Financial Institution must contractually commit to adhere to "Impartial Conduct Standards" when providing investment advice to the Retirement Investor regarding Assets:

> i. The fiduciary must provide advice in the "Best Interest" of the Retirement Investor. "Best Interest" is defined to require the Adviser and Financial Institution to "act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and the needs of the Retirement Investor." The Best Interest standard is ERISA-based and the Department expects it to be interpreted "in light of forty years of judicial experience with ERISA's fiduciary standards and hundreds more with the duties imposed on trustees under the common law of trusts." Under it, the Adviser and Financial Institution must make recommendations without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.
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> ii. The fiduciary must agree that it will not recommend an Asset if the total amount of compensation anticipated to be received by the Adviser, Financial Institution, and their Affiliates and Related Entities in connection with the purchase, sale or holding of the Asset by the Retirement Investor will exceed reasonable compensation in relation to the total services they provide to the Retirement Investor.
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> iii. The fiduciary may make only "not misleading" statements about Assets, fees, material conflicts of interest, and any other matters relevant to a Retirement Investor's investment decisions.

d. Warranties. The contract must contain specific warranties, which, if broken, could result in contractual liability for breach of warranty but that would not result in loss of the exemption, as long as the breach did not involve violation of one of the exemption's other conditions.

> i. The Adviser and Financial Institution must warrant that they and their Affiliates will comply with all applicable federal and state laws regarding the rendering of the investment advice, the purchase, sale or holding of the Asset, and the payment of compensation related to the purchase, sale and holding. *Note:*

This could be a back-door to permitting Retirement Investors to bring state law claims that would otherwise be preempted by ERISA.

ii. The Financial Institution must warrant that it has adopted written policies and procedures that are reasonably designed to mitigate the impact of material conflicts of interest that exist with respect to the provision of investment advice to Retirement Investors and ensure that individual Advisers adhere to the Impartial Conduct Standards described above.

e. Policies and Procedures Related to Conflicts. In formulating its policies and procedures, the fiduciary must specifically identify material conflicts of interest and adopt measures to prevent those material conflicts from causing violations of the Impartial Conduct Standards, and it may not use quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives to the extent they would tend to encourage individual Advisers to make recommendations that are not in the best interest of Retirement Investors.

i. The Financial Institution's policies and procedures *must not* authorize compensation or incentive systems that would tend to encourage individual Advisers to make recommendations that are not in the best interest of Retirement Investors.

iii. While the Department notes that a "level-fee" structure, in which compensation for Advisers does not vary based on the particular investment product recommended, is not required to satisfy this condition, it provides five examples of "broad approaches to compensation structures that could help satisfy the contractual warranty regarding the policies and procedures:"

- Independently certified computer models. The Adviser provides investment advice that is in accordance with an unbiased computer model created by an independent third party.
- Asset-based compensation. The Financial Institution pays the Adviser a percentage, which does not vary based on the types of investments, of the dollar amount of assets invested by the Retirement Investor with the Adviser.
- Fee offsets. The Financial Institution establishes a fee schedule for its services. It accepts transaction-based payments directly from the plan, participant or beneficiary account, or IRA, and/or from third party investment providers. To the extent the payments from third party investment providers exceed the established fee for a particular service, such amounts are rebated to the plan, participant or beneficiary account, or IRA.
- Differential payments based on neutral factors. The Financial Institution establishes payment structures under which transactions involving different investment products result in differential compensation to the Adviser based on a reasonable assessment of the

time and expertise necessary to provide prudent advice on the product or other reasonable and objective neutral factors.

- Alignment of interests. The Financial Institution's policies and procedures establish a compensation structure that is reasonably designed to align the interests of the Adviser with the interests of the Retirement Investor.

iv. Financial Institutions could consider the following components of effective policies and procedures relating to an Adviser's compensation:

- Avoiding creating compensation thresholds that enable an Adviser to increase his or her compensation disproportionately through an incremental increase in sales;
- Monitoring the activity of Advisers approaching compensation thresholds such as higher payout percentages, back-end bonuses, or participation in a recognition club, such as a President's Club;
- Maintaining neutral compensation grids that pay the Adviser a flat payout percentage regardless of product type sold (so long as they do not merely transmit the Financial Institution's conflicts to the Adviser);
- Refraining from providing higher compensation or other rewards for the sale of proprietary products or products for which the firm has entered into revenue sharing arrangements;
- Stringently monitoring recommendations around key liquidity events in the investor's lifecycle where the recommendation is particularly significant (e.g., when an investor rolls over his pension or 401(k) account); and
- Developing metrics for good and bad behavior (red flag processes) and using claw backs of deferred compensation to adjust compensation for employees who do not properly manage conflicts of interest.

f. Contractual Disclosures. The Financial Institution and Adviser must provide certain written disclosures in the contract. If an Adviser or Financial Institution fails to provide the disclosures, the exemption is not available. The written disclosures are contractually enforceable.

i. The Financial Institution and the Adviser must identify in the written contract any material conflicts of interest. This disclosure may be generally identify the applicable types of conflicts, so long as the disclosure also states that a more specific and current description is available on the Financial Institution's website and by mail, upon request.

ii. The contract must disclose the Retirement Investor's right to obtain complete information about all of the fees currently associated with the Assets in which it is invested, including all of the fees payable to the Adviser,

Financial Institution, and any Affiliates and Related Entities in connection with such investments.

iii. The contract must disclose whether the Financial Institution offers proprietary products or receives third party payments with respect to the purchase, sale or holding of any Asset.

g. Prohibited Contract Terms. The contract with the Retirement Investor *must not* contain the following terms. If the terms are included, the exemption is not available.

- An exculpatory provision that disclaims or otherwise limits liability for an Adviser's or Financial Institution's violations of the contract's terms.
- The Retirement Investor's agreement to waive or qualify its right to bring or participate in a class action or other representative action in a contract dispute with the Adviser or Financial Institution.

h. Additional Disclosures. In addition to the contractual disclosure, the exemption requires additional disclosures.

i. The Financial Institution must maintain a public webpage, which provides the following information, updated not less than quarterly and written in a manner easily accessible to a Retirement Investor and the general public. The Department provided a template chart.

- The direct and indirect material compensation payable to the Adviser, Financial Institution and any Affiliate for services provided in connection with each Asset (or, if uniform across a class of Assets, the class of Assets) that a Retirement Investor is able to purchase, hold, or sell through the Adviser or Financial Institution, and that a Retirement Investor has purchased, held, or sold within the last 365 days, the source of the compensation, and how the compensation varies within and among Asset classes.

ii. A point of sale disclosure must be provided to the Retirement Investor prior to the execution of an investment transaction. The Department provided a template chart.

- It must provide the all-in cost and anticipated future costs of recommended Assets in in a summary chart. It would include the "total cost" to the Retirement Investor for 1-, 5- and 10- year periods expressed as a dollar amount, assuming an investment of the dollar amount recommended by the Adviser, and reasonable assumptions about investment performance, which must be disclosed.
- "Total cost" of investing in an asset means the sum of the following, as applicable: acquisition costs, ongoing costs, disposition cost, and

any other costs that reduce the asset's rate of return, are paid by direct charge to the Retirement Investor, or reduce the amounts received by the Retirement Investor (e.g., contingent fees, such as back-end loads, including those that phase out over time, with such terms explained beneath the table).

- If the same Asset is recommended more than once within a 12 month period and the total cost has not materially changed, a second point of sale disclosure would not be required.
- The point of sale disclosure does apply to insurance and annuity contracts that are securities under federal securities law, such as variable annuities, and insurance and annuity contracts that are not, such as fixed annuities.

iii. The Adviser or Financial Institution must provide each Retirement Investor with an annual written disclosure within 45 days of the end of the applicable year. The annual disclosure must include:

- A list identifying each Asset purchased or sold during the applicable period and the price at which the Asset was purchased or sold.
- A statement of the total dollar amount of all fees and expenses paid by the Retirement Investor, both directly and indirectly, with respect to each Asset purchased, held or sold during the applicable period.
- A statement of the total dollar amount of all compensation received by the Adviser and Financial Institution, directly or indirectly, from any party, as a result of each Asset sold, purchased or held by the Retirement Investor during the applicable period.
- The annual disclosure requirement does apply to insurance and annuity contracts that are securities under federal securities law, such as variable annuities, and insurance and annuity contracts that are not, such as fixed annuities.

iv. Webpage disclosure, in a machine readable format, of direct and indirect material compensation payable to the Adviser, Financial Institution, and any Affiliate, including its source, with respect to each Asset that a plan, participant or beneficiary account, or an IRA is able to purchase/hold/sell through the Adviser or Financial Institution, and that the plan, participant or beneficiary account, or IRA has purchased/held/sold within the last 365 days.

i. <u>Further Conditions Applicable with Limited Range of Investment Options.</u> Additional conditions apply if a Financial Institution limits the investment products a Retirement Investor may purchase, sell or hold.

i. Before a Financial Institution limits the investment products a Retirement Investor may purchase, sell or hold, the Financial Institution must make a specific written finding that the limitations do not prevent the Adviser

from providing advice that is in the best interest of the Retirement Investor or from otherwise adhering to the Impartial Conduct Standards.

ii. The payments received in connection with limited menus must be reasonable in relation to the value of specific services provided to Retirement Investors in exchange for the payments and not in excess of the services' fair market value.

iii. Before giving any recommendation to a Retirement Investor, the Financial Institution or Adviser must give clear written notice to the Retirement Investor of any limitations placed by the Financial Institution on the investment products offered by the Adviser.

iv. The Adviser must notify the Retirement Investor if the Adviser does not recommend a sufficiently broad range of investment options to meet the Retirement Investor's needs.

Note: These conditions do not apply to an Adviser or Financial Institution with respect to the provision of investment advice to a participant or beneficiary of a participant directed individual account plan concerning the participant's or beneficiary's selection of designated investment options available under the plan, provided the Adviser and Financial Institution did not provide advice to the responsible plan fiduciary regarding the menu of designated investment options.

j. EBSA Disclosure. Before receiving prohibited compensation in reliance of the exemption, the Financial Institution must notify EBSA of its intention to rely on this exemption.

k. Data Requests. The Financial Institution would be required to maintain and, upon request, disclose to the Department information related to "Inflows," "Outflows," "Holdings," and "Returns." This information would need to be maintained for six years from the date of the applicable transaction. Information must be provided within a reasonable time, but in no event longer than 6 months after receiving a request from the Department.

- "Inflows." At the Financial Institution level, for each Asset purchased, for each quarter, the Financial Institution must provide upon request: the aggregate number and identity of shares/units bought; the aggregate dollar amount invested and the cost to the plan, participant, or beneficiary account, or IRA associated with the purchase; the revenue received by the Financial Institution and any Affiliate in connection with the purchase of each Asset disaggregated by source; and the identity of each revenue source (*e.g.*, mutual fund, mutual fund adviser) and the reason for the compensation.

- "Outflows." At the Financial Institution level for each Asset sold, for each quarter, the Financial Institution must provide upon request: the aggregate number of and identity of shares/units sold; the aggregate dollar amount

received and the cost to the plan, participant or beneficiary account, or IRA, associated with the sale; the revenue received by the Financial Institution or any Affiliate in connection with the sale of each Asset disaggregated by source; and the identity of each revenue source and the reason for the compensation.

- "Holdings." At the Financial Institution level for each Asset held at any time during each quarter, the Financial Institution must provide upon request: the aggregate number and identity of shares/units held at the end of the quarter; the aggregate cost incurred by the plan, participant or beneficiary account, or IRA, during the quarter in connection with the holdings; the revenue received by the Financial Institution and any Affiliate in connection with the holding of each Asset during the quarter for each Asset disaggregated by source; and the identity of each revenue source (*e.g.*, mutual fund, mutual fund adviser) and the reason for the compensation.

- "Returns." At the Retirement Investor level, the Financial Institution must provide upon request: The identity of the Adviser, the beginning-of-quarter and end-of-quarter values of the Retirement Investor's "Portfolio"; each external cash flow to or from the Retirement Investor's "Portfolio" during the quarter and the date on which it occurred. For this purpose, "Portfolio" means the Retirement Investor's combined holding of assets held in a plan or IRA advised by the Adviser.

l. Recordkeeping. The Financial Institution would be required to comply with certain recordkeeping requirements and would be required to provide the Department and others with access to the Financial Institution's records. *Note: It would authorize an employee or representative of the Department or the Internal Revenue Service to examine privileged trade secrets or privileged commercial or financial information of the Financial Institution, or information identifying other individuals.*

7) Potential Sources of Liability for Advice Fiduciaries Who Fail to Comply with the Terms of the Exemption

a. Contractual liability to IRA owners.

b. Liability under ERISA section 502(a)(2) and (3) to Plans, Plan Participants, and Beneficiaries to recover any loss in value to the plan (including the loss in value to an individual account), or to obtain disgorgement of any wrongful profits or unjust enrichment. *Note: The Department also states, "Additionally, plans, participants and beneficiaries could enforce their obligations in an action based on breach of the agreement." This could allow for state law claims.*

c. Liability under ERISA section 502(a)(2) and (3) in connection with suits by the Department for claims related to employee benefit plans but not IRAs.

d. Excise tax to the Internal Revenue Service of generally 15% of the amount involved for pension plans, HSAs and IRAs.