GROOM LAW GROUP

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Fiduciary Rule – Executive Summary

On April 6, 2016, the U.S. Department of Labor ("DOL") made available its much-anticipated final regulation on the definition of "fiduciary" under section 3(21)(a)(ii) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The new rule will have a profound impact on the retirement system and how services are provided throughout the industry. The package of materials released by DOL includes the following:

- A final regulation re-defining who is a "fiduciary" by reason of providing investment advice to a plan or an IRA (the "Final Regulation");

- Final versions of the Best Interest Contract Exemption ("BIC Exemption"), related supplemental exemptions, and the new prohibited transaction class exemption for principal transactions in certain investments (the "Principal Transactions Exemption"); and

- Final amendments to several existing prohibited transaction class exemptions, including prohibited transaction class exemption PTE 84-24 ("PTE 84-24"), currently the primary source of prohibited transaction exemptive relief for the sale of insurance and annuity products to plans and IRAs.

From a broad perspective, DOL did not deviate from its original goal of significantly expanding the types of communications that constitute fiduciary investment advice, particularly with respect to rollovers. And the Final Regulation and accompanying exemptions reflect a favoring of fee-leveling over commission-based compensation. That said, the retirement industry should take some solace in the fact DOL made many improvements to the new rules. Although it still remains to be seen whether the rules will be workable, the breadth of the changes is significant, and DOL has committed to working on sub-regulatory guidance over the coming months to help with implementation.

The Final Regulation, changes to existing class exemptions, and certain elements of the BIC Exemption will be effective 60 days after the date of their publication in the Federal Register. Despite this relatively early effective date, the terms of the rules generally delay their applicability until April 10, 2017. In the case of the BIC Exemption, special transition relief further delays the applicability of most conditions until January 1, 2018.

This alert provides an executive summary of the new rules and briefly discusses the future of the Final Regulation and related exemptions.

I. Executive Summary

A. Overview

The Final Regulation – sometimes referred to as the conflicted advice rule – is the most consequential change to the laws governing retirement plans since the passage of ERISA over four decades ago. It significantly expands the universe of those who are subject to fiduciary responsibility under ERISA and the Internal Revenue Code of 1986, as amended, for providing investment advice and generally conditions the availability of exemptive relief on the adherence to a new "best interest" standard of care on those advising IRA holders. The Final Regulation is also accompanied by several new or amended prohibited transaction class exemptions (including the BIC Exemption), which will require fundamental changes to how advisers, broker-dealers, banks, insurance companies, and consultants provide services and are compensated.

The Final Regulation is the result of a long rulemaking process that began in 2010 when DOL issued its first Notice of Proposed Rule Making regarding the definition of "investment advice." The proposal was quickly withdrawn in reaction to widespread criticism and remained dormant until it was re-proposed in 2015 ("2015 Proposed Regulation"). The 2015 Proposed Regulation generated fierce debate, reflected in the thousands of comment letters submitted on both sides of the issue, testimony provided over the course of a multi-day hearing last August, and hundreds of meetings between DOL and the regulated community.

B. Key Changes in Final Regulation

Although the Final Regulation preserves many key elements of the 2015 Proposed Regulation, DOL did make several important concessions. The most significant changes include the following:

- "Hire me" – The Final Regulation clarifies that recommending oneself or one's affiliate to provide investment advice or investment management services is not, by itself, the type of recommendation that necessarily leads to fiduciary status. However, if the "hire me" recommendation is coupled with a rollover recommendation, or effectively includes a recommendation as to how to invest or manage plan or IRA assets, the adviser will not be shielded from fiduciary status. In the latter case, the adviser would likely need to use the BIC Exemption. This could substantially limit the utility of an otherwise favorable change.

- Scope of a "Recommendation" – The Final Regulation also more closely aligns the definition of a "recommendation" with FINRA guidance, indicating that communications need to be more tailored to the particular recipient to be a recommendation. The definition still includes a "suggestion," which is a broad standard, but there are specific exclusions from the definition of "recommendation" for general communications (*e.g.*, general marketing materials and other widely circulated communications).

- Participant Education – The Final Regulation excludes from the description of a "recommendation" investment education, including asset allocation models and

interactive materials that reference specific investments or products available under ERISA-covered plans (provided that certain conditions are met). Importantly, this change *does not extend to education provided to IRAs or IRA holders.*

- Exception for Sales – Under the Final Regulation, advice provided to a fiduciary independent of the adviser in the context of an arm's-length sale, loan, exchange or other investment-related transaction will not result in fiduciary status for the adviser if the independent fiduciary is a bank, insurance company, registered investment adviser, registered broker dealer, or manages or controls total assets of at least $50 million (aggregated across clients, and not limited to plan or IRA clients) and certain other conditions are met. This change should help address the "wholesaler" or "daisy chain" issue, but the relief is more conditional than expected in that it requires disclosures to otherwise sophisticated financial intermediaries and may require representations from such firms.

- Platform Exception – The Final Regulation affirms that offering a platform of investment alternatives to a fiduciary of a participant-directed defined contribution plan will not be viewed as a fiduciary recommendation, and there is language in the preamble suggesting that the "segmenting" of platforms based on general categories is permitted. DOL also clarified that platform providers may provide RFP responses or objective financial data regarding alternatives meeting objective criteria established by a plan sponsor without triggering fiduciary status.

- Welfare Plans – DOL clarified that the Final Regulation does not include recommendations with respect to welfare plans (*e.g.*, health, disability, or term life insurance policies) if those products do not have an investment component. However, DOL did not exclude HSAs from the scope of the Final Regulation, so marketing HSAs together with group health insurance will have to be carefully monitored.

C. Key Changes to BIC Exemption

DOL made important changes to the BIC Exemption that reflect the significant advocacy efforts by the financial services industry and likely make the exemption somewhat more workable for a variety of firms. From DOL's perspective, greater reliance on the BIC Exemption will further its goal of creating an actionable a best interest standard for IRAs. In this regard, DOL made the following important changes to the BIC Exemption:

- DOL eliminated the requirement that a separate written contract be entered into for recommendations to ERISA Title I plans and participants, since those plans and participants have recourse through ERISA's civil enforcement provisions. In lieu of the contract, the financial institution of the adviser making such recommendations is generally required, among other things, to provide a unilateral writing acknowledging fiduciary status and to provide disclosures. Where a financial institution proposes a rollover for purposes of providing level advice (*i.e.*, advice where compensation does not vary either at the adviser level or at the financial institution level), the financial institution is not required to provide the same warranties or disclosures, but is required to document

the specific reason or reasons the rollover recommendation was in the client's best interest.

- DOL retained the contract requirement when advisers seek to use the BIC Exemption when providing advice to IRA holders so as to provide a contract-based private right of action. The requirements for contract formation have been eased somewhat in that the contract document may be incorporated into other account opening documentation and may be signed either electronically or manually by the client. In the case of already existing accounts, a "negative consent" process is available for forming the contract (during a transition period).

- DOL eliminated the requirement that the individual adviser be a party to the BIC Exemption contract, merely requiring a contract between the client and the financial institution that employs or retains the individual adviser.

- The BIC Exemption was amended to apply to recommendations of any asset as opposed to the restricted list of assets included in the proposed exemption.

- DOL expanded the availability of the BIC Exemption to small businesses that sponsor participant-directed plans. This is intended to address the "gap" problem we brought to DOL's attention.

- The BIC Exemption contains special provisions clarifying how it can be used for recommendations of proprietary products, including a requirement that financial institutions determine that the limitations are not so severe that the adviser will generally be unable to satisfy the exemption's best interest standard and other requirements.

- DOL eliminated the annual disclosure and disclosures requiring 1, 5, and 10 year projections as well as the proposed exemption's data retention requirements. However, DOL retained the conflict of interest disclosure requirement and website disclosure requirement. The final exemption also requires certain disclosures in the contract and, in certain circumstances, prior to or at the time of a transaction (and no less frequently than annually). Moreover, those subject to the BIC Exemption can request more detailed disclosures on costs and fees.

- The BIC Exemption contains a streamlined "level fee" provision, which enables advisers and financial institutions that receive only a level fee in connection with the advice they provide to rely on the exemption without entering into a contract so long as special attention is paid and documentation is kept to show that certain specific recommendations, including a recommendation to rollover assets from an employer plan to an IRA, are in the customer's best interest. Importantly, no contract is required. However, the level fee condition extends to all affiliates, so for example, it may not provide a basis to recommend a rollover into an arrangement otherwise covered by an exemption that only requires level fees for the adviser (*e.g.*, ERISA section 408(b)(14)).

- The BIC Exemption includes a grandfathering provision that allows for receipt of compensation from previously acquired assets. The grandfather provision includes recommendations to hold, as well as systematic purchase agreements but requires that any additional advice satisfy the best interest and reasonable compensation requirements.

D. Key Changes to PTE 84-24

Consistent with its "encouragement" of the BIC Exemption, DOL has limited the circumstances in which those recommending insurance products or proprietary mutual funds may rely on PTE 84-24. The key changes to PTE 84-24 are as follows:

- PTE 84-24 is no longer available for recommendations of variable annuities, indexed annuities, and similar contracts to IRAs *or* plans. (The proposed exemption would have permitted plans to purchase variable annuities in reliance on PTE 84-24. These will now need to be covered by the BIC Exemption).

- The "commissions" covered for sales of fixed rate annuity contracts to plans and IRAs and mutual fund shares to plans have been narrowly defined (excluding, for example, revenue sharing).

- Any recommendations covered under PTE 84-24 must meet the same impartial conduct standards applicable to BIC Exemption-users.

E. Effective Date

The Final Regulation is effective 60 days after it is published in the Federal Register. However, the Final Regulation and several conditions of the BIC Exemption (*e.g.*, the acknowledgement of fiduciary status, adhering to the best interest standard, and certain conflict of interest disclosures) have a delayed applicability date of April 10, 2017. Other requirements of the BIC Exemption (*e.g.*, the contract requirement and certain representations and warranties regarding firm conflicts) will not go into full effect until January 1, 2018. In the period between publication and January 1, 2018, an interim rule that mirrors the conditions of the existing regulation will be in effect.

II. Future of the Final Regulation

Notwithstanding the issuance of the Final Regulation and related exemptions, DOL has indicated that it will work with stakeholders on further guidance. There will also be efforts this year to stop the new rules in Congress and the courts.

A. Additional DOL Guidance

The Final Regulation and related exemptions are extremely complex, and there are a number of issues that were left unaddressed. Typically, DOL provides additional guidance after the release of major regulations, and this case appears to be no exception. DOL has stated that it "will work with interested parties on compliance assistance activities and materials." The

agency also "invites stakeholders to identify areas or specific issues where they believe additional clarifying guidance is needed."

B. Potential Congressional Action

The Republican-controlled Congress is almost certain to take steps to overturn or halt implementation of the Final Regulation. In fact, a recent post on Speaker of the House Paul Ryan's blog declared that House Republicans are "determined to do everything possible to protect consumers and stop this rule." Immediately after the release of the Final Regulation, Republicans on several committees of jurisdiction released statements criticizing it.

Sources on the Hill have indicated that Congress may soon attempt to overturn the Final Regulation using the Congressional Review Act ("CRA"). The CRA creates a window of time in which Congress can utilize a "fast track" process for considering administrative rules. The process significantly limits procedural roadblocks in the Senate (*e.g.*, the filibuster) and, in essence, allows Congress to overturn a final regulation with a simple majority vote. A successful CRA challenge nullifies the rule at issue, and the agency is prohibited from reissuing the same regulation again or promulgating a regulation that is substantially similar. However, as a practical matter, CRA challenges are rarely successful because they can be vetoed by the President, and it would require a two-thirds vote in both the House and Senate to override the veto.

It is very likely that, because of certain timing requirements, any CRA challenge to the Final Regulation will occur in this Congress. The action would almost certainly be vetoed by President Obama, and it will likely be difficult for Congress to override the veto.

Another potential avenue for intervention is for Congress to pass legislation to override the Final Regulation. There have been several bills to that effect introduced. The most discussed is a pair of bipartisan sister bills – the Affordable Retirement Advice Protection Act (H.R. 4293; S. 2502) and the SAVERS Act of 2015 (H.R. 4294; S. 2505) – which would statutorily redefine "investment advice," narrowing the scope when compared to the Final Regulation. Together, the bills would also hold those providing IRA-related investment advice to a best interest standard of care and would require additional disclosures of conflicts and fees.

The bills were approved by the House Education and Workforce Committee and the House Ways and Means Committee in February on mostly party-line votes, despite their bipartisan co-sponsorship. House leadership has, in the past, indicated that the bills could be considered by the House but that they would be merged together. Similar legislation has been introduced in the Senate but does not yet have Democratic support and has not been considered by the relevant committees. President Obama would likely veto the bills if they were to pass Congress.

A third and final option for opponents is to try to halt implementation of the Final Regulation using Congress's power of the purse. Congress makes annual appropriations for government operations through specific funding bills, and those bills almost always include policy riders. In 2011, for example, DOL's funding appropriation contained a prohibition on the

use of funds to finalize the fiduciary rule as proposed in 2010. (The rider was dropped from subsequent funding bills.) Congress must pass an appropriations package before the end of September, and it is possible Congress could insert a provision halting the Final Regulation. However, Democrats in the House and Senate have previously blocked such efforts.

C. Litigation

A number of organizations have already indicated they are considering challenging the Final Regulation in court. At the moment, it is unclear exactly what arguments will be made, but there are at least two potential legal theories. First, a plaintiff could argue that DOL failed to satisfy the requirements for agency rulemaking under the Administrative Procedure Act. In other words, DOL failed to take all of the procedural steps necessary for the Final Regulation to have the force and effect of law. A second potential argument is that DOL lacked the statutory authority to promulgate all or part of the Final Regulation (*e.g.*, the authority to impose ERISA-like requirements on IRAs).

Regardless of the merits of either argument, litigation is often slow moving and may not be completed before the industry must comply with the Final Regulation. It is possible for a court to stay a rule pending the outcome of an action. However, that is often a high bar, requiring a court to determine, among other things, that the plaintiff has a likelihood of prevailing on the merits and will suffer irreparable harm if a stay is not granted.

III. Summary Materials

In addition to this executive summary, please see below for links to additional information:

- A memorandum outlining the key elements and scope of the Final Regulation;
- An outline of the finalized BIC Exemption;
- An outline of the changes to PTE 84-24;
- An outline of the finalized Principal Transactions Exemption;
- A chart showing the final amendments to existing prohibited transaction class exemptions; and
- An outline of the "Hire Me" Issue.

The Final Regulation and related exemptions raise a host of consequential issues. We will continue to provide updates as we further analyze the proposal and its implications, and we invite you to contact us for assistance in evaluating how the Final Regulation will impact your business.