The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 23, NO. 7 • JULY 2016

Department of Labor's Final "Investment Advice" Regulation and Its Impact on the Retail Investor Marketplace

By David C. Kaleda

On April 6, 2016, the Department of Labor (Department or DOL) issued its final regulation (Final Regulation) defining the term "investment advice" for purposes of the Employee Retirement Income Security Act of 1974, as amended (ERISA) and the Internal Revenue Code of 1986, as amended (Code).[1] The Department also issued a new prohibited transaction exemption called the best interest contract exemption (BIC) designed to address conflicts that, in the Department's view, arise when a person provides advice to "retail" investors who are particularly vulnerable to adviser and firm conflicts of interest.[2] Finally, the Department substantially revised several current prohibited transaction exemptions, including Prohibited Transaction Exemption 84-24 (PTE 84-24),[3] with the intent of pushing advisers and firms to primarily rely upon the BIC when they provide "investment advice."

As a result of its rulemaking, the Department will require broker-dealers, registered investment advisers, banks, insurers, and other financial services companies to substantially change the way they distribute investment products and services to individual retirement account (IRA) owners and holders of other accounts defined in Code section 4975(e), even though such accounts are not governed by ERISA. Importantly, while the Department has previously had regulatory authority over IRAs by virtue of its responsibility to interpret how the Code's prohibited transaction provisions apply to IRAs and other non-ERISA accounts,[4] the Final Regulation, BIC, and changes to the current exemptions represent an unprecedented foray by the Department into the "retail" investor marketplace.

The purpose of this article is to: (i) provide a summary of the definition of "investment advice" under the Final Regulation; (ii) discuss the impact of the Final Regulation and the prohibited transaction exemptions, particularly the BIC and PTE 84-24, on the distribution of products and services; and (iii) provide some recommendations on how to proceed. Some of the provisions of the rule, including a requirement to act in the advice recipient's "best interest," are effective April 10, 2017 and the remaining provisions, including extensive contract and disclosure requirements, are effective January 1, 2018.

Definition of "Investment Advice"

Pursuant to the Final Regulation, a person provides "investment advice" if, for a fee, he or she provides certain recommendations (Covered Advice) to owners of accounts subject to the prohibited transaction provisions of Code section 4975 (Affected Accounts) and certain relationship conditions (Relationship Conditions) exist. Further, the Final Regulation provides for a number of exceptions. Each of these is, in turn, discussed below.

Affected Accounts

Certain "plans" as defined in Code section 4975(e)(1) are not subject to the fiduciary provisions in Title I of ERISA, but are subject to the prohibited transaction provisions of Code section 4975. These include IRAs under Code section 408(a), individual retirement annuities under Code section 408(b), Archer medical savings accounts described in Code section 220(d), health savings accounts described in Code section 223(d), and Coverdell education savings accounts described in Code section 530. This article focuses on IRAs. However, the reader should note that the analysis in the article applies to the other plans described in this paragraph. They are all impacted by the Final Regulation.

Covered Advice

The Final Regulation identifies the following categories of recommendations that give rise to fiduciary status under the Code by reason of providing investment advice:

(1) a recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property;
(2) 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;
(3) 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, selection of investment account arrangements (for example, brokerage versus advisory); or
(4) 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.[5]

The four categories described above represent a significant broadening of the types of conduct that are currently viewed as advice for purposes of the Code. For example, a person under current law generally does not provide investment advice to an ERISA-covered plan participant or IRA owner when he or she speaks to the participant about taking a distribution and rolling over the distribution to an IRA. Additionally, a recommendation regarding whether an investor should be in a commission-based account or fee-based account is not considered by most advisers and firms to be investment advice under current law.

A "recommendation" is defined broadly to include 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."[6] The Department points to FINRA's "call to action" standard in explaining the inclusion of the "would reasonably be viewed as a suggestion" language in the definition.[7] However, it stopped short of adopting the FINRA definition of recommendation.

The determination regarding whether a person makes a recommendation is an objective rather than subjective determination. The Final Regulation provides that the more specifically tailored a communication is to an advice recipient, the more likely it is to be construed as a recommendation. The Final Regulation specifically states that the provision of a selective list of securities to a particular advice recipient under the premise that such list is appropriate for that investor is a recommendation even if no recommendation is made with respect to any one security. Furthermore, a series of actions, directly or indirectly (for example, through or together with any affiliate), may together be a recommendation even though no one action by itself is a recommendation. Finally, the Department notes that it makes no difference whether a recommendation is made by a person or a computer software program.[8]

Relationship Condition

In addition to providing Covered Advice, one of the following relationship conditions must apply in order for the person to be deemed providing investment advice under the Final Regulation:

(i) he or she represents or acknowledges that he or she is acting as a fiduciary within the meaning of ERISA or the Code;
(ii) he or she renders the 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
(iii) he or she directs the 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 IRA.[9]

The last relationship condition makes the definition of investment advice particularly broad because the advice need only be directed at the specific advice recipient, rather than individualized to the investor's needs.

Importantly, the rule represents a substantial shift in the Department's thinking because the Final Regulation effectively provides that the sale of investment products and services, with limited exceptions, results in the provision of investment advice. In fact, the preamble to the Final Regulation states, "In addition, and perhaps more fundamentally, the Department rejects the purported dichotomy between a mere 'sales' recommendation, on the one hand, and advice, on the other in the context of the retail market for investment products."[10]

Exceptions

The Final Regulation provides for a number of situations in which a person will not provide a recommendation for purposes of the Final Regulation. These situations may be viewed as exceptions or safe harbors pursuant to which advisers and firms can operate without becoming fiduciaries. However, even if an exception is not applicable, a person does not necessarily provide investment advice. Rather, the facts and circumstances should be analyzed to determine whether the person provides Covered Advice and one of the Relationship Conditions exists. The exceptions as they apply to IRAs are discussed below.

Counterparty Exception

The exception includes the provision of any advice to a fiduciary of an IRA who is independent of the adviser with respect to an arm's length sale, purchase, loan, exchange or other transaction related to the investment of securities or other investment property. An independent fiduciary is either a US bank or insurance company, a US registered adviser or broker-dealer or a fiduciary that holds, or has under management or control, total assets of at least \$50 million.[11] The \$50 million threshold includes both plan and non-plan assets.

The conditions of the exception, which can be fulfilled by written representations, are:

- The person knows or reasonably believes that the independent fiduciary is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies;
- The person fairly informs the independent fiduciary that the person is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with the transaction and fairly informs the independent fiduciary of the existence and nature of the person's financial interests;
- The person knows or reasonably believes that the independent fiduciary is a fiduciary under

the Code, with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction; and

- The person does not receive a fee or other compensation directly from the IRA or IRA owner for the provision of investment advice (as opposed to other services in connection with the transaction).

Importantly, the independent fiduciary cannot be the IRA owner.[12] Therefore, the $50 million threshold is effectively unavailable for sales to IRAs. Furthermore, it is uncommon in the current marketplace for an IRA owner to be advised by a fiduciary that is a financial institution and independent from the seller.

Investment Education Exception

The provision of certain categories of investment-related information and materials to an IRA owner is not investment advice so long as "the information and materials do not include (standing alone or in combination with other materials) recommendations with respect to specific investment products or specific plan or IRA alternatives, or recommendations with respect to investment or management of a particular security or securities or other investment property."[13]

The categories of investment-related information and materials covered by the exception include the following:

1. *Plan information*. Information and materials that, without reference to the appropriateness of any individual investment alternative or any individual benefit distribution option for the IRA or IRA owner, explain the terms or operation of the IRA, inform an IRA owner about the benefits of increasing IRA contributions, retirement income needs, varying forms of distributions (for example, rollovers, annuitization, other forms of lifetime income payments), and provide the IRA owner information about the investments available through the IRA (for example, fees and expenses, trading, restrictions, investment objectives and philosophies, risk and return characteristics, historical return information, or related prospectuses), and other IRA-related information.
2. *General financial, investment, and retirement information*. General financial, investment, and retirement information materials that do not address specific investment products, specific IRA investment alternatives or distribution options available to the IRA or IRA owner, or specific investment alternatives or services offered outside the IRA.
3. *Asset allocation models*. Information and materials (for example, pie charts, graphs, or case studies) that provide an IRA owner with models of asset allocation portfolios of hypothetical individuals with different time horizons and risk profiles and meet a number of requirements outlined in the Final Regulation. Importantly, with regard to an IRA, the models cannot be populated with investment options available for investment by the IRA. The Department views that as a recommendation and thus investment advice.
4. *Interactive investment materials*. Questionnaires, worksheets, software, and similar materials that provide an IRA owner with the means to estimate future retirement income needs and assess the impact of different asset allocations on retirement income, evaluate distribution options, products, or vehicles by providing information set forth in the Final Regulation, or estimate a retirement income stream that could be generated by an actual or hypothetical account balance. The materials must meet certain requirements in the Final Regulation including that they do not include or identify any specific investment alternative or distribution option available under the IRA, unless specified by the IRA owner.

The "investment education" exception can be an effective pathway whereby a party can provide investment information to an IRA owner during the sales process without becoming a fiduciary. However, the exception should be applied carefully. The language in the Final Regulation is clear that the information cannot be coupled with a recommendation, so the presentation of the information and materials is very important in order to avoid fiduciary status. For example, any kind of specificity as to whether a particular investment should be made or a distribution should be taken will, in many cases, result in investment advice rather than education.

Platform Providers & Selection and Monitoring Assistance Exceptions

The Final Regulation provides that the provision of a platform of investment options to plans and the provision of information about the investment options on the platform is not a recommendation of such investment options if certain disclosure requirements are met.[14] However, these exceptions are not available if a platform is provided to IRAs. Therefore, firms that provide investment platforms to IRAs must carefully review the types of Covered Advice and the Relationship Conditions to determine whether offering the platform constitutes investment advice. A determination as to whether a recommendation occurs will be determined by the facts and circumstances.

General Communications

Furnishing or making available to an IRA or IRA owner general communications that a reasonable person would not view as an investment recommendation does not constitute investment advice. The Final Regulation provides several examples of such communications, which include general circulation newsletters, commentary in publicly 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.[15]

Impact of Definition

As a result of the broadening of the definition of "investment advice" and the relatively narrow exceptions applicable to IRAs, advisers and their supervising firms who are presently not fiduciaries will, in many cases, become fiduciaries beginning in April 2017. The following are examples of activity that will likely be fiduciary: (i) recommendations of securities and investment programs that are currently subject to FINRA's suitability standard made by representatives of broker-dealers; (ii) recommendations by advisers to move assets from an ERISA-governed plan to an IRA or from one IRA to another IRA so that the adviser may provide advisory services; (iii) recommendations by insurance agents of certain insurance products; and (iv) recommendations of CD IRAs by bank employees. Furthermore, while the sale of one's advisory services by itself may not give rise to fiduciary status, the coupling of such sales activities with a recommendation does result in fiduciary status.

Advisers and their firms should evaluate their product offerings, service offerings, and sales processes for purposes of identifying when they will provide "investment advice" with regard to IRAs and IRA owners. This step is important because the payment of compensation and other amounts to the adviser or firm in connection with the advice provided may, in the eyes of the Department, give rise to prohibited conflicts of interest under Code section 4975.

Application of the Best Interest Contract Exemption & Other Exemptions

In the event a person is a fiduciary with regard to an IRA, the fiduciary is prohibited from dealing with the income or assets of an IRA plan in his own interests or for his own account—in other words, no self-dealing.[16] Furthermore, the person is prohibited from receiving any consideration for his own personal account from any party dealing with the IRA in connection with a transaction involving the income or assets of the plan—in other words, no kickbacks.[17] In order to mitigate such conflicts, the Department issues prohibited transaction exemptions with which fiduciaries must comply to avoid negative tax consequences.

To that end, the Department issued the new prohibited transaction exemption to address fiduciary conflicts that arise when a fiduciary provides investment advice to what the Department identifies as "Retirement Investors," which include IRA owners. According to the Department, the purpose of the BIC is to allow persons who provide advice and their affiliates to receive compensation that is otherwise prohibited under the Code's prohibited transaction provisions.[18]

Such "prohibited compensation" covers commissions paid directly by the IRA as well as "Third Party Payments," which include: sales charges when not paid directly by the IRA; gross dealer concessions; revenue sharing payments; 12b-1 fees; distribution, solicitation or referral fees; volume-based fees; fees for seminars and educational programs; and any other compensation, consideration, or financial benefit provided to the "Adviser," "Financial Institution" or any affiliates by a third party as a result of a transaction involving the IRA.[19]

The "Adviser" is the employee, independent contractor, agent, or registered representative of a Financial Institution who "satisfies the federal and state regulatory and licensing requirements of insurance, banking, and securities laws with respect to the covered transaction, as applicable."[20] The "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.[21]

The requirements of the BIC, which are summarized below, are substantial. Further, the Department amended many of its current exemptions, particularly PTE 84-24, with regard to the payment of commissions and other compensation in connection with the sale of most insurance products to IRAs, and Prohibited Transaction Exemption 86-128, with regard to the payment of commissions in connection with recommendations of securities to IRAs, so that most conflicts must be addressed under the BIC. Notwithstanding, there are other exemptions that may still be available outside of the BIC. These other exemptions are briefly discussed below.

Overview of the BIC

The BIC includes several substantial compliance requirements, which include the following:

1. acknowledgement of fiduciary status;
2. Impartial Conduct Standards (including the "best interest" standard);
3. implementation of policies and procedures designed to prevent violations of the Impartial Conduct Standards;
4. warranties that the BIC conditions will be met;
5. contract, transaction/point of sale, and website disclosures about fees and other aspects of the relationship; and
6. prohibitions against exculpatory language and limitations on ability to participate in class action law suits in contracts.[22]

Furthermore, a "streamlined" version is available for "Level Fee Fiduciaries" as defined in the BIC.[23] Several of these requirements are discussed in further detail below.

Impartial Conduct Standards

Under the BIC, the Financial Institution must state on its own behalf, and on behalf of its Advisers, that they will adhere to "Impartial Conduct Standards," as described below, when providing investment advice to the Retirement Investor.

- Best Interest Standard: The fiduciary, at the time of the recommendation, must provide advice in the "Best Interest" of the Retirement Investor.

- Reasonable Compensation: The recommended transaction may not cause the Financial Institution, Adviser or their affiliates to receive, directly or indirectly, compensation for their services that is in excess of reasonable compensation, within the meaning of ERISA Section 408(b)(2) and Code section 4975(d)(2). Notably, the Department confirmed in the preamble to the BIC that an Adviser and Financial Institution do not necessarily have to recommend a transaction that results in the lowest cost or that generates the lowest fees.
- Not Materially Misleading: The fiduciary may make only "not materially misleading" statements about the recommended transaction, fees, "Material Conflicts of Interest," and any other matters relevant to the IRA owner's investment decisions. A "Material Conflict of Interest" exists when an Adviser or Financial Institution has a financial interest that a reasonable person would conclude could affect the exercise of its best judgment as a fiduciary in rendering advice to an IRA Owner.[24]

The Best Interest, Policy, and Warranty requirements are discussed in more detail below.

The Adviser and Financial Institution act in the "best interest" if they act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims would exercise based on the investment objectives, risk tolerance, financial circumstances, and the needs of the Retirement Investor without regard to the financial or other interests of the Adviser, Financial Institution or any" affiliates or parties in which they have an interest.[25] DOL states that it should be interpreted in the same manner as the courts have interpreted ERISA's fiduciary duty standard and in accordance with state trust law.[26]

Notably, the courts have generally held that Section 404 does not require omniscience on the part of a fiduciary or that the fiduciary must always be right.[27] Rather, the focus of the law is on the process utilized by the fiduciary in gathering appropriate facts and information to make a reasoned determination within ERISA's fiduciary standards; this is commonly referred to as "procedural prudence" in court opinions and in the regulations.[28]

The Department has also issued a regulation that describes how ERISA's prudence requirements apply when making investment decisions with respect to assets of an ERISA-governed plan.[29] This may be informative as to how the Adviser and Financial Institution should evaluate recommendations under the Best Interest standard. Pursuant to the regulation, an investment fiduciary must give "appropriate consideration" to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties.[30] "Appropriate consideration" includes (i) making a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) and (ii) considering factors such as the composition of the portfolio with regard to diversification, the liquidity needs of the portfolio, and the projected return of the portfolio relative to the funding objectives of the plan.[31]

In the Preamble to the BIC, the Department also noted that the Financial Institution, in evaluating whether Advisers are making recommendations in the best interest, should consider the nature of the investment being recommended. The Department states that it "expects that Advisers and Financial Institutions providing advice will exercise special care when assets are hard to value, illiquid, complex, or particularly risky. Financial Institutions responsible for overseeing recommendations of these investments must give special attention to the policies and procedures surrounding such investments and their oversight of Advisers' recommendations."[32]

BIC Compliance Policies and Procedures

Under the BIC, the Financial Institution must also specifically identify and document its Material Conflicts of Interest, which exist when an Adviser or Financial Institution has a financial interest that a reasonable person would conclude could affect the exercise of its best judgment as a fiduciary in rendering advice to an IRA owner.[33] In addition, the Financial Institution must adopt measures reasonably and prudently designed to prevent Material Conflicts of Interest from causing violations of the Impartial Conduct Standards.[34] Further, the BIC requires that the Financial Institution designate one or more persons, whether identified by name, title, or function who are responsible for addressing Material Conflicts of Interest and monitoring their Advisers' adherence to the Impartial Conduct Standards.[35]

More specifically, the Department requires that the Financial Institution must specifically identify and document Material Conflicts of Interest and adopt measures "reasonably and prudently designed" to prevent those material conflicts from causing violations of the Impartial Conduct Standards. These policies must provide that the Financial Institution does not allow, and to the best of the Financial Institution's knowledge, any affiliates or persons in which they have an interest, will not allow, the use of quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other actions or incentives to the extent they "would reasonably be expected" to cause individual Advisers to make recommendations that are not in the Best Interest of Retirement Investors.[36]

The Department provides five examples of "possible approaches" Financial Institutions could take to mitigate conflicts of interest that arise in connection with the payment of Adviser compensation. The DOL emphasized that these examples are not exhaustive of potentially permissible policies and procedures, and "are not intended to provide detailed descriptions of all the attributes of strong and effective policies and procedures," and that "these examples and the policies and procedures are not intended as mere "check the box" exercises, but rather must involve the adoption and monitoring of meaningful policies and procedures reasonably and prudently designed to ensure Advisers' adherence to the Impartial Conduct Standards."[37] The examples of compensation structures include the following:

- Independently certified computer models;
- Rewards for Best Interest Advice;
- Asset-based compensation; and
- Fee offsets

Notably, these examples provide for compensation paid to the Adviser that does not vary by what recommendation is made or the use of an independently certified computer model under which such compensation to the Adviser may, presumably, vary by what recommendation is made.

The Department also noted that compensation paid to the Adviser may vary by what recommendation is made so long as any variance in the compensation paid is based upon "neutral factors" and the Financial Institution has adequate procedures in place to monitor Adviser recommendations to ensure compliance with the best interest standard. The Department appears to view "neutral factors" as "tied to the differences in the services delivered to the investor with respect to the different types of investments."[38]

In the preamble to the BIC, the Department provides as an example that "in many circumstances, it may require more time to explain the features of a complex annuity product than a relatively simpler mutual fund investment" and, therefore, that "the Financial Institution's policies and procedures could permit the payment of greater commissions in connection with annuity sales" subject to appropriate controls and oversights, an example of which is described below.[39] The Department further provides that "[d]ifferential compensation between *categories* *of investments* could be permissible as long as the compensation structure and lines between categories were drawn based on neutral factors that were not tied to the Financial Institution's own conflicts of interest, such as the time or complexity of the advisory work, rather than on promoting sales of the most lucrative products" (emphasis added).[40] The phrase "categories of investments" is not defined. However, Financial Institutions that wish to pay differential transaction-based compensation will need to identify such categories.

As previously discussed, even if the transaction-based compensation model is structured in a way to address conflicts, the Financial Institution must implement supervisory and monitoring mechanisms to police Advisers' recommendations to ensure Advisers are not making recommendations that are not in the "best interest" of the advice recipient, such as recommendations for certain products because of higher commissions. In an example in the preamble called "Commissions and stringent supervisory structure," the Department noted a number of procedures and controls that it believes are reflective of the intent and purposes of the BIC. Such procedures include the following:

- A system to monitor and supervise Adviser recommendations, evaluate the quality of the advice individual customers receive, properly train Advisers, and correct any identified problems. Particular attention is given to recommendations associated with higher compensation and recommendations at key liquidity events of an investor (for example, rollovers);
- Systems to evaluate whether Advisers recommend imprudent reliance on investment products sold by or through the Financial Institution;
- The use of metrics for behavior (for example, red flags), comparing an Adviser's behavior against those metrics, and basing compensation in part on them;
- Penalizing Advisers and supervisors (including the branch manager) by reducing compensation based on the receipt of customer complaints or indications that conflicts are not being carefully managed, and/or using clawback provisions to revoke some or all of deferred compensation based on the failure to properly manage conflicts of interest;
- Appointment of a committee to assess the risks and conflicts associated with new investment products, determine the prudence of the products for retirement investors, and assess the adequacy of the Financial Institution's procedures to police any associated conflicts of interest;
- Ensuring that no Adviser nor any supervisor (including the branch manager) participates in any revenue sharing from a "preferred provider," earns more for the sale of a product issued by a "preferred provider," or earns more for the sale of a proprietary product over other comparable products, and ensuring that the Adviser discloses to customers the payments that the Financial Institution and its Affiliates have received from a preferred provider or for a proprietary product; and,
- Periodically reviewing (and revising, if necessary) the policies and procedures.[41]

The above is only offered as an example, but should be understood as what the Department believes is a strong compliance program. Further, the Department expects that the person at the Financial Institution responsible for compliance with the BIC will correct recommendations that violate the procedures and then make adjustments to the procedures as needed to prevent further violations.

The BIC imposes additional requirements if a Financial Institution "restricts Advisers' investment recommendations, in whole or part, to Proprietary Products or to investments that generate Third Party Payments."[42] In this case, the Financial Institution must do the following:

1. Prior to, or at the same time as, the execution of the recommended transaction, disclose to the

IRA owner that the Financial Institution offers proprietary products or receives Third Party Payments and the limitations placed on the universe of investments that the Adviser may recommend to the IRA owner;

2. Prior to, or at the same time as, the execution of the recommended transaction, inform the IRA owner of any Material Conflicts of Interest;
3. The Financial Institution (i) documents in writing its limitations on the universe of recommended investments; (ii) documents in writing the Material Conflicts of Interest associated with any contract, agreement, or arrangement providing for its receipt of third party payments or associated with the sale or promotion of proprietary products; (iii) documents in writing any services it will provide to the IRA owner and on behalf of third parties (including the payor) in exchange for third party payments; (iv) reasonably concludes that the limitations on the universe of recommended investments and material conflicts of interest will not cause the Financial Institution or its Advisers to receive compensation in excess of reasonable compensation; (v) reasonably determines that these limitations and material conflicts of interest will not cause the Financial Institution or its Advisers to recommend imprudent investments; and (vi) documents in writing the bases for its conclusions;
4. The Financial Institution adopts, monitors, implements, and adheres to policies and procedures and incentive practices that are reasonably designed to mitigate conflicts including not using compensation arrangements that would reasonably be expected to cause the Adviser to make imprudent investment recommendations, to subordinate the interests of the IRA owner to the Adviser's own interests, or to make recommendations based on the Adviser's considerations of factors or interests other than the investment objectives, risk tolerance, financial circumstances, and needs of the IRA owner; and
5. The Adviser's recommendation is made in the "best interest" as set forth above, except that the standard does not require the analysis without regard to the financial benefit to the Adviser, Financial Institution, and affiliates, but rather provides that the "recommendation is not based on the financial or other interests of the Adviser or on the Adviser's consideration of any factors or interests other than the investment objectives, risk tolerance, financial circumstances, and needs of the" IRA owner.[43]

Written Contract and Warranties

One of the key components of the BIC is the requirement of a written contract in which the Financial Institution (not the Adviser) commits that the Financial Institution and the Advisers it supervises will commit to BIC compliance. More specifically, in a written, legally enforceable contract, the Financial Institution must warrant to the following:

1. it has adopted, and will comply with, written policies and procedures that are reasonably "and prudently" designed to ensure that its Advisers adhere to the Impartial Conduct Standards;
2. its policies and procedures require that neither the Financial Institution nor (to the best of its knowledge) any affiliate or party in which it has an interest use or rely upon quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other actions or incentives that are intended or would reasonably be expected to cause Advisers to make recommendations that are not in the Best Interest of the IRA owner; and
3. it has specifically identified and documented its Material Conflicts of Interest.[44]

The IRA owner must sign, either by hand or electronically, the BIC contract. Further, the contract may not include exculpatory language with regard to compliance with the BIC or limit the ability of an IRA owner to join a class action or other representative action to enforce the BIC.[45] The Department intends that compliance with the BIC will be enforced through the threat of a class action lawsuit brought against the Financial Institution for failing to meet said contractual requirements.

Level Fee Fiduciary

A streamlined version of the BIC is available if the Adviser and Financial Institution are a "Level Fee Fiduciary" and the Adviser makes a recommendation to rollover from an ERISA-covered plan or IRA to an IRA or recommends that the investor move from a commission-based account to a fee-based account.[46] An Adviser and Financial Institution are a Level Fee Fiduciary if "the only fee received by the Financial Institution, the Adviser and any Affiliate in connection with advisory or investment management services to the Plan or IRA assets is a Level Fee that is disclosed in advance to the" IRA owner. A fee is a "Level Fee" if it is a "fee or compensation that is provided on the basis of a fixed percentage of the value of the assets or a set fee that does not vary with the particular investment recommended, rather than a commission or other transaction-based fee."[47]

The addition of the streamlined BIC highlights two conflicts. Even if the fiduciary does not have a fee conflict in providing recommendations with regard to investing IRA assets, a conflict still exists if the Adviser makes a rollover recommendation because, without the rollover, the Adviser will not get paid in the first place. Therefore, under the streamlined BIC, DOL requires specific steps to demonstrate that the recommendation is made in the interest of the plan participant or IRA owner. A similar conflict exists when recommending a participant to move from a commission-based account to a fee-based account.

Practically, the Level Fee Fiduciary requirements will be difficult to meet for many Advisers and Financial Institutions since they may typically receive revenue in addition to a Level Fee, from, for example, revenue sharing or from recommending proprietary products. In the event the streamlined BIC is not available, the Adviser and Financial Institution should look to the full BIC.

Disclosure and Recordkeeping under the BIC

The BIC imposes substantial disclosure obligations on the Financial Institution. DOL divided the disclosures into three categories: (1) contract disclosures, (2) transaction disclosures, and (3) web disclosures. While this article does not describe the disclosure requirements in detail, it is important to note the requirements and also note that they will require significant revisions to current disclosures, as well as operational changes. The contract disclosure must be "clearly and prominently" displayed in the contract and provided prior to, or at the same time as, the execution of the recommended transaction. Further, the transaction disclosure must be provided at least annually or more frequently if the Adviser recommends a different investment product during that one year period. In either case, the Financial Institution must give the IRA owner the opportunity to ask for and receive additional information about fees, other information, and the disclosure.[48] However, the BIC does not state what additional information must be provided, so Financial Institutions must decide exactly what information will be provided.

Under the BIC, the Financial Institution must maintain a public webpage, which provides certain information, freely accessible to the public (but that can require a user name and password) that is updated not less than quarterly.[49] Thus, the information on the website will be accessible by competitors, regulators, plaintiff's attorneys, and others, though the registration and password requirements will limit the ability of outside parties to data mine the contents of the website.

The Financial Institution must disclose to the Department that it intends to rely on the BIC. Additionally, it must maintain for six years records necessary for the Department, IRA owners, and others to verify compliance with the BIC.[50]

Application of BIC & Other Exemptions

In conjunction with the Final Regulation and BIC, the Department has amended several of the current prohibited transaction exemptions so that almost all advice provided by financial professionals to IRAs and IRA owners must be provided in accordance with the requirements of the BIC. However, there are other exemptions that may be available for Advisers and Financial Institutions providing such advice to IRAs and IRA owners.

Prohibited Transaction Exemption 84-24 (PTE 84-24)

PTE 84-24 has been significantly amended and narrowed by the DOL. However, if the requirements are met, PTE 84-24 exempts prohibited transactions that arise by reason of recommending that an IRA owner purchase a "Fixed Rate Annuity" or "insurance contract."[51] A Fixed Rate Annuity is a fixed annuity contract issued by an insurance company that is either (i) an immediate annuity contract or (ii) a deferred annuity contract. Further, the contract must either (i) satisfy applicable state standard non-forfeiture laws at the time of issue or, (ii) in the case of a group fixed annuity, guarantee return of principal net of reasonable compensation and a guaranteed declared minimum interest rate in accordance with the rates specified in the standard non-forfeiture laws in that state that are applicable to individual annuities. Finally, the benefits of such fixed annuity contract do not vary, in whole or in part, based upon (i) the investment experience of a separate account or accounts maintained by the insurer or (ii) the investment experience of an index or investment model.[52]

The definition of Fixed Rate Annuity specifically excludes "a variable annuity or an indexed annuity." Therefore, prohibited transactions that arise by reason of the sale of variable annuities and fixed indexed annuities should be addressed through the BIC.[53]

Notably, PTE 84-24 contains several requirements that must be met in order for the exemption to apply. Importantly, such requirements include disclosure, the payment of reasonable compensation, and compliance with the above-discussed Impartial Conduct Standards.

ERISA Section 408(b)(4)

Code section 4975(d)(4)[54] provides a statutory exemption for transactions that are otherwise prohibited by the anti-self-dealing provision in Code section 4975(c)(1)(E) that arise by reason of the investment of all or a part of an IRA's assets in deposits bearing a reasonable rate of interest in a bank or similar financial institution supervised by the United States or a state. The exemption is available even though such bank is a fiduciary with respect to the IRA. However, the exemption does not apply to prohibited transactions that arise by reason of the anti-kickback prohibitions under Code section 4975(c)(1)(F).

Code Sections 4975(d)(17) & 4975(f)(8)

Code sections 4975(d)(17) and 4975(f)(8), commonly referred to as the "PPA Exemption," provide for an exemption of the prohibited transactions that arise by reason of a person providing investment advice through a fee-leveling program or a computer modeling program for purposes of the Code, so long as the requirements of the exemption are met. The exemption was added to the Code when the Pension Protection Act of 2006 was enacted by Congress.

The number of financial services firms that have adopted programs that meet the exemption is relatively low, in part due to the extensive requirements (including the review and verification of such programs by independent third parties) and the continued availability of DOL Advisory Opinion 2001-09A, also known as the SunAmerica Opinion. However, in light of the number of Advisers and Financial Institutions that will now be fiduciaries, this exemption may prove more attractive. One advantage of the exemption is that while the fees paid to the Adviser and the Financial Institution must be level, affiliates can receive non-level compensation such as, for example, revenue sharing or 12b-1 fees.

Prohibited Transaction Exemption 77-4 (PTE 77-4)

PTE 77-4 allows IRAs to invest in mutual funds managed by an affiliate of a fiduciary under the Code who provides investment advice to such IRA if the plan does not pay a "double fee" for investment management services and the other conditions of the exemption are met. The conditions include, among other things, a prohibition on the receipt of commissions, 12b-1 fees, and certain other payments and fees, prospectus delivery requirements, and approval of the investment of IRA assets in proprietary funds by the IRA owner. In addition, the Department amended PTE 77-4 to include the above-discussed Impartial Conduct Standards.[55]

Principal Trading Exemption

In conjunction with its issuance of the Final Regulation, the Department issued a new prohibited transaction class exemption that addresses fiduciary conflicts that arise in the context of riskless principal trades and principal trades with regard to the sale of certain debt securities, unit investment trusts, and certificate of deposits by fiduciaries to IRAs. The requirements of the exemption are considerable, which among other things include the application of the Impartial Conduct Standards and limitations on the Principal's ability to be an underwriter. However, the exemption may prove the only alternative for some principals because the BIC is only available to exempt conflicts that arise when the trade involves a riskless principal transaction.

Other DOL Guidance

Several years ago, the Department issued DOL Advisory Opinion 97-15A,[56] commonly known as the "Frost Opinion," and DOL Advisory Opinion 2010-05A,[57] commonly known as the "Country Trust Opinion," in which it said self-dealing or anti-kickback prohibited transactions do not occur if the fiduciary is paid a level fee previously approved by the IRA owner so long as any direct or indirect compensation subsequently received by the fiduciary or an affiliate is offset, dollar-for-dollar, against the pre-approved fee. Any such revenue in excess of said fee must be credited to investor accounts. Additionally, the Department issued Advisory Opinion 2001-09A, the SunAmerica Opinion. In this opinion, DOL explains that IRA service providers who offer participant investment advice programs, based on the investment advice of an independent financial expert, will not be exercising the authority, control, or responsibility that makes them a fiduciary so as to violate the Code's prohibitions against fiduciary conflicts. The guidance in the Frost, Community Trust and SunAmerica advisory opinions appears to still be available.

Considerations

As discussed, the Department drafted the BIC and revised current exemptions used by fiduciaries to avoid non-exempt prohibited transactions so that most advisers and financial services companies must rely on the BIC to address conflicts that arise when providing investment advice to IRAs and IRA owners. However, there are alternatives to the BIC available through other exemptions and other DOL guidance that may be available under certain circumstances.

Whether an adviser or financial services company relies on the BIC, any other exemption that continues to be available, or DOL guidance that continues to be available, will be largely dependent on the individual circumstances of each financial services company. A general services broker-dealer and registered investment adviser that provides brokerage and advisory services will in large part be reliant on the BIC, so reliance on multiple exemptions may not be of interest unless the BIC is not available; such a situation may arise if, for example, the Adviser and Financial Institution engage in principal trades that are not riskless principal trades. However, for financial services companies that have different types of operations, such as banks that sell CD IRAs, reliance upon another exemption, for example, ERISA section 408(b)(4), may make sense.

Notwithstanding the foregoing, even if an alternative to the BIC is used, the Department makes clear that it believes the recommendation of a rollover or the recommendation that assets be moved from a commission-based to a fee-based account results in a conflict even if another exemption is available once the assets are on the Adviser's and Financial Institution's platform. The Department revised PTE 84-24 to address the rollover transaction. However, the other exemptions and prior guidance may not be available to address the rollover or account transfer recommendation. In such cases, reliance on the streamlined BIC or full BIC may be the only option to address the conflicts that arise in connection with the rollover or account transfer recommendation.

Next Steps

Based upon the foregoing, many financial services companies and their representatives will become fiduciaries with regard to IRAs and IRA owners by reason of providing investment advice in situations where they take the position that they are not fiduciaries today. Therefore, they will need to address the fiduciary conflicts that are prohibited under ERISA section 4975.

The Final Regulation, the BIC, and the revised exemptions are applicable in two phases. On April 10, 2017, the following provisions apply:

1. The definition of "investment advice";
2. For the period from April 10, 2017 to January 1, 2018 (Transition Period), an Adviser and Financial Institution who wish to rely on the BIC must do the following:
    a. Comply with the Impartial Conduct Standard;
    b. Provide a written notice to the IRA owner prior to or at the same time as the execution of the recommended transaction, which may cover all transactions during the Transition Period, that:
        i. Acknowledges its and its Adviser(s) fiduciary status under the Code;
        ii. States in writing that it and its Advisers will comply with the Impartial Conduct Standards and disclose its Material Conflicts of Interest;
        iii. Discloses whether the Financial Institution recommends proprietary products or investments that generate Third Party Payments; and, to the extent the Financial Institution or Adviser limits investment recommendations, in whole or part, to Proprietary Products or investments that generate Third Party Payments, the Financial Institution must notify the Retirement Investor of the limitations placed on the universe of investment recommendations.
3. The revisions to the current exemptions are applicable so that the BIC applies to most recommendations to IRAs and IRA owners except PTE 84-24 and the other exemptions discussed above.

Effectively, this means that most Advisers and Financial Institutions must implement their conflict mitigation efforts required under the BIC, for example, adjustments to Adviser compensation to eliminate conflicts, by April 10, 2017.

On January 1, 2018, the Transition Period ends and the remaining BIC compliance requirements go into effect. This includes, but is not limited to, revising existing, non-grandfathered agreements to meet the BIC contract requirements and assuring the BIC disclosure requirements are met. Therefore, the Department gave additional time to comply with some of the BIC conditions that will in many cases require operational and technology enhancements. Furthermore, the BIC contract requirements that give rise to a contract lawsuit are delayed for a time.

Based upon the foregoing, advisers and financial services companies must get ready for one of the most transformative regulatory initiatives to impact the retirement services industry. They should consider some of the following action items (note the advice below assumes at least some compliance with the BIC):

1. Identify products and service offerings made available to IRAs and IRA owners, interactions with IRAs and IRA owners, and identify client accounts impacted;
2. Determine at what point the adviser or financial services company will act as a fiduciary and for what purposes, and determine if an exception, for example, investment education, to the general "investment advice" definition is available in the event fiduciary status is not intended or desired;
3. Identify direct and indirect compensation streams, fees and others amounts paid to advisers and the financial services companies (including affiliates) that are paid in connection with providing investment advice (with an emphasis on proprietary products and Third Party Payments);
4. Identify any conflicts in the areas of compensation and elsewhere;
5. Determine whether the firm will rely upon the BIC, other prohibited transactions, or still applicable prior DOL guidance;
6. Establish compliance procedures for demonstrating compliance with the Best Interest standard and surveillance procedures for monitoring compliance with such standard;
7. Develop training programs to ensure that advisers understand their obligations under a Best Interest standard;
8. Identify which accounts will be treated as grandfathered;
9. Prepare disclosures required for the April 10, 2017 deadline;
10. Prepare an amendment to current contracts for purposes of complying with the BIC effective January 1, 2018; and
11. Draft disclosures and develop a website as required by the BIC (or other applicable exemptions).

In short, there is a great deal of work to be done in the next twenty months. Financial services companies, their legal advisers, consultants, and service providers will in many cases need to work together a great deal during this period to ensure compliance by the above-discussed deadlines.

Mr. Kaleda is a principal at Groom Law Group Chartered.

NOTES

1 81 Fed. Reg. 20946 (April 8, 2016).
2 81 Fed. Reg. 21022 (April 8, 2016).
3 81 Fed. Reg. 21147 (April 8, 2016).
4 Reorganization Plan No. 4, 1978 (43 Fed. Reg. 47713, October 17, 1978).
5 29 C.F.R. § 2510.3-21(a)(1)(i) & (ii).
6 29 C.F.R. § 2510.3-21(b)(1).
7 81 Fed. Reg 20946, 20972.
8 29 C.F.R. § 2510.3-21(b)(1).
9 29 C.F.R. § 2510.3-21(a)(2).
10 81 Fed. Reg. 20946, 20981.
11 29 C.F.R. § 2510.3-21(c)(1)(i).
12 29 C.F.R. § 2510.3-21(g)(7).
13 29 C.F.R. § 2510.3-21(b)(2)(iv).
14 29 C.F.R. § 2510.3-21(b)(2)(i) & (ii).
15 29 C.F.R. § 2510.3-21(b)(2)(iii).
16 I.R.C. § 4975(c)(1)(E).
17 I.R.C. § 4975(c)(1)(F).
18 Best Interest Contract Exemption, § I(a).
19 Best Interest Contract Exemption, §§ IV & VIII(q).
20 Best Interest Contract Exemption, VIII(a).
21 Best Interest Contract Exemption, VIII(e).
22 Best Interest Contract Exemption, §§ II & III.
23 Best Interest Contract Exemption, § II(h).
24 Best Interest Contract Exemption, § II(c).
25 Best Interest Contract Exemption, § II(c)(1).
26 81 Fed. Reg. 21002, 21026.
27 Roth v. Sawyer Cleator Lumber Co., 16 F.3d 915, 918 (8th Cir. 1994) (the "prudent person standard is not concerned with results").

28 Donovan v. Mazzola, 716 F.2d 1226, 1232 (9th Cir. 1983).

29 29 C.F.R. § 2550.404a-1(b).

30 *Id.*

31 *Id.*

32 81 Fed. Reg. 21002, 21037.

33 Best Interest Contract Exemption, § II(d)(2).

34 Best Interest Contract Exemption, § II(d)(1).

35 *Id.*

36 Best Interest Contract Exemption, § II(d)(3).

37 81 Fed. Reg. 21002, 21038.

38 81 Fed. Reg. 21002, 21078-79.

39 81 Fed. Reg. 21002, 21037.

40 *Id.*

41 81 Fed. Reg. 21002, 21038.

42 Best Interest Contract Exemption, § II(d)(1).

43 *Id.*

44 Best Interest Contract Exemption, § II(d).

45 Best Interest Contract Exemption, § II(f).

46 Best Interest Contract Exemption, § II(h).

47 Best Interest Contract Exemption, § VII(h).

48 Best Interest Contract Exemption, § III.

49 Best Interest Contract Exemption, § III(b).

50 Best Interest Contract Exemption, § V.

51 81 Fed. Reg. 21147 (Apr. 8, 2016).

52 DOL Prohibited Transaction Exemption 84-24 § VI(k).

53 *Id.*

54 *See* I.R.C. § 4975(d)(4); 26 C.F.R. § 54.4975-6(b).

55 81 Fed. Reg. 21208 (Apr. 8, 2016).

56 DOL Adv. Op. 97-15A (May 22, 1997).

57 DOL Adv. Op. 2005-10A (May 11, 2005).