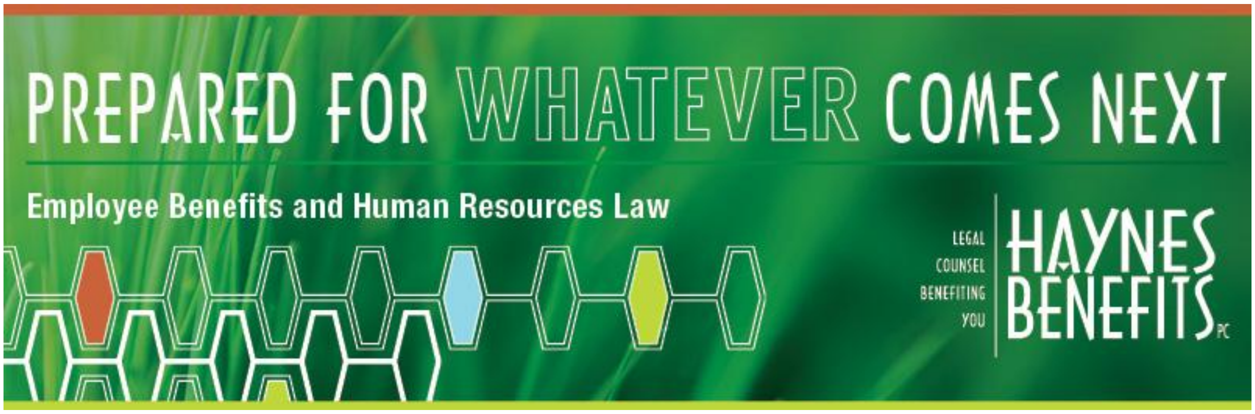

DOL Final Fiduciary Rule; Best Interest Contract Exemption or Level Fee Fiduciary Exemption from the Perspective of Advisers and Financial Institutions

The purpose of this article is to help Advisers and Financial Institutions focus on whether to comply with DOL Final Fiduciary Rule by satisfying the Best Interest Contract Prohibited Transaction Exemption or the Level Fee Fiduciary Prohibited Transaction Exemption. The Final Fiduciary Rule is not described in detail in this article. This article assumes you are an “Adviser’ or “Financial Institution” who provides investment advice for a fee or other compensation and, therefore, must comply in a timely manner with either the Best Interest Contract Prohibited Transaction Exemption or the Level Fee Fiduciary Prohibited Transaction Exemption.

I. Background

In April 2016, the DOL Fiduciary Rule and its exemptions were issued in final form. The Final Fiduciary Rule replaces the fiduciary rules issued in 1975 when the retirement savings marketplace was primarily employer-sponsored defined benefit plans. The current retirement savings marketplace has experienced a dramatic shift to participant-directed 401(k) plans, coupled with widespread growth in assets in individual retirement accounts and annuities. The DOL notes that this has increased the importance of sound investment advice for workers, their families and plan fiduciaries. The DOL believes that, while many advisers act in their customer’s best interest, not everyone is legally obligated to do so and some do not. The DOL believes that many investment professionals, consultants, brokers, insurance agents and other advisers operate within compensation structures that are misaligned with their customers’ interests and they often create strong incentives to steer customers into particular investment products. These conflicts of interest do not always have to be disclosed. Advisers have limited liability under federal pension law for any harms resulting from the advice they provide to plan sponsors and retirement investors. The DOL believes these harms include the loss of billions of dollars a year for retirement investors in the form of eroded ERISA plan investment results, and often after rollovers out of ERISA protected plans into IRAs.[1] ERISA and the Internal Revenue Code prohibit fiduciary advisers to employee benefit plans and individual retirement accounts from receiving compensation that varies according to their investment advice. Similarly, fiduciary advisers are prohibited from receiving compensation from third parties in connection with their advice. The Best Interest Contract Exemption or the Level Fiduciary Fee Exemption permits certain persons who provide investment advice to retirement investors and associated Financial Institutions, Affiliates, and other related entities to receive such otherwise prohibited compensation, as hereinafter described.

II. Definitions

The Best Interest Contract Exemption defines several terms, including the following:

(a) An "Adviser" is a fiduciary of the Plan or an IRA by reason of investment advice as described in ERISA Section 3(21) and Code Section 4975(e)(3)(B) or both and the applicable regulations with respect to the assets of the Plan or IRA.

(b) An "Affiliate" of an Adviser or Financial Institution or any person directly or indirectly controlled by or under the common control of the Adviser or Financial Institution.

(c) "Financial Institution" means:

  (1) A Registered Investment Advisor (under either the Investment Advisors Act of 1940 or applicable state law);

  (2) A Bank or similar Financial Institution;

  (3) An Insurance Company qualified to do business under the laws of a state; or

  (4) A Broker-Dealer registered under the Securities Exchange Act of 1934.

(d) "IRA" means any account or annuity described in Code Section 4975(e)(1)(B) through (F) including an individual retirement account described in Code Section 408(a) and a Health Savings Account described in Code Section 223(d).

(e) "Material Conflict of Interest" exists when an Adviser or Financial Institution has a financial interest that a reasonable person would

[1] This explains why advice to Retirement Investors about whether to rollover to an IRA is subject to the Final Fiduciary Rule and must satisfy either the Best Interest Contract Exemption or the Level Fiduciary Fee Exemption.

conclude could affect the exercise of its best judgment as a fiduciary in rendering investment advice to a Retirement Investor.

(f) “Plan” means any Plan described in ERISA Section 3(3) or Code Section 4975(e)(1)(A).

(g) “Related Entity” means an entity, other than an Affiliate in which the Adviser or Financial Institution has an interest which may affect the exercise of its best judgment as a fiduciary.

(h) “Proprietary Product” means a product that is managed, issued, or sponsored by the Financial Institution or any of its Affiliates.

(i) “Retail Fiduciary” means a fiduciary of an ERISA Plan or IRA that is not a Financial Institution.

(j) “Retirement Investor” means:

(1) A participant or beneficiary of a Plan or an IRA;

(2) The beneficial owner of an IRA, acting on behalf of the IRA; or

(3) A Retail Fiduciary.

III. Best Interest Contract Exemption Requirements

(a) An IRA or other non-ERISA Plan must enter into an enforceable written contract with the Financial Institution that acknowledges fiduciary status for itself and its Advisers. An alternative to executing a new contract with an IRA or other non-ERISA Plan is to amend an existing contract to include the terms described in III(c), (d), and (e) (that does not include any of the Ineligible Contract provisions described in III(f). This contract amendment must be provided to the Retirement Investor prior to January 1, 2018 with notice that it will be deemed to be accepted unless the Retirement Investor terminates the contract within a 30-day period. If the contract is terminated, the exemption will provide relief for 14 days after the date the termination notice is received by the Financial Institution. This is referred to as “negative consent provisions.”

(b) The Financial Institution must affirmatively state in writing that it and its Advisers are fiduciaries under ERISA or the Internal Revenue Code (the “Code”) and will adhere to the fiduciary standards in ERISA or the Code.

(c) Impartial Conduct Standards: The Financial Institution must state in writing that:

(1) its advice at the time of the recommendation will be in the best interest of the Retirement Investor;

(2) that the recommended transaction will not cause the Financial Institution, Adviser, or their Affiliates or Related Entities to receive directly or indirectly compensation for its services that are in excess of reasonable compensation within the meaning of ERISA Section 408(b)(2) and Code Section 4975(d)(2); and

(3) that statements by the Financial Institution and its Advisers about the recommended transaction, fees, compensation, Material Conflicts of Interest and other matters relevant to a Retirement Investor's investment decision will not be materially misleading at the time they are made.

(d) Warranties:

(1) The Financial Institution must affirmatively warrant that it has adopted and will comply with written policies and procedures designed to ensure that its Advisers will adhere to the Impartial Conduct Standards.

(2) The Financial Institution must designate a person (or persons), identified by name, title or function who will be responsible for addressing Material Conflicts of Interest and monitoring their Advisers' adherence to the Impartial Conduct Standards.

(3) The Financial Institution must require that neither it (nor to the best of its knowledge, its Affiliates or any related entity) will use or rely upon quotes, appraisals, performance, or personal actions, bonuses, contests, special awards, differential compensation or other compensation that would reasonably be expected to cause recommendations to be made that are not in the best interest of the Retirement Investor. However, differential compensation, such as commissions, based on investment decisions by Plans, participant or beneficiary accounts, or IRAs are permitted, to the extent the Financial Institution's policies and procedures and incentive practices as a whole are reasonably designed to avoid a misalignment of the interest of Advisers with the interest of the Retirement Investors they serve as fiduciaries.

(e) Required Written Disclosures:

The following written disclosures from a Financial Institution to a Retirement Investor in a contract with an IRA investor or in a statement with respect to ERISA must be provided prior to or at the same time as the execution of a recommended transaction.

(1) A statement of the Standard of Care owed by the Adviser and Financial Institution to the Retirement Investor, including how the Retirement Investors will pay for services directly or through third party payments.

(2) Material Conflicts of Interest, including fees or charges the Financial Institution, its Affiliates and the Adviser expects to receive from third parties.

(3) A statement of the Retirement Investor's right to receive the Financial Institution's written description of its policies and procedures, which will include sufficient information (in dollar amounts, percentages, and other means) reasonably designed to permit the Retirement Investor to make an informed judgment of the costs of the transaction and the significance of Material Conflicts of Interest.

(4) A link to the Financial Institution's website with certain required information.

(5) Disclosure to the Retirement Investor of whether the Financial Institution offers Proprietary Products or receives third party payments.

(6) Contact information (telephone and email) the Retirement Investor may use to contact the Financial Institution, including if applicable, a statement describing how the Retirement Investor can research the Financial Institution and its Advisers using the FINRA Broker Check database or the Investment Adviser Registration depository.

(f) Ineligible Contract Provisions:

(1) Exculpatory provisions disclaiming or otherwise limiting liability of the Adviser or the Financial Institution.

(2) A provision under which the Plan, IRA or Retirement Investor waives its right to participate in a class action or

other action in court in a dispute with the Adviser or Financial Institution.

(3) Agreements to arbitrate or mediate in venues that are distant or otherwise unreasonably limit the ability of the Retirement Investor to assert claims safeguarded by the Best Interest Contract Exemptions.

(g) ERISA Plans:

The written contract requirement described in Section III(a) does not apply to ERISA Plans. Instead the following applies.

(1) Prior to or at the same time as a recommended transaction is executed, the Financial Institution must provide the ERISA Plan investor with a written statement of the Financial Institution's and Adviser's fiduciary status in accordance with III(b).

(2) The Financial Institution and the Adviser must comply with the Impartial Conduct Standards described in III(c) hereof.

(3) The Financial Institution must adopt policies and procedures incorporating the warranty requirements and prohibitions set forth in III(d) hereof.

(4) The Financial Institution must provide the required disclosures described in III(e) hereof.

(5) The Financial Institution or Adviser does not in any contract, instrument or communication include any of the ineligible contract provisions described in III(f) hereof.

Web and Transaction Based Disclosures

A Financial Institution must satisfy the following conditions with respect to an investment recommendation to be covered by the Best Interest Contract Exemption.

(a) Transaction Disclosures:

The Financial Institution provides the Retirement Investor prior to or at the same time as the execution of the recommended investment, the following disclosure, clearly and prominently in a single written document that:

(1) 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;

(2) Informs the Retirement Investor of its right to obtain copies of the policies and procedures adopted in accordance with III(d) hereof, as well as specific disclosures of costs, fees, and other compensation, including third party payments regarding recommended transactions. This information must be provided prior to the transaction if requested prior to a transaction, or if requested after the transaction, the information must be provided within 30 business days after the request; and

(3) This information does not need to be repeated for subsequent transactions within one year after the disclosure under III(e) hereof unless there have been material changes.

(b) Web Disclosures:

In addition to the disclosures previously described herein, in order to satisfy the Best Interest Contract Exemption, a Financial Institution must maintain a website freely accessible to the public and updated no less frequently than quarterly which contains:

(1) A discussion of the Financial Institution's business model;

(2) A schedule of typical contract fees and service charges;

(3) A model contract or model notice of contract terms and required disclosures in III(b) to (e) hereof, which are reviewed quarterly and updated within 30 days thereafter, if necessary;

(4) A written description of the Financial Institution's policies and procedures;

(5) A disclosure of the Financial Institution's compensation and incentive arrangements with its Advisers; and

(6) A list of all product manufacturers and all other parties with whom the Financial Institution maintains relationships that cause third party payments to be made to the Adviser or Financial Institution.

IV. Disclosure to the DOL and Recordkeeping

The following disclosures to the Department of Labor and record retention requirements must be made by a Financial Institution, in order for a Best Interest Contract Exemption to be available.

(a) DOL/EBSA Disclosure. The Financial Institution must notify the Department of Labor/Employee Benefits Security Administration of its intention to rely on the Best Interest Prohibited Transaction Exemption by email to e-BICE@dol.gov. The notice need not identify any Plan or IRA. The notice remains in effect until revoked in writing by the Financial Institution.

(b) The Financial Institution must retain for six years all records necessary for the DOL and other entities (such as Plan fiduciaries, participants, beneficiaries and IRA owners) to determine whether the conditions of the Best Interest Contract Exemption have been satisfied.

V. Level Fee Fiduciaries

(a) A Financial Institution and Adviser are "Level Fee Fiduciaries" 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 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.

(b) Sections III(a), (d), (e), (f), (g) and IV of this article do not apply to Level Fee Fiduciaries.

(c) Therefore, only the following provisions apply to Level Fee Fiduciaries:

  (1) The Financial Institution must affirmatively state in writing that it and its Advisers are fiduciaries under ERISA or the Code and will adhere to the fiduciary standards in ERISA or the Code.

  (2) Impartial Conduct Standards: The Financial Institution must state in writing that:

    A. its advice at the time of the recommendation will be in the best interest of the Retirement Investor;

B. that the recommended transaction will not cause the Financial Institution, Adviser, or their Affiliates or Related Entities to receive directly or indirectly compensation for its services that are in excess of reasonable compensation within the meaning of ERISA Section 408(b)(2) and Code Section 4975(d)(2); and

C. that statements by the Financial Institution and its Advisers about the recommended transaction, fees, compensation, Material Conflicts of Interest and other matters relevant to a Retirement Investor's investment decision will not be materially misleading at the time they are made.

Comments

A Financial Institution that decides to be a Level Fee Fiduciary must satisfy the Level Fee Fiduciary requirements by April 10, 2017. Retirement Advisers, such as Broker-Dealers or Insurance Companies who do not elect to become Level Fee Fiduciaries will need to modify their procedures by not later than January 1, 2018 to satisfy the more comprehensive Best Interest Contract Exemption duties and obligations described herein.

Please let us know if we can be of assistance.

Written by: Thomas C. Graves

The content herein is provided for educational and informational purposes only and does not contain legal advice.