GROOM LAW GROUP

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# Fiduciary Rule – Best Interest Contract Exemption

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 (the "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, currently the primary source of prohibited transaction exemptive relief for the sale of insurance and annuity products to plans and IRAs.

The Final Regulation, changes to existing class exemptions, and certain elements of the BIC Exemption will be effective 60 days from the date of their publication in the Federal Register (*i.e.*, June 7, 2016). 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 client alert provides an overview of the finalized changes to the BIC Exemption. For an analytical summary of the Final Regulation, PTE 84-24, the Principal Transactions Exemption, and changes to other existing exemptions, please see our client alerts covering those subjects.

## I. Rationale for Exemption

In the absence of an exemption, receipt by a fiduciary adviser of compensation 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 sections 406(a)(1)(D) and 406(b) because the amount of the fiduciary's compensation would be affected by the investment advice it provides. DOL views prohibited compensation as the receipt of compensation by a fiduciary that varies based upon the

investment advice given by the fiduciary and the receipt of compensation by fiduciaries from third parties in connection with their advice. As such, the final BIC Exemption covers commissions paid directly by the plan or IRA, as well as “Third Party Payments,” which include sales charges when not paid directly by the plan, participant or beneficiary account, or 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 Financial Institution or an Affiliate or Related Entity by a third party as a result of a transaction involving a plan, participant or beneficiary account, or IRA.

According to DOL, the final BIC Exemption is designed to: (i) 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 (particularly when such IRAs and plans are not represented by knowledgeable fiduciaries); and (ii) facilitate the continued provision of advice to such retail investors by permitting Advisers to receive brokerage or insurance commissions, 12b-1 fees, revenue sharing payments, and other forms of direct and indirect compensation, even though the receipt of such compensation otherwise gives rise to nonexempt prohibited transactions under ERISA and/or the Internal Revenue Code of 1986, as amended (“Code”).

Notably, DOL has made substantial changes to the BIC Exemption since it proposed the BIC Exemption last spring. Many of those changes are intended to make compliance with the BIC Exemption easier for advisers and their supervising institutions. We believe that DOL has accomplished this goal at least in part. However, the BIC Exemption continues to include substantial disclosure and compliance requirements. The BIC Exemption still employs a “standards-based approach” at the center of which is a requirement to (i) adhere to Impartial Conduct Standards in rendering advice, (ii) adopt, implement, and follow policies and procedures designed to mitigate the dangers posed by “Material Conflicts of Interest,”[1] (iii) disclose important information relating to fees, compensation, and conflicts, and (iv) retain documents and data relating to investment recommendations. Further, DOL has broadened the applicability of the BIC Exemption to a larger group of investors and transactions. Finally, the BIC Exemption retains substantially similar remedial provisions found in the proposed BIC Exemption so that IRA owners can bring class action suits against Advisers and their supervising institutions for failing to meet the “Best Interest”[2] and other BIC Exemption

[1] The final BIC Exemption defines “Material Conflict of Interest” as 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 a Retirement Investor.

[2] According to the final BIC Exemption, investment advice is in the “Best Interest” of the Retirement Investor when the Adviser and Financial Institution providing the advice 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, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.

requirements, thus using the threat of litigation and actual litigation to enforce the BIC Exemption requirements.

## II. Covered Transactions and Relief Provided

The exemption would provide relief from the restrictions of ERISA sections 406(a)(1)(D) and 406(b) and Code sections 4975(c)(1)(D), (E), and (F) for the receipt of prohibited compensation by "Advisers," "Financial Institutions," "Affiliates," and "Related Entities" for services provided in connection with the provision of investment advice to a "Retirement Investor." (*Note: these terms and others in quotation marks are defined throughout the summary.)*

- The final BIC Exemption does not use the term "Assets," which was used in the proposed BIC Exemption. Therefore, the final BIC Exemption is available to exempt prohibited transactions that arise by reason of the payment of otherwise prohibited compensation in connection the recommendation of any security or investment product.
    - *This is welcome news for Advisers and Financial Institutions that recommend covered calls, non-publicly traded REITS, alternative investment funds, structured notes, and other securities and products that were not included in the definition of "Assets." However, in the preamble, DOL said 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." Further, DOL stated that a Financial Institution "must give special attention" in its oversight of the policies and procedures "surrounding such investments." DOL will be looking at recommendations of such securities and products during its investigations.*
- The final BIC Exemption exempts prohibited transactions that arise by reason of the payment of prohibited compensation in connection with the provision of "investment advice." Therefore, the final BIC Exemption applies to investment advice provided in connection with recommendations of distributions and rollovers, as well as of investment managers and investment advice providers.
    - *DOL stated that its intent always was that the BIC Exemption would cover these recommendations. However, this is a helpful clarification.*
- These provisions of the BIC Exemption are intended by DOL to be coordinated with the DOL's changes to PTE 84-24, which no longer covers prohibited transactions that arise in connection with the payment of otherwise prohibited compensation for the sale of annuities that are not fixed rate annuities, e.g., variable annuities, indexed annuities. *Therefore, in order to receive prohibited compensation in connection with recommending these products, the Adviser and Financial Institution must comply with the BIC Exemption.*

## III. Covered Recipient of Advice

A "Retirement Investor" is a (i) 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 ("ERISA Plan"), (ii) a participant or beneficiary of a plan described in section 4975(e)(1)(A) of the Code with authority to direct the investment of assets in his or her plan account or to take a distribution ("Other Plan"), (iii) the beneficial owner of an IRA acting on behalf of the IRA, or (iv) a Retail Fiduciary with respect to an ERISA Plan, Other Plan, or IRA. A "Retail Fiduciary" is a fiduciary that is not a registered investment adviser, registered broker-dealer, insurance company, or plan fiduciary that holds, manages, or controls $50 million or more of assets.

*By adding the Retail Fiduciary component to the definition of Retirement Investor, DOL addresses what we at Groom identified as the "gap problem." The proposed BIC Exemption and the proposed changes to the existing prohibited transaction exemptions resulted in a situation where Advisers and Financial Institutions would be prohibited from receiving commissions and Third Party Payments in connection with advice given to certain plans including participant-directed defined contributions plans and large pension and other trustee-directed plans. This change to the definition of Retirement Investor from the proposed BIC Exemption provides relief for the receipt of otherwise prohibited compensation with regard to a broader array of investors for which prohibited transaction exemptive relief is needed.*

## IV. 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 BIC Exemption.

- 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.

- 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.

  *The definition of Financial Institution in the final BIC Exemption includes an option whereby an organization may apply for an independent prohibited transaction exemption pursuant to which the entity will be recognized as a Financial Institution for purposes of applying an exemption that mirrors the BIC Exemption. We believe this was added to accommodate situations where Advisers are not supervised by entities that qualify as a Financial Institution.*

- 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, partner, employee, or relative of the Adviser or Financial Institution; and (iii) any corporation or partnership of which the Adviser or Financial Institution is an officer, director, or partner.

- 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.

## V. Exclusions

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

- If the Adviser, Financial Institution, or Affiliate is the employer of employees covered by the ERISA Plan.

- If the Adviser or Financial Institution is a named fiduciary or plan administrator (or an affiliate thereof) with respect to an ERISA Plan, unless the Adviser or Financial Institution was selected to provide advice by an independent fiduciary.

- If the compensation is received as a result of a principal transaction between the Financial Institution and the ERISA Plan, participant or beneficiary account, or IRA, unless the transaction is a riskless principal transaction.

- 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 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, unless the robo-advice provider is a Level Fee Fiduciary (as described below).

- The Adviser has or exercises discretion with respect to the recommended transaction.

## VI. Conditions of Relief

Unlike the proposed BIC Exemption, the final BIC Exemption offers Advisers and Financial Institutions an opportunity to comply with a "streamlined" BIC Exemption in the case of a "Level Fee Fiduciary" and a "Bank Networking Agreement." In all other cases, full compliance with the BIC Exemption is required.

### A. Level Fee Fiduciary

#### 1. Eligibility

This streamlined exemption is available if the only fee received by the Financial Institution, the Adviser, *and* any Affiliate *in connection with* advisory or investment management services to the ERISA Plan, Other Plan, or IRA assets is a Level Fee that is disclosed in advance to the Retirement Investor. A "Level Fee" 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. While robo-advice is generally not covered by the BIC Exemption, this exemption is available if the advice provider is a Level Fee Fiduciary.

*Because the Level Fee requirement applies to Financial Institution, the Adviser, and any Affiliate, the utility of the streamlined approach is questionable for many advice programs and arrangements.*

#### 2. Streamlined Requirements

- Prior to, or at the same time as, the execution of the recommended transaction, the Financial Institution must provide the Retirement Investor with a written statement of the Financial Institution's and its Adviser's fiduciary status;

- The Financial Institution and Adviser must comply with the Impartial Conduct Standards;

- In the case of a recommendation to *roll over from an ERISA Plan to an IRA*, the Financial Institution must document the specific reason or reasons why the recommendation was considered to be in the Best Interest of the Retirement Investor. This documentation must include consideration of the Retirement Investor's alternatives to a rollover, including leaving the money in his or her current employer's plan, if permitted, and must take into account the fees and expenses associated with both the ERISA Plan and the IRA. The documentation should also discuss whether the employer pays for some or all of the plan's administrative expenses, as well as the different levels of services and investments available under each option; and,

- In the case of a recommendation to *rollover from another IRA or to switch from a commission-based account to a Level Fee arrangement*, the Level Fee Fiduciary must document the reasons why the arrangement is considered to be in the Best Interest of the Retirement Investor, as well as specify the services that will be provided for the fee.

*In the preamble, DOL unequivocally recognized a conflict in providing distribution and rollover advice even when after the distribution and rollover the Adviser, Financial Institution, and their Affiliates receive compensation in a manner that does not*

*give rise to a fee conflict. For example, in the absence of the distribution and rollover from a plan or IRA not maintained by the Financial Institution, the Adviser and Financial Institution will not get paid. Therefore, an exemption is needed to address the conflict. It appears that the BIC Exemption may be the only exemption available to address this conflict.*

*Additionally, the justification of moving a Retirement Investor from a commission-based account to a Level Fee arrangement is important. This requirement appears to be in response to Adviser and Financial Institution questions whether compliance with the BIC Exemption requires all Retail Investors to be forced into a "fee-based" account. DOL appears to be stating that this is not the case and that doing so may violate the "Best Interest" requirement under the Impartial Conduct Standards.*

**B. Bank Networking Arrangement**

- To the extent an employee of a bank, and a Financial Institution that is a bank or similar financial institution receives compensation pursuant to a "Bank Networking Arrangement" in connection with providing investment advice to a Retirement Investor, the bank employee and Financial Institution are exempt from the prohibitions of ERISA sections 401(a)(1)(D) and 406(b), so long as the advice adheres to the Impartial Conduct Standards.

- A "Bank Networking Arrangement" is an arrangement for the referral of retail nondeposit investment products that satisfies applicable federal banking, securities, and insurance regulations, under which employees of a bank refer bank customers to an unaffiliated investment adviser, broker or dealer, or insurance company (each meeting certain registration qualifications).

*Importantly, bank personnel may provide "investment advice," as defined in the Final Regulation, and receive compensation in circumstances that are not a Bank Networking Arrangement. In such circumstances, the personnel and bank may need to rely on one or more prohibited transaction exemptions.*

**C. Generally Applicable Exemption**

**1. Written Contract**

As the first condition, the Financial Institution must enter into an enforceable contract with IRAs and Other Plans pursuant to which the Financial Institution agrees that it, and its Advisers, will comply with the BIC Exemption's standards. Importantly, DOL concluded that a contract is *not* necessary with regard to an ERISA Plan because the remedial provisions of ERISA largely give the plan's participants and beneficiaries the rights and remedies intended to be created under the BIC Exemption's contract requirements, *e.g.,* the right to bring a class action to recover damages.

The contract must be entered prior to, or simultaneous with, the *execution* of a recommended transaction, rather than before a recommendation was made (which was wholly impracticable). Further, the contract terms may be incorporated into account opening documents and other commonly-used agreements with new customers (including master agreements). However, in the case of an ERISA Plan where no contract is required, the conditions of the BIC Exemption may be complied with in some form of written statement. Lastly, the final BIC Exemption offers a safe harbor, under limited circumstances, for the failure to enter a written contract.

*In the case of securities or products distributed through broker dealers or other entities that are "Financial Institutions," the product manufacturer need not be a party to the BIC Exemption contract in order for the BIC Exemption to be available. However, in the case where the products are recommended by Advisers who are not associated with or supervised by entities that are not Financial Institutions (e.g., certain selling or marketing organizations) an issue arises whether a product manufacturer must become a party to the BIC Exemption contract in order for the BIC Exemption to be available.*

**2. Acknowledge Fiduciary Status**

The Financial Institution must affirmatively state in writing that the Financial Institution and the Adviser(s) act as fiduciaries under ERISA, the Code, or both, with respect to any investment advice provided by the Financial Institution or the Adviser subject to a contract or, in the case of an ERISA plan, with respect to any investment recommendations regarding the Plan or participant or beneficiary account.

*The fact that the Adviser is not required to be a party to the contract is a welcome change, particularly for Financial Institutions whose Advisers provide advice by telephone and because of the high turnover among Advisers experienced by some Financial Institutions.*

**3. Impartial Conduct Standards**

Under the BIC Exemption, 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. With respect to ERISA Plans, these standards need only be *complied with* (and not separately stated in a written document).

- The fiduciary, at the time of the recommendation, 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 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 Affiliate, Related Entity, or other party." This definition was modified from what was offered in the proposed BIC Exemption in order to "more closely track the statutory language of ERISA section 404(a)."[3] We note that DOL stated in the final BIC Exemption's preamble that the "Best Interest" standard, and the "without regard to" clause, are intended to reflect the duties of loyalty and prudence under ERISA and trust law. Consequently, according to DOL, the standard is not designed to prohibit the provision of advice from investment menus that are restricted to proprietary products, or generate third party payments.

*Notwithstanding these assurances, the "with regard to" language may still present unnecessary litigation risk to Advisers and Financial Institutions relying on the BIC Exemption. Furthermore, to confuse matters, DOL eliminated the "without regard to" language from the "Best Interest" standard in situations where Financial Institutions limit, in whole or in part, recommendations of Advisers to proprietary products and investments that make Third Party Payments to the Financial Institution.*

- The recommended transaction may not cause the Financial Institution, Adviser or their Affiliates, or Related Entities 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, DOL confirmed in the preamble to the BIC Exemption that an Adviser and Financial Institution do *not* necessarily have to recommend a transaction that is the lowest cost or that generates the lowest fees.

- The fiduciary may make only "not materially misleading" statements about the recommended transaction, fees, Material Conflicts of Interest (as described below), and any other matters relevant to a Retirement Investor's investment decisions. We note that this is measured at the time the statement is made. DOL did *not* adopt suggestions to incorporate a reliance element.

### 4. Warranties

The following substantive provisions must be met. For IRAs and Other Plans, the Financial Institution must "warrant" in the contract (see above) that it has satisfied and will satisfy these conditions. With respect to ERISA Plans, for which no contract is necessary, these conditions may be satisfied *without* having to warrant their satisfaction. In either case, the conditions must *in fact* be complied with.

- The Financial Institution must warrant that it has adopted, and will comply with, written policies and procedures that are reasonably "and prudently" designed to

[3] DOL expressly said that the Best Interest standard does *not* incorporate as one of its elements FINRA's "suitability" obligation imposed upon broker-dealers. The failure to satisfy the suitability standard will result in the failure to satisfy the Best Interest standard; however, a recommendation in accordance with the suitability obligation may or may not satisfy the Best Interest standard.

ensure that its Advisers adhere to the Impartial Conduct Standards, described below.[4]

- The Financial Institution must warrant that its policies and procedures require that neither the Financial Institution nor (to the best of its knowledge) any Affiliate or Related Entity (as those terms are defined in the BIC Exemption) 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 Retirement Investor. Importantly, this warranty would *not* preclude the Financial Institution, its Affiliates, or Related Entities from providing Advisers with differential compensation (whether in type or amount, and including, but not limited to, commissions) based on investment decisions by plans, participant or beneficiary accounts, or IRAs, provided that such policies and procedures and incentive practices, *when viewed as a whole*, are reasonably and prudently designed to avoid a misalignment of the interests of Advisers with the interests of the Retirement Investors they serve as fiduciaries. The BIC Exemption expressly provides that such compensation practices may include differential compensation based on neutral factors that are a function of differences in the services delivered to the Retirement Investor with respect to the different types of investments. Moreover, DOL cited an infrequently traded account as an example of where transaction-based compensation may be more appropriate than level compensation.

- The Financial Institution must also warrant that it has specifically identified and documented 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 a Retirement Investor. 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. Interestingly, the BIC Exemption now 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.

The final BIC Exemption does not contain the warranty that the Financial Institution and the Adviser comply with all applicable laws included in the proposed BIC Exemption.

[4] DOL explained in the preamble that "[t]he exemption's goal is not to wring out every potential conflict, no matter how slight, but rather to ensure that Financial Institutions and Advisers put Retirement Investors' interests first, take care to minimize incentives to act contrary to investors' interests, and carefully police those conflicts that remain."

### 5. Policies and Procedures Related to Conflicts

In formulating its policies and procedures, 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* Affiliate or Related Entity, to use 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.

- These policies and procedures *do not prevent* the Financial Institution, its Affiliates, or Related Entities from providing Advisers with differential compensation (whether in type or amount, and including, but not limited to, commissions) based on investment decisions by plans, participant or beneficiary accounts, or IRAs, to the extent that the Financial Institution's policies and procedures and incentive practices, *when viewed as a whole*, are reasonably and prudently designed to avoid a misalignment of the interests of Advisers with the interests of the Retirement Investors they serve as fiduciaries. The BIC Exemption expressly permits differential compensation *based on* neutral factors that are *tied to* variations in the services delivered to the Retirement Investor with respect to the different types of investments (rather than where the differential amounts based on the specific investment recommendation).

- While DOL 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 "possible approaches" Financial Institutions could take to mitigate conflicts of interest. DOL emphasized that these examples are not exhaustive of potentially permissible policies and procedures, "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." The examples include:

    - <u>Independently certified computer models</u>. The Adviser interacts directly with the Retirement Investor, but provides investment advice that is in accordance with an unbiased computer model created by an independent third party. In a footnote, DOL clarified that BIC Exemption relief is not available if the information produced by the computer model is not *conveyed by a person*. DOL also confirmed that this example does not nullify prior DOL guidance on differential compensation, such as DOL

Advisory Opinion 2001-09A, and that relief may be separately provided by section 408(b)(14) of ERISA.

- o Rewards for Best Interest Advice. 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.

- o 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. Furthermore, the Adviser earns the same percentage on the same payment schedule, regardless of how the Retirement Investor's assets are allocated between different investments, and the Financial Institution gives particular attention to recommendations that increase the Adviser's base (e.g., advice to roll money out of a plan into IRA investments that generate fees for the Adviser).

- o Fee offsets. The Financial Institution establishes a fee schedule for its and its Advisers' services. The fees are both reasonable (in relation to the services provided) and are not themselves intended, nor reasonably expected, to cause Advisers to violate the Impartial Conduct Standards. 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. The Adviser retains only the amount of compensation set forth in the fee schedule.

The following example was included in the preamble to the proposed BIC Exemption. DOL included it in the preamble to the final BIC with a greater emphasis on a stringent supervisory structure.

- Commissions and stringent supervisory structure. 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 (e.g., time or complexity of work involved). The Adviser's compensation is not a function of how much revenue or profits a particular investment product generates for the Financial Institution. Moreover, the Financial Institution adopts a stringent supervisory structure to ensure that Advisers' recommendations are based on the customer's financial interest. DOL provided examples of a prudent supervisory structure, including:

- 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 (e.g., 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 (e.g., 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.

In the preamble to the final BIC Exemption, DOL stated that while Financial Institutions retain the latitude to design their compensation structures, the DOL expects that the Financial Institution will undertake a prudent process in designing and monitoring the structure and to correct any violations (isolated or systemic).

**6. Prohibited Contract Terms**

The contract with the Retirement Investor (as applicable) *must not* contain the following terms. If the terms are included, the BIC 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 plan's, IRA's, or 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, or in an individual or class claim agrees to an amount representing liquidated damages for breach of the contract. Newly added by the final BIC Exemption is an ability for the parties to knowingly agree to waive the Retirement Investor's right to obtain punitive damages or rescission of recommended transactions, to the extent such a waiver is permissible under applicable state or federal law.

*These provisions are in DOL's view essential to the effectiveness of the BIC Exemption because compliance with the BIC Exemption as to IRAs is enforced through the threat of litigation or the conduct of litigation.*

### 7. Disclosures

The final BIC Exemption does not include some of the more onerous disclosures required in the proposed BIC Exemption, including projected fees and an extensive annual disclosure requirement. However, the disclosure obligations under the final BIC Exemption are substantial. DOL divided the disclosures into three categories: (i) Contract Disclosures, (ii) Transaction Disclosures, and (iii) Web Disclosures. We discuss those in turn.

- <u>Contract Disclosures</u>. Either in contract (where the recipient is an IRA or Other Plan) or in a written statement (where the recipient is an ERISA plan), the Financial Institution must "clearly and prominently" provide a writing, prior to, or at the same time as, the execution of the recommended transaction, that:
    - States the Best Interest standard of care owed by the Adviser and Financial Institution to the Retirement Investor; informs the Retirement Investor of the services provided by the Financial Institution and the Adviser; and describes how the Retirement Investor will pay for services;
    - Describes Material Conflicts of Interest; discloses any fees or charges the Financial Institution, its Affiliates, or the Adviser impose upon the Retirement Investor or the Retirement Investor's account; and states the types of compensation that the Financial Institution, its Affiliates, and the Adviser expect to receive from third parties in connection with investments recommended to Retirement Investors;
    - Informs the Retirement Investor that the Retirement Investor has the right to obtain copies of the Financial Institution's written description of its policies and procedures (described above), as well as the specific disclosure of costs, fees, and compensation regarding recommended transactions, to permit the Retirement Investor to make an informed judgment about the costs of the transaction and about the significance and

severity of the Material Conflicts of Interest, and describes how the Retirement Investor can get the information, free of charge; provided that if the Retirement Investor's request is made prior to the transaction, the information must be provided prior to the transaction, and if the request is made after the transaction, the information must be provided within 30 business days after the request;

*In this and other circumstances, the Retirement Investor may request more detailed information. DOL made this part of a "two-tiered" approach to disclosure where more general information is initially provided and then more detailed information is provided upon request.*

- States whether the Financial Institution offers proprietary products or receives third party payments with respect to any recommended investment;

- Includes a link to the Financial Institution's website (as part of the website disclosure requirement) and informs the Retirement Investor that: (i) model contract disclosures updated as necessary on a quarterly basis are maintained on the website, and (ii) the Financial Institution's written description of its policies and procedures are available free of charge on the website;

- Provides contact information (telephone and email) for a representative of the Financial Institution that the Retirement Investor can use to contact the Financial Institution with any concerns about the advice or service they have received; and,

- Describes whether or not the Adviser and Financial Institution will monitor the Retirement Investor's investments and alert the Retirement Investor to any recommended change to those investments, and, if so monitoring, the frequency with which the monitoring will occur and the reasons for which the Retirement Investor will be alerted. Importantly, a duty to monitor may be imposed based what was communicated (in any number of documents) to the Retirement Investor. Also, DOL said that certain investments (particularly, complex ones) cannot be prudently recommended "in the first place" without a duty to monitor the investment on an ongoing basis.

*Please note that the BIC Exemption provides that the Financial Institution will not fail to satisfy these required disclosures (or violate a contractual provision based thereon) "solely because" it, when acting in "good faith and with reasonable diligence," makes an error or omission in disclosing the required information, provided that the Financial Institution discloses the correct information as soon as practicable, but not later than 30 days*

*after the date on which it discovers or reasonably should have discovered the error or omission.*

- Transaction Disclosures. A point of sale disclosure must be provided to the Retirement Investor prior to or at the time of the execution of an investment transaction in a standalone document or a clearly broken out section of a contract. If an Adviser subsequently makes a recommendation with respect to the same product, a new disclosure is only required if a year has passed or if there has been a material change. It must provide a disclosure that:

    - States the Best Interest standard of care owed by the Adviser and Financial Institution to the Retirement Investor and describes any Material Conflicts of Interest.

    - Informs the Retirement Investor that the Retirement Investor has the right to obtain copies of the Financial Institution's written description of its conflict mitigation policies, as well as specific disclosure of costs, fees, and other compensation including third party payments regarding recommended transactions. Financial arrangements can be described in the form of dollar amounts, percentages, formulas, or other means reasonably calculated to present a materially accurate description of the arrangements.

    - Includes a link to the Financial Institution's website, informs the Retirement Investor of the information available through the Web Disclosures (discussed below), and notifies the Retirement Investor that the information is available free.

- Web Disclosures. The Financial Institution must maintain a public webpage, which provides the following information, freely accessible to the public (but that can require a user name and password) that is updated not less than quarterly. *DOL eliminated the requirement that this disclosure be in a machine readable format and now allows Financial Institutions to place the web disclosure behind a log in. This could limit the ability to data-mine Financial Institutions' websites.*

    - A discussion of the Financial Institution's business model and the Material Conflicts of Interest associated with that business model.

    - A schedule of typical account or contract fees and service charges.

    - A model contract or other model notice of the contractual terms and certain required disclosures under the BIC Exemption.

    - A written description of the Financial Institution's policies and procedures that accurately describes or summarizes key components of the policies and procedures relating to conflict-mitigation and incentive practices in a

manner that permits Retirement Investors to make an informed judgment about the stringency of the Financial Institution's protections against conflicts of interest.

  - To the extent applicable, a list of all product manufacturers and other parties with whom the Financial Institution maintains arrangements that provide third party payments to either the Adviser or the Financial Institution with respect to specific investment products or classes of investments recommended to Retirement Investors; a description of the arrangements, including a statement on whether and how these arrangements impact Adviser compensation, and a statement on any benefits the Financial Institution provides to the product manufacturers or other parties in exchange for the third party payments.

  - Disclosure of the Financial Institution's compensation and incentive arrangements with Advisers including, if applicable, any incentives (including both cash non-cash compensation or awards) to Advisers for recommending particular product manufacturers, investments, or categories of investments to Retirement Investors, or for Advisers to move to the Financial Institution from another firm or to stay at the Financial Institution, and a full and fair description of any payout or compensation grids, but not including information that is specific to any individual Adviser's compensation or compensation arrangement. Products may be grouped by categories.

- Further Conditions Applicable for Proprietary Products and Third Party Payments to Financial Institutions. Additional conditions apply if a Financial Institution limits an Adviser's investment recommendations in whole or part, to proprietary products or to investments that generate third party payments:

  - Prior to, or at the same time as, the execution of the recommended transaction, the Retirement Investor is clearly and prominently informed in writing that the Financial Institution offers proprietary products or receives Third Party Payments with respect to the purchase, sale, exchange, or holding of recommended investments, and the Retirement Investor is informed in writing of the limitations placed on the universe of investments that the Adviser may recommend to the Retirement Investor;

  - Prior to, or at the same time as, the execution of the recommended transaction, the Retirement Investor is fully and fairly informed in writing of any material conflicts of interest that the Financial Institution or Adviser have with respect to the recommended transaction, and the Adviser and Financial Institution comply with the disclosure requirements, described above;

- The Financial Institution documents in writing its limitations on the universe of recommended investments; 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; documents in writing any services it will provide to Retirement Investors in exchange for Third Party Payments, as well as any services or consideration it will furnish to any other party, including the payor, in exchange for the Third Party Payments; 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 for Retirement Investors; reasonably determines that these limitations and material conflicts of interest will not cause the Financial Institution or its Advisers to recommend imprudent investments; and documents in writing the bases for its conclusions;

- The Financial Institution adopts, monitors, implements, and adheres to policies and procedures and incentive practices that are reasonably designed to mitigate conflicts; neither the Financial Institution nor (to the best of its knowledge) any Affiliate or Related Entity uses or relies 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 the Adviser to make imprudent investment recommendations, to subordinate the interests of the Retirement Investor 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 Retirement Investor;

- At the time of the recommendation, the amount of compensation and other consideration reasonably anticipated to be paid, directly or indirectly, to the Adviser, Financial Institution, or their Affiliates or Related Entities for their services in connection with the recommended transaction is not in excess of reasonable compensation within the meaning of ERISA section 408(b)(2);

- The Adviser's recommendation reflects 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, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, and the Adviser's 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 Retirement Investor. *Unlike elsewhere in the BIC Exemption, this*

*standard of care does not contain, "without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party." This adds some uncertainty about whether compensation to the Financial Institution may be taken into account.*

- DOL Disclosure. Before receiving prohibited compensation in reliance of the BIC Exemption, the Financial Institution must notify DOL of its intention to rely on this Exemption. *The disclosure is provided to DOL via email. As a positive development, DOL declined to accept comments suggesting that it create an online database where third-parties can verify what Financial Institutions are relying on the BIC Exemption.*

### *8. Data Retention*

The proposed BIC Exemption would have required a Financial Institution to maintain and, upon request, disclose to DOL information related to "Inflows," "Outflows," "Holdings," and "Returns." Financial Institutions noted that developing systems to compile this data would be an enormous and costly undertaking. The final BIC Exemption eliminated this requirement.

### *9. Recordkeeping*

The language in the recordkeeping section is largely unchanged in the final BIC Exemption. A Financial Institution using the BIC Exemption will be required to comply with certain recordkeeping requirements to demonstrate that they complied with the BIC Exemption's requirements and would be required to provide DOL and others with access to the Financial Institution's records. Failure to maintain records for a transaction will result in the loss of the BIC Exemption for such transaction. *An employee or representative of DOL or the Internal Revenue Service may examine privileged trade secrets or privileged commercial or financial information of the Financial Institution, or information identifying other individuals.*

## VII. Exemption for Purchases and Sales, including Insurance and Annuity Contracts

- Prohibited Transaction. Sections 406(a)(1)(A) and 406(a)(1)(D) of ERISA and counterparts under the Code prohibit the purchase by a Retirement Investor of an investment product from a Financial Institution that is a service provider (or other "party in interest" or "disqualified person").

- Applicable Exemption. The restrictions of ERISA section 406(a)(1)(A) and 406(a)(1)(D) shall not apply to the purchase of an investment product by a Retirement Investor if:

- o The transaction is effected by a Financial Institution in the ordinary course of business.

- o The Financial Institution, Affiliates, and Related Entities receive no more than reasonable compensation within the meaning of ERISA section 408(b)(2).

- o The terms of the transaction are at least as favorable to the Retirement Investor as terms generally available in an arm's length transaction with an unrelated party.

*DOL significantly broadened this Exemption in two ways. As proposed, the Exemption was limited to transactions involving insurance or annuity contracts. Additionally, the proposed BIC Exemption had only offered relief to transactions for cash. The BIC Exemption was also broadened to permit plan fiduciaries and IRA owners to transact in-kind.*

## VIII. Potential Sources of Liability for Advice Fiduciaries Who Fail to Comply with the Terms of the BIC Exemption

- Contractual liability to IRA owners. IRA owners can also participate in class actions. Liquidated damages provisions are invalid, but waivers of punitive damages or rescission rights are valid to the extent permitted under applicable laws.

- 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. Plans or plan participants and beneficiaries could participate in ERISA class actions.

- Liability under ERISA section 502(a)(2) and (3) in connection with suits by DOL for claims related to employee benefit plans but not IRAs. Statutory penalty under ERISA section 502(l) for up to 20 percent of the amount recovered by DOL.

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

## IX. Exemption for Pre-Existing Transactions

- <u>Rationale for Exemption</u>. Some Advisers and Financial Institutions may have, prior to the applicability date, provided advice without considering themselves fiduciaries. Their receipt, after the applicability date, of compensation attributable to advice provided as to the purchase, holding, sale, or exchange of securities or other property (i) acquired before the applicability date, or (ii)

acquired pursuant to a purchase program established before the applicability date, might otherwise raise prohibited transaction concerns. The Exemption for Pre-Existing Transactions would provide relief for the receipt of this compensation.

The Exemption is also intended to assist those Advisers and Financial Institutions who were considered fiduciaries before the Applicability Date, but who entered into transactions involving plans and IRAs before that date in accordance with the terms of a prohibited transaction exemption that has since been amended.

- Transactions Covered and Relief. The exemption provides relief from ERISA sections 406(a)(1)(A), 406(a)(1)(D) and 406(b) and Code sections 4975(c)(1)(A), (D), (E), and (F) for the receipt of compensation by an Adviser, Financial Institution, and any Affiliate and Related Entity, for advice provided as to the purchase, holding, sale, or exchange of securities or other property (i) acquired before the applicability date, or (ii) acquired pursuant to a purchase program established before the applicability date.

- Conditions.

    - The compensation is received pursuant to an agreement, arrangement, or understanding that was entered into prior to the applicability date and that has not expired or come up for renewal post-applicability date.

    - The original purchase, exchange, holding, or sale of the securities or property was not a non-exempt prohibited transaction under ERISA section 406 and Code section 4975 on the date it occurred.

    - The compensation is not received in connection with an additional amount invested in the security or other property acquired before the applicability date. (An exchange within a mutual fund family or a variable annuity contract is permitted as long as the exchange does not result in the Adviser, Financial Institution, and their Affiliates and Related Entities, receiving more compensation than they were entitled to receive prior to the applicability date.).

    - The amount of compensation paid to the Adviser, Financial Institution, or their Affiliates or Related Entities, is not in excess of reasonable compensation under ERISA section 408(b)(2) and Code section 4975(d)(2).

    - Any advice provided after the applicability date satisfies the Best Interest standard.