

# Living with the DOL Fiduciary Rule

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**June 28, 2017**

# Overview of Presentation

- History of the DOL Rule
- The Substance of the Rule
- The Exemptions
- Changes in How Broker-Dealers Are Interacting with Clients
- What We Can Expect for the Future of the Rule
- Legal Liability and Potential Litigation

# History of the DOL Fiduciary Rule

- In October 2010, the DOL first proposed its Fiduciary Rule, which was withdrawn in September 2011.
- In April 2015, the DOL issued a new proposed Fiduciary Rule, which became final in April 2016.
- The Final Rule became effective in June 2016, with implementation dates delayed to April 10, 2017 (general), and January 1, 2018 (contract requirements).
- The DOL issued a series of three FAQs on the Fiduciary Rule in October 2016 and January 2017 to provide guidance with regard to the implementation of the Fiduciary Rule.

- On February 3, 2017 President Trump directed the DOL to consider the impact of the Fiduciary Rule on the ability of Americans to gain access to retirement information and financial advice and to prepare an updated economic and legal analysis regarding the Fiduciary Rule.
- In response to President Trump's directive, in March and April 2017 the DOL issued a notice to extend the Applicability Date 60 days from April 10, 2017 to June 9, 2017.
- In late May 2017, Secretary of Labor Acosta announced in a Wall Street Journal op ed piece that the DOL would not seek to extend the June 9, 2017 effective date for the definition of who is a fiduciary and the impartial conduct standards.

- The DOL also issued revised versions of the Best Interest Contract Exemption (the BIC Exemption) and the Principal Transaction Exemption with relaxed requirements to comply with each during a transition period from June 9, 2017, to December 31, 2017 (the “Transition Period”).
- In May 2017 the DOL issued a Field Assistance Bulletin regarding its enforcement policy during the Transition Period and another set of FAQs regarding the application of the Fiduciary Rule and applicable exemptions during the Transition Period.
- The DOL has left open the possibility that during the Transition Period it may seek to delay implementation dates further, revise the Fiduciary Rule and the BIC and Principal Transaction Exemptions or propose new exemptions.

# DOL Fiduciary Rule Basics

- The Fiduciary Rule itself (excluding the BIC and Principal Transaction exemptions) went into full effect on June 9, 2017.
- The DOL Fiduciary Rule greatly expands the scope of who might be deemed a fiduciary when dealing with retail retirement accounts.
  - Investment advice includes any suggestion to the client regarding a proposed action or inaction.
    - Covers investments in specific products, investment strategies and referrals to investment advisers
    - Both the individual who provides the advice (the “Advisor”) and his/her employer (the “Financial Institution”) are deemed fiduciaries
- Consequences of being deemed a fiduciary:
  - Must act in best interest of client
  - Must avoid conflicts of interest with client or obtain written consent

- For example, if a party is a fiduciary under ERISA, any advice it gives to a retirement account client that results in increased compensation to the party or its affiliate is a self-dealing prohibited transaction unless there is an available exclusion or exemption.
- As a consequence of this conflict of interest rule, an adviser may not receive commissions or other variable compensation except in compliance with applicable exceptions or exemptions.
- The consequences of a prohibited transaction are an initial 15% excise tax on the amount involved, rising to a 100% if the transaction is not undone following notice from the Internal Revenue Service. The party could also be subject to fiduciary liability under ERISA.
- As will be discussed later, the major means of addressing such liability as a fiduciary under the Fiduciary Rule are to:
  - Qualify for the Sophisticated Investor Exception,
  - Act as a level-fee fiduciary, or
  - Meet the Requirements of the BIC or Principal Transaction Exemptions.

# Actions That Cause You to Be Deemed a Fiduciary

- Under the former DOL rules, which had been in effect for over 40 years, a person was considered a fiduciary only if he or she provided investment advice (i) on a regular basis (ii) pursuant to a mutual agreement, arrangement or understanding that was (iii) the primary basis for investment decisions and (iv) was individualized for the particular needs of the retirement investor.
- The new DOL Fiduciary Rule removes the requirements that (i) the advice be given on a regular basis, (ii) it be pursuant to a mutual agreement or understanding or (iii) it serve as a primary basis for the investment decision.
- Therefore, any individualized investment advice will trigger fiduciary status.

# What Is Investment Advice?

- The new Fiduciary Rule expands the scope of what is considered investment advice.
- The former rules limited their scope to investment advice regarding:
  - The value of securities or other property, and
  - The advisability of investing in, purchasing or selling securities or other property.
- The new DOL Fiduciary Rule covers advice regarding:
  - Purchase, sale or holding of securities or other investment property;
  - Investment strategy or management of investment assets;
  - Advice as to rollovers or changing investment accounts from fee-based to commission-based or vice-versa; and
  - Recommendation of others to provide investment advice.

- The new DOL Fiduciary Rule looks to FINRA guidance as to what constitutes an investment recommendation. Any communication that could reasonably be viewed as a “suggestion” that the client take certain action or refrain from taking certain action in relation to a security or investment strategy will be deemed a recommendation.
- See FINRA Notice to Members 11-02.
- Broad definition will cover many communications between a Financial Institution and its customers.
- Educational communications are carved out.
  - But need to be careful not to stray over the line into tailored investment recommendations
- “Hire me” and general communications are carved out.
  - See FAQs 8 – 19 (Jan. 2017)

# What Are the Consequences of Being Deemed a Fiduciary?

- There is a significant increase in the duties resulting from being deemed a fiduciary.
- Must act in Best Interest of client.
  - Requires an understanding of the client's circumstances and objectives
  - Prudent person rule
  - Recommendations must be without regard for the personal interests of the fiduciary
  - Suitability standard not sufficient
- Must avoid conflicts of interest or obtain written waiver.
  - One of the most problematic aspects of fiduciary status for market makers, underwriters, etc.
  - BIC Exemption and Principal Transactions Exemption have specific requirements for identifying, disclosing and mitigating conflicts
- Commissions and other forms of variable compensation are generally prohibited.
  - Level fee arrangements are generally okay
  - Others need to find an available exemption or exception

# Exclusion for Dealing with Certain Institutional or Professionally Managed Retirement Accounts

- The “sophisticated investor exception” carves out from the Fiduciary Rule advice to certain sophisticated clients or professionally managed plans
- Exception is available if the person responsible for the retirement investor is independent of the seller and is:
  - A bank;
  - Certain insurance companies;
  - A registered investment adviser;
  - A registered broker-dealer; or
  - An independent fiduciary that holds, or has under management assets of, at least \$50 million.

- In addition, to qualify for the Sophisticated Investor Exception, the seller must:
  - Know or reasonably believe that the independent fiduciary of the plan or IRA is capable of evaluating investment risks independently; and
  - Know or reasonably believe that the independent fiduciary of the plan or IRA is a fiduciary under ERISA or the Code, or both, with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction.

(For the above requirements, the seller may rely on written representations of the person acting as the fiduciary for the plan or IRA, which Transition Period FAQs clarify can be established by negative consent (e.g., deemed representations.)

The seller must also:

- Fairly inform the independent fiduciary that the seller is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity;
- Fairly inform the independent fiduciary of the seller's financial interest in the transaction; and
- Finally, to qualify for the Sophisticated Investor Exception, the seller must not receive a fee or other compensation directly from the plan or IRA for the provision of investment advice, but can receive a fee or compensation from another party.

**Exclusion for Dealing with Certain Institutional or Professionally Managed Retirement Accounts, cont'd.**

# Scope and Requirements of the BIC Exemption

- The BIC Exemption creates an approach for undertaking transactions with retail retirement clients who would not qualify for the Sophisticated Investor Exception.
- The BIC Exemption is available for transactions in all classes of securities, but it covers only transactions effected on an agency or riskless principal basis.
- Principal transactions, which are defined to include purchases or sales on behalf of a Financial Institution's own account or the account of an affiliate, may not be effected under the BIC Exemption.
- Proprietary products, i.e., products that are managed or sponsored by the Financial Institution or an affiliate, may be sold under the BIC Exemption.
  - But subject to more challenging compliance requirements

# Impartial Conduct Standards

- During the Transition Period from June 9, 2017 to December 31, 2017 the Financial Institution and Adviser must adhere to the following “Impartial Conduct Standards”:
- Must act in the Best Interest of the client.
  - The advice should reflect the care, skill, prudence, and diligence that a prudent person would use;
  - Advice must be based on the investment objectives, risk tolerance, financial circumstances and needs of the client; and
  - Advice must be furnished without regard to the financial or other interests of the Financial Institution or its affiliates.
- No excessive compensation resulting from the transaction.
- Disclosure regarding the recommended transaction, fees and compensation; material conflicts of interest, and any other relevant matters must not be materially false or misleading.

# BIC Exemption Contract Requirements

- Unless the BIC Exemption is changed, after the Transition Period, the following additional requirements must be met:
- Transactions under the BIC Exemption must be effected pursuant to a written contract if the client is an IRA, or a written statement if the client is an ERISA plan. In the contract, the Financial Institution must warrant that it:
  - Will adhere to impartial conduct standards;
  - Has adopted written policies and procedures reasonably designed to mitigate the impact of material conflicts of interest and to ensure that its Advisors adhere to the impartial conduct standards;
  - Has specifically identified material conflicts of interest and adopted measures to prevent them from causing violations of the impartial conduct standards
  - Has designated persons responsible for addressing material conflicts of interest and monitoring adherence to the impartial conduct standards;
  - Will not use compensation incentives that would tend to encourage Advisors to make recommendations that are not in the Best Interest of the client;

- Contract requirements (cont'd)
  - Contracts must not have (a) exculpatory provisions disclaiming or otherwise limiting the liability of the Financial Institution or (b) requiring the client to waive or qualify its right to bring or participate in a class action;
  - Contract must inform the client of the services provided and describe how the client will pay for services, directly or through third-party payments, such as revenue sharing or 12b-1 fees;
  - Contract must inform the client that they have the right to obtain a written description of the Financial Institution's policies and procedures, as well as the specific disclosure of costs, fees and compensation;
  - Contract must include a link to the Financial Institution's website and inform the client that on its website can be found: (a) model contract disclosures and (b) a written description of its policies and procedures;
  - Contract must disclose whether the Financial Institution offers proprietary products or receives third-party payments with respect to any recommended investments;

- **Contract requirements (cont'd)**
  - Contract must disclose whether the Financial Institution limits investment recommendations, in whole or part, to proprietary products or investments that generate third-party payments; and
  - Contract must disclose whether the Advisor and Financial Institution will monitor the client's investments and alert the client to any recommended change to those investments, and, if so, the frequency with which the monitoring will occur and the reasons for which the client will be alerted

# Required Website Disclosures

- Additional requirements for the BIC Exemption following the Transition Period:
  - The Financial Institution must maintain a website that discusses:
    - The Financial Institution's business model and any material conflicts of interest associated with that business model;
    - A schedule of typical fees and charges;
    - A model contract or other model notice of the contractual terms;
    - A written description of the Financial Institution's policies and procedures relating to conflict-mitigation;
    - A list of persons that provide third-party payments to the Financial Institution for specific investment products or classes of investments; and
    - Disclosure of the Financial Institution's compensation and incentive arrangements with its Advisors, including any incentives for recommending particular investments or categories of investments.

# Proprietary Products

- If the recommendations relate to any proprietary products or products that generate third-party payments following the Transition Period, then the following is required:
  - The Financial Institution must notify the client of any limitations on its product offerings as well as any material conflicts of interest;
  - The Financial Institution must evaluate whether or not the recommendation of a proprietary product or a product that generates third-party payments is consistent with the client's best interests;
  - The Financial Institution must evaluate whether or not the limitations on its products offering are consistent with its fiduciary obligations to retirement investors and would not cause it to recommend imprudent investments or to pay its Advisors excessive compensation; and
  - The Financial Institution must document in writing and retain the foregoing analysis and conclusions.

# Scope and Requirements of the Principal Exemption

- The Principal Exemption is an avenue for the sale or purchase of a limited group of investment products on a principal basis.
- The exemption is available only for:
  - “Debt Securities”
    - U.S. Treasury and Agency securities
    - U.S. dollar denominated debt issued by a U.S. corporation in an offering registered under the Securities Act of 1933;
  - Certificates of deposit;
  - Unit investment trusts; and
  - Such other securities as the DOL may determine.

- During the Transition Period, sales may be made under the Principal Exemption by complying with the impartial conduct standards discussed under the BIC Exemption. In addition, the Financial Institution must seek to obtain best execution.
- Unless the Principal Exemption is changed, after the Transition Period, the following additional requirements will apply to the Principal Exemption:
- Debt Securities must meet certain additional conditions:
  - May not be issued by the Financial Institution or any of its affiliates;
  - May not be sold through an underwriting if the Financial Institution or any of its affiliates are members of the underwriting syndicate;
  - May not have a greater than “moderate credit risk”; and
  - Must be “sufficiently liquid” so that they could be sold at or “near” their carrying value within a “reasonably short period of time.”
    - None of the quoted terms above are defined in the Principal Exemption
- Thus, the Principal Exemption is a relatively narrow exemption.

# Level Fee Fiduciaries

- Level fee fiduciaries are fiduciaries.
  - They must act in the Best Interest of the client and avoid conflicts of interest
- Because they do not receive commissions or other variable compensation, their compensation does not vary depending on what they recommend, and so there is no self-dealing and they need not comply with the BIC or Principal Exemptions.
  - Level fee fiduciaries may only receive compensation that does not vary with the product recommended and is not transaction-based
  - May not receive third-party payments tied to client transactions
  - Level fee fiduciary may not limit advice to proprietary products
  - Not clear if level fee fiduciary may ever advise on proprietary products

- Exception: a level fee fiduciary that makes a recommendation on a rollover during the Transition Period will need to comply with the impartial conduct standards under the BIC Exemption that apply during the Transition Period.
- Unless the BIC Exemption is changed, a level fee fiduciary that makes a recommendation on a rollover after the Transition Period will need to comply with a streamlined version of the BIC Exemption.
  - Acknowledge fiduciary status, adhere to impartial conduct standards and document basis for advice

# Changes in How Broker-Dealers Are Interacting with Clients

- Financial Institutions are evaluating their client base to assess the potential impact of DOL regulations.
  - Transactions with institutional and professionally managed retirement investors should be eligible for the Sophisticated Investor Exception and will largely be unaffected by the new rules before or after the Transition Period.
    - Need to implement on-boarding procedures to confirm status of client as eligible for the Sophisticated Investor Exception and to verify provision of appropriate notices to client
  - For retail retirement accounts, Financial Institutions will need to assess the costs/risks of fiduciary status.
    - Can compliance with the Best Interest standard be achieved at an acceptable cost and level of risk exposure?
    - Move some or all retail retirement accounts to level fee arrangements?
    - Close smaller accounts or move them to a robo-adviser alternative?

# Implications for Product Mix

- Financial Institutions are re-evaluating their product mix with a view to complying with the Best Interest standard.
  - Efforts to reduce the impact of commissions and other costs as may be necessary to serve the best interest of the client
  - Compare product costs to similar products
    - T-shares
  - Flattening internal compensation arrangements to avoid creating inappropriate incentives for sales force to sell higher risk/higher cost/lower liquidity products
- Expect greater scrutiny for sale of proprietary products or products involving third-party payments.
  - Need to implement a process to undertake and document the required analysis before such products may be sold
  - Consider eliminating or reducing third-party payments?

# Implications for Underwriters and Distributors

- Financial Institutions engaging in distributions are revising their distribution arrangements.
  - Principal Exemption if unchanged will be largely unavailable for underwritten products or for products issued by the Financial Institution or an affiliate
    - For structured products, not always clear who is the “issuer”
  - Implementing distribution arrangements on a riskless principal or best efforts agency basis that could comply with the BIC Exemption
    - Requires revision of underwriting documents
  - Establishing distribution channels through independent broker-dealers and not directly to retail retirement accounts
  - Some offerings may not be made available to retail retirement investors

# Implications for Internal Compliance

- Product approval procedures
  - More stringent evaluation of product risks and costs; comparisons to competing products
- Advisor compensation arrangements
  - Compensation arrangements must not reward production at the expense of clients
  - Volume-based rewards okay, but need to be carefully structured and monitored. See FAQ 9 (Oct. 2016)
  - Back-end loaded sign-up bonuses probably not acceptable. See FAQ 12 (Oct. 2016)
  - Need to continually assess how compensation arrangements are affecting Adviser behavior

- Disclosure and documentation
  - Client on-boarding; obtaining enough information to understand the client's objectives, risk tolerance, etc.
  - Independent fiduciary verification
  - Basis for recommendations: supporting a Best Interest analysis
- Training
  - Best interest standard of care vs. suitability standard

# What We Can Expect for the Future of the Rule

- Impossible to predict at this time what will happen to the current rule.
  - Congressional or judicial roadblocks looking less likely
    - Financial Choice Act would stop implementation of the Fiduciary Rule
    - However, to become law it may need to survive a filibuster in the Senate
    - Not clear how much political capital President Trump will spend on this issue
  - Administrative repeal or reform possible, but not a certainty
    - Executive order did not mandate repeal or reform
    - SEC position unclear, but could further complicate the situation
- For many Financial Institutions, there is no going back.
  - Have gone too far in their preparations to reverse course
  - Many investors are now alert to this issue
  - Difficult to walk back a commitment to act in the best interest of clients
- Be prepared to proceed while monitoring events.
  - Distinguish the principles set forth in the impartial conduct standards vs. the prescriptive requirements and limitations in the BIC and Principal Transactions Exemptions

# Legal Liability and Potential Litigation

- In Field Assistance Bulletin 2017-02, the DOL stated that during the Transition Period it will not “pursue claims against fiduciaries who are working diligently and in good faith to comply with the fiduciary duty rule and exemptions, or treat those fiduciaries as being in violation of the fiduciary duty rule and exemptions.” See also IRS Announcement 2017-4.
- This moratorium by the DOL and IRS does not apply to the rights of private parties.
- Private plaintiffs may be expected to add a breach of fiduciary claim to future actions. However, those actions may, for the time being, be limited to arbitrations.