Understanding a Smidgen of the DOL's

"Definition of the Term 'Fiduciary'; Conflict of Interest Rule - Retirement Investment Advice"

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Tucson, Arizona
September 21, 2016

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Background of the Conflict of Interest Rule

- Since 2010, the U.S. Department of Labor (DOL) has tried to fashion a fiduciary rule that will mitigate conflicts of interest arising from advisors' receipt of variable compensation - commissions, 12b-1 fees, revenue-sharing, etc. - when rendering investment advice to retirement investors

- The result, on April 8, 2016, was issuance of the DOL's long-awaited Rule titled: "Definition of the Term 'Fiduciary'; Conflict of Interest Rule - Retirement Investment Advice"

Lots and Lots of Words: The Conflict of Interest Rule and Related Commentary

- This long-winded 12-word title is the first of about 66,000 words that comprise the Rule which takes up 58 pages of the Federal Register.
- I have not read the Rule.
- However, since April I have read nearly 340,000 words of commentary on the Rule – which takes up about 525 pages in a WORD file.
- Opinions about the Rule and its implications are diverse.
- Most say that it's the best thing since sliced bread so offending advisors will now be reined in.
- Others say that the Rule is much ado about nothing so offending advisors will continue to run amok.

1974 to Now

- When ERISA was enacted in 1974, defined benefit plans were about the only kind of retirement plan around.
- The fiduciaries of DB plans sponsored by companies made all the decisions and bore all the risks of investing.
- Individual Retirement Accounts had just been created by ERISA.
- IRAs were intended to provide individuals not covered by a work-related retirement plan with a tax-advantaged savings program and they were also intended to complement qualified plans by allowing rollover of assets at retirement or when changing jobs.
- In 2016, the retirement landscape is much more complex.
- Now, 401(k) and other defined contribution plans such as 403(b)s and 457(b)s as well as IRAs dominate the retirement marketplace
- Now, it's investors themselves – not others like fiduciaries of DB plans - that have to make the decisions and bear the risks of investing.
- Now, there are countless more and increasingly complex investment products such as Target Date Funds (TDFs), Exchange Traded Funds (ETFs), hedge funds, private equity funds, Real Estate Investment Trusts (REITs) and insurance products such as fixed indexed annuities.
- Now, in addition to traditional IRAs, there are Roth IRAs, SEP-IRAs, SAR-SEP IRAs and SIMPLE IRAs.
- Many of these investment products are marketed directly to plan participants and IRA owners by non-fiduciaries that enjoy a vast asymmetric information advantage within a *caveat emptor* environment.
- As a result, many plan participants and IRA owners today have little ability to assess the value of investment advice or potential conflicts of interest intelligently.

The Reason For the Rule: IRAs

- The motivation to issue the Rule never involved qualified retirement plans. Although litigation over the last decade has shown that hidden - and therefore high – costs exist even in multi-billion dollar 401(k) plans sponsored by giant corporations, the $4.7 trillion held in 401(k)s is relatively better regulated and subject to relatively lower costs than the $7.4 trillion held in IRAs (more than 50% greater than in 401(k)s).
- The real reason for issuance of the Rule is to mitigate what the DOL regards as the bad effects resulting from the practices of advisors providing conflicted investment advice and products to unsuspecting IRA owners.
- The HR director at a large plan for which our RIA is the 3(38) investment manager referred to those engaged in such practices as "circling sharks" waiting for plan participants to retire so that they could place them in high-priced investment products. He wanted our firm to provide an IRA rollover option for his company's retirees to protect them from this.
- Since our RIA is a fiduciary to the plan, we didn't believe that we could provide IRA rollover services given the legally gray area of DOL Advisory Opinion 2005-23A which holds that any rollover advice given by a plan fiduciary might trigger a prohibited transaction for which there is no corresponding exemption. According to the DOL Opinion, though, such advice given by an advisor that's not a plan fiduciary won't trigger a prohibited transaction.
- So while an advisor that's a plan fiduciary likely couldn't provide rollover services, the plan's record-keeper that's not a plan fiduciary could swoop in and provide rollover services – even though, according to the HR director, those services are usually much more costly and sub-optimal to boot.

Some Advisors Are Unhappy With the DOL

- Some advisors are unhappy that the DOL would “move into” their IRA rollover business through issuance of the Rule. While understandable, the DOL is on firm legal footing in its seeming invasion of the IRA marketplace. Here’s why.
- It is true that IRAs are not employer-sponsored “plans” under ERISA and so any B/Ds or RIAs that provide services to IRAs are not subject to ERISA’s fiduciary duties or prohibited transaction rules.
- However, IRAs are “plans” for purposes of the prohibited transaction rules in the Internal Revenue Code (IRC) which includes a definition of “fiduciary” that closely tracks that found in ERISA. (See IRC section 4975.)
- So even though IRAs and other non-ERISA plans are not subject to ERISA, an Executive Order issued by Jimmy in 1978 Carter transferred from the IRS to the DOL rule-making authority over the fiduciary status and prohibited transaction provisions of IRC section 4975 that correspond to those in ERISA. (See Reorg. Plan No. 4 of 1978, § 102(a) (43 FR 47713, October 17, 1978 and confirmed by statute in P.L. 98-532 (1984).) It is this authority, granted nearly 40 years ago, that <u>allows the DOL to bring IRAs under its purview in the Rule</u>.
- The kicker, though, is that the DOL has <u>no power to enforce any penalties</u> against those advisors who engage in prohibited transactions when rendering investment advice to IRA owners. The IRS does have this power and it could exercise it by imposing excise taxes on advisors who engage in a prohibited transaction by, for example, earning more than “reasonable” compensation from an IRA owner. (See IRC section 4975(d)(2).)
- But the IRS has chosen not to enforce any such penalties against offending advisors. Through such non-enforcement, the IRS has, by default, allowed advisors rendering advice to IRA owners to be governed by the suitability standard instead of the more stringent fiduciary standard. The issuance of the Rule now subjects such advisors to the fiduciary standard and some of them are unhappy about that.

Class Action Lawsuits

- So while the DOL has the power to regulate IRAs, it cannot legally enforce any penalties against offending advisors.

- And while the IRS has such powers of enforcement, it has chosen not to exercise them against such advisors.

- The Rule's solution to this conundrum is to allow IRA owners to sue - on their own or by joining a class action - offending advisors for breach of fiduciary duty (by alleging violation of the Best Interest fiduciary standard) - just as participants in ERISA plans are able to do so already.

On to the Main Event

- Now that we've covered the preliminaries of the Rule – its background, the reason for it, and how the DOL can allow IRA owners to join class action lawsuits - let's get to the main event this evening: understanding (or hoping to understand) just a smidgen of this very long, quite complicated Rule.

- To help with that, let's first have a look at "Fiduciary Central" of the Employee Retirement Income Security Act of 1974 (ERISA).

“Fiduciary Central” of ERISA

ERISA section 3(21) defines the THREE “kinds” of plan fiduciaries:

FIRST [3(21)(A)(i))]: A fiduciary that exercises any discretionary authority or discretionary control with respect to management of such plan or exercises any authority or control with respect to management or disposition of its **assets**;

- I term this a discretionary fiduciary decision-maker
- An example of this “kind” of 3(21) fiduciary is an ERISA section 3(38) investment manager

SECOND [(3(21)(A)(ii))]: A fiduciary that renders **investment advice** for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or

- I term this a non-discretionary fiduciary advice-giver

THIRD. [3(21)(A)(iii)]: A fiduciary that has any discretionary authority or discretionary responsibility in the **administration** of such plan.

The Rule Pertains to One Kind of ERISA Fiduciary

- We can ignore the third kind of ERISA fiduciary – an administrative fiduciary - because it has nothing to do with investing. Remember, part of the title of the Rule is "retirement investment advice."

- We can also ignore the first kind of ERISA fiduciary – a discretionary decision-maker – because, in making such decisions, the benefits of the Best Interest Contract Exemption are not available to fiduciaries that receive variable compensation in exchange for rendering discretionary investment advice – only non-discretionary advice.

- It's only the second kind of fiduciary – a non-discretionary advice-giver – which the Rule pertains to: (1) a fiduciary (2) that renders (non-discretionary) investment advice (3) for compensation.

- All three of these elements must be present in order for the Rule to apply to an advisor communicating with a plan participant or an IRA owner.

Element 1 – “Fiduciary”

The Rule broadens the class of entities - “Financial Institutions” – subject to the “fiduciary” moniker to include:

•RIAs/B-Ds/banks/insurance cos.; and

•Their respective employees/contractors/agents/representatives/affiliates/related entities.

Element 2 - "Investment Advice"

- The Rule broadens the definition of "investment advice." More exactly, "<u>retirement</u> investment advice" rendered to:
- Participants in ERISA plans such as 401(k) plans, profit-sharing plans, money purchase pension plans and defined benefit plans; as well as
- Owners of IRAs and participants in non-ERISA plans.
- Note that the Rule does not pertain to investment advice rendered to those investing in taxable accounts and non-retirement accounts. That retail environment is within the purview of the SEC.

- Determining whether an advisor has rendered investment advice in a given situation requires posing a threshold question:

- <u>Has the advisor made a "recommendation" as defined by the Rule</u>?
- If there's no recommendation, then there's no investment advice and since investment advice is one of the three elements of ERISA section 3(21)(A)(ii), the communication will not make the advisor a fiduciary subject to the Rule.

- So how does the Rule define a "recommendation?"

Element 2 - "Investment Advice" (cont.): Four Different Kinds of Communication Can Define a "Recommendation"

- A "recommendation" means a communication that, based on its content, context and presentation, would reasonably be viewed as a suggestion (some have termed a "call to action") that the recipient of the investment advice engage in, or refrain from taking, a particular course of action.

- A "recipient of investment advice" is defined as a plan/plan fiduciary/plan participant or beneficiary/IRA/IRA owner.

- The following four Rule-defined kinds of communication are each considered a "recommendation:"

- 1. The advisability of acquiring/holding/disposing of/exchanging investment property; or
- 2. How investment property should be invested after the property is rolled over/transferred/distributed from a plan/IRA; or
- 3. The management of investment property, including recommendations on investment policies/strategies, portfolio composition, selection of other persons to provide investment advice, or investment management services, types of investment account arrangements (e.g., brokerage vs. advisory); or
- 4. Whether/in what amount/in what form/to what destination a rollover/transfer/distribution from a plan/IRA should be made.

Element 2 - "Investment Advice" (cont.): Comments on a "Recommendation"

- The test is whether a "reasonable person" – not the advice recipient itself – will view the communication as being a recommendation.
- The more individually tailored the communication is to a specific advice recipient, the more likely it will be seen as a recommendation.
- A series of actions may constitute a recommendation in the aggregate even if they would not when viewed individually.
- It doesn't matter if the communication was initiated by a human being or computer software program (i.e., robo-advice).
- An advisor's "hire me" communication in a marketing scenario will not be deemed a recommendation – BUT only if the advisor describes just its services and fees.
- If the advisor adds to that by suggesting, for example, to an IRA owner that a particular product, investment or platform should be used, then that's no longer just a "hire me" communication but instead a recommendation.
- An advisor's suggestion to select other persons to provide advice is a recommendation.

Element 2 - "Investment Advice" (cont.): A Recommendation Made in Three Contexts

- When an advisor provides a Rule-defined recommendation, it rises to the level of "investment advice" but only when the advisor delivers it in one of the <u>three following contexts</u> by:

- 1. Representing/acknowledging that it's acting as a fiduciary under ERISA or the IRC in rendering investment advice; or
- 2. Rendering investment advice with a written/unwritten understanding that it's based on particular investment needs of advice recipient(s); or
- 3. Directing investment advice to specific advice recipient(s) about the advisability of a particular investment decision/recommendation.

Element 3 - “Compensation”

- No fiduciary investment advice is deemed rendered if no fee or other compensation is given in exchange.

- The Rule broadens the definition of “fee or other compensation” to include:
- Any explicit fee/compensation for the advice received by the person (or an affiliate) from any source; or
- Any fee/compensation received from any source in connection with, or as a result of, the recommended purchase/sale of a security or the provision of investment advice services.

- <u>Examples</u> of compensation **i**nclude but are not limited to:
- Commissions, loads, finder’s fees, revenue-sharing payments, shareholder servicing fees, marketing or distribution fees, underwriting compensation, payments to brokerage firms in return for shelf space, recruitment compensation paid in connection with transfers of accounts to a registered representative’s new broker-dealer firm, gifts and gratuities, and expense reimbursements.

- <u>But-For Test</u>
- A fee or compensation is paid “in connection with, or as a result of” investment advice if the fee or compensation would not have been paid <u>but for</u> the recommended transaction or advisory service, or if eligibility for, or the amount of, the fee or compensation is based in whole or in part on the transaction or service.

Inquiry to Determine If an Advisor is Subject to the Rule

- In order for an advisor to become subject to the Rule in a given situation, it must be a <u>fiduciary</u> providing <u>investment advice</u> for <u>compensation</u> (ERISA section 3(21)(A)(ii))
- Here's an analytic inquiry that can be used to determine that:

- Is any one of four different kinds of communication deemed a "recommendation?"
- If so, is the recommendation delivered by the advisor in one of three different contexts?
- If so, the recommendation is deemed "investment advice."
- Is the investment advice rendered in exchange for "a fee or other compensation?"
- If so, then, *ipso facto*, "fiduciary" status is conferred on the advisor.
- If the recommendation is a safe harbor exception/exclusion designated in the Rule, it's not considered investment advice. And if there's no investment advice, one of the three elements of ERISA section 3(21)(A)(ii) is lacking. In that case, the Rule will not apply to an advisor.

Some Communications Are Not a "Recommendation" So They're Not "Investment Advice"

- 1. Marketing or making available a platform
- 2. General communications
- 3. Investment education

1. Marketing or Making Available a Platform

- A person such as a plan record-keeper may market to a plan fiduciary its platform or make investment options available through its platform without being considered making a recommendation <u>as long as</u>:

- 1. The person is independent of the plan fiduciary;
- 2. The person provides written disclosure that it's not providing impartial investment advice or fiduciary advice; and
- 3. The plan's individualized needs, its participants, or beneficiaries are not discussed.

- However, the person is allowed to:
- Identify options that meet objective criteria set by a plan fiduciary - but it must disclose in writing any financial interest in the options
- Identify a sample list of investment options based on plan size or current investment options in response to an RFP - but it must disclose in writing any financial interest in the options
- Provide to a plan fiduciary objective financial data and comparisons with independent benchmarks

2. General Communications

- Furnishing or making available general communications that a reasonable person would not view as an investment recommendation such as:
- •Remarks and presentations in widely attended speeches and conferences;
- •General circulation newsletters;
- •Talk shows;
- •Research or news reports prepared for general distribution;
- •General marketing materials;
- •General market data including data on market performance, market indices or trading volumes;
- •Price quotes;
- •Performance reports; and
- •Prospectuses.

3. Investment Education: Plan Information

- Similar to current safe harbor Interpretive Bulletin 96-1

- Describe the terms or operation of the plan/IRA;
- Inform about benefits of participation or increasing contributions;
- Impact of pre-retirement withdrawals;
- Pluses/minuses of different kinds of distributions;
- Product features;
- Investor rights and obligations; and
- Fee/expense information, etc.

3. Investment Education (cont.): General Financial, Investment and Retirement Information

- Information and materials that don't address specific investment products/investment options offered under a plan/IRA and which inform the plan fiduciary/plan participant or beneficiary/IRA owner about:
- –General financial and investment concepts;
- –Historic differences in rates of return between different asset classes based on standard market indices;
- –Effects of fees and expenses on rates of return;
- –Effects of inflation;
- –Estimating future retirement income needs;
- –Determining investment time horizons;
- –Assessing risk tolerance;
- –Retirement-related risks; and
- –General methods and strategies for managing assets in retirement.

3. Investment Education (cont.): Asset Allocation Models and Interactive Materials

- Asset Allocation Models
- Model must be based on generally accepted investment theories and historic asset class returns
- Provide a statement that other assets, income and investments outside the model must be considered
- For IRAs, strict requirements to not reference specific investment products

- Interactive Materials
- •Questionnaires, worksheets etc. provided to plan participants/IRA owners to assist in estimating income needs or retirement income streams, that take into account generally accepted investment theories and use an objective correlation between asset allocation and income stream
- •Material facts and assumptions must be provided by participant/IRA owner, or accompany the materials
- •Use of specific investment options must be provided by participant/IRA owner

- Asset allocation models and interactive materials cannot reference specific investment options unless:
  - Investment options with similar risk/return trade-offs are identified
  - Statement of how more information may be obtained must be provided

Some Communications Are Not From a "Fiduciary" So They're Not "Investment Advice"

- **1. Sellers to Sophisticated Investors**
- This exclusion applies to advice provided by seller of investment products to sophisticated fiduciaries of plans/IRAs such as banks, insurance carriers, RIAs, B/Ds, and any plan fiduciary independent of the seller that has at least $50 million in total assets under management (i.e., sophisticated investors).
- Seller must know/reasonably believe that the independent fiduciary can evaluate investment risks and may rely on written representations of same from the plan or fiduciary
- Seller must "fairly inform" the independent fiduciary:
- Seller isn't providing impartial investment advice or fiduciary advice/of the seller's financial interest in the transaction/seller may not receive a fee for providing investment advice in the transaction from the plan/independent fiduciary/plan participant or beneficiary/IRA/IRA owner
- **2. Employees of Plan Sponsor**
- This exclusion applies to advice provided by employees of plan sponsor, acting in their capacity as employees, to a plan fiduciary/another employee/independent contractor of the plan sponsor. Exclusion (a) keeps investment education from becoming investment advice and (b) prevents employees from inadvertently becoming plan fiduciaries.
- Advice from Employee to Plan Sponsor:
- Exclusion applies if employee doesn't receive compensation more than normal pay
- Advice from HR Employee to Co-Worker
- Exclusion applies if HR employee:
  - Job description doesn't include giving advice;
  - Doesn't receive compensation more than normal pay; and
  - Not licensed (or required to be licensed) under securities or insurance laws.

The Best Interest Contract Exemption (BICE)

- Under ERISA, fiduciaries cannot:
- Breach their fiduciary duties owed to plans/plan participants and beneficiaries; or
- Engage in prohibited transactions involving self-dealing and receipt of third-party compensation for transactions involving plan/IRA assets.
- The BICE allows fiduciaries to receive variable compensation which ordinarily violates the prohibited transaction rules since any investment advice rendered could affect such compensation, which includes:
- Commissions paid by the plan/plan participant or beneficiary/IRA; and
- Sales loads/12b-1 fees/revenue-sharing/other payments and commissions from third parties providing investment products.
- The BICE, a centerpiece of the Rule, allows advisors wide latitude in how they choose to be compensated as long as they enter into a written contract to act in a client's best interest, are prudent and loyal, don't charge unreasonable compensation and are honest.
- The BICE is not available for fiduciaries who receive variable compensation in exchange for rendering discretionary investment advice (e.g., if an investment manager has the power to invest IRA assets without approval from the IRA owner and it earns any compensation or revenue-sharing, it would be a violation of the prohibited transaction rules and the BICE would not be available for protection because the advice is discretionary).

Only "Financial Institutions" May Invoke the BICE

- Only eligible <u>Financial Institutions</u> may invoke the BICE in rendering investment advice to <u>retail retirement investors</u> (i.e., unsophisticated investors)

- "<u>Financial Institutions</u>" include:
- RIAs/B-Ds/banks/insurance cos.; and
- Their respective employees/contractors/agents/representatives/affiliates/related entities.

- "<u>Retail retirement investors</u>" include:
- ERISA plans (with less than $50 million; i.e., unsophisticated investors)/plan fiduciaries/plan participants and beneficiaries/non-ERISA plans such as Keogh plans and Solo plans)/IRAs/IRA fiduciaries/HSAs/Archer medical savings accounts/Coverdell education savings accounts

- The Rule does NOT cover investment advice rendered to 529 plans/non-ERISA 403(b) plans/457 plans/non-qualified, non-ERISA plans, so the BICE isn't relevant in such cases

Requirements of Financial Institutions Invoking the BICE

- Adopt "Impartial Conduct Standards" which must:
- Adhere to a Best Interest standard similar to ERISA's fiduciary duties, including:
- –Prudent advice based on the investment objectives, risk tolerance, financial circumstances and needs of retirement investor;
- –Without regard to financial or other interests of the advisor, financial institution, or their affiliates, related entitles or other parties;
- Not allow recommendation of transactions that will result in the receipt of unreasonable compensation; and
- Not allow the making of materially misleading statements.
- Adopt "Anti-Conflict Policies and Procedures" which cannot allow:
- Material conflicts of interest that cause advisors to violate the Impartial Conduct Standards; or
- The use of compensation, personnel or other actions that incentivizes advisers to make recommendations not in the best interest of retirement investors.
- Anti-conflict policies and procedures must be in writing readily available to retirement investors free of charge on the Financial Institution's website.
- Disclosures
- Describe any material conflicts of interest in a transaction
- Disclose the recommendation of proprietary products and those that generate third party payments
- Inform a retirement investor that it may obtain disclosure of detailed costs/fees/other compensation in a transaction
- Make such disclosure, but only on request
- Notification to the DOL
- A Financial Institution generally must file a one-time notice with the DOL that it's invoking the BICE. No need, however, to specifically identify any plan or IRA nor is DOL approval required.

The Best Interest Contract (BIC)

- In cases of IRAs and applicable non-ERISA plans which lack the greater protections of ERISA, the BICE requires that investment advice be rendered pursuant to a written "best interest contract" (BIC), a copy of which must be made available through the Financial Institution's website.
- In cases where a fiduciary is charging level fees, a "BIC Lite" is adequate since fee levelization eliminates the prohibited transaction to begin with; hence, no BICE is needed because there is no conflict of interest.
- In cases of ERISA plans, no BIC is needed since ERISA (§502(a)(2) and (3)) contains a direct right of action against a fiduciary for a prohibited transaction or breach of fiduciary duty. However, Financial Institutions are still required to adhere to the same standards of fiduciary conduct listed on the previous slide.

- In a BIC, a Financial Institution may not:
- Limit its liability for a violation of its terms;
- Force arbitration in remote venues (e.g., Fairbanks, AK);
- Force arbitration that unreasonably limits enforcement of the BIC; or
- Limit a retirement investor's ability to bring a class action claim.

“Fully Leaded BIC” for IRAs and Non-ERISA Plans

- Required Terms in Fully Leaded BIC
  - A statement of the fiduciary standard of care;
  - Acknowledge fiduciary status in writing;
  - General disclosures on compensation and conflicts of interest;
  - Compliance policies that mitigate conflicts;
  - Provide, upon request, detailed compensation figures; and
  - Mandatory transaction disclosures for each investment made focusing on fiduciary standards and conflicts.

  - Other Requirements
  - Mandatory arbitration with reasonable venue (but cannot limit class action rights)
  - Make available Webpages describing business model and conflicts of interest.

“BIC Lite” for Level Fee Fiduciaries

- BIC Lite available only if the sole fee received by the Financial Institution/adviser/any affiliate in connection with advisory or investment management services to the plan or IRA assets is a level fee.
- “Level fee:” Compensation provided as a fixed percentage of the value of the assets, or a set fee that doesn’t vary based on the particular investment recommended.
- Fee levelization eliminates the prohibited transaction to begin with (i.e., no variable compensation involved) so it’s less prone to conflicts of interest; hence, no need for the BICE.
- BIC Lite can apply whether the level fee fiduciary has an existing relationship with a plan or not, or solicits “off the street” participants for rollover services
- <u>Financial Institution must</u>:
- Acknowledge fiduciary status in writing;
- Adhere to the Impartial Conduct Standards; and
- Document in writing (internally) reason(s) for the recommendation(s) to roll over from an ERISA plan to an IRA/roll over from an IRA/change from a commissioned to a level fee account (e.g., A shares paying 25 bps to advisory fee of 75 bps) and why they meet the best interest standard under the BICE.
- No need for a written contract or other required disclosures
- No need for compliance policies
- <u>How to “Levelize” Fees</u>
  - Change compensation formula so that it’s fixed such as an asset-based commission of 50 bps
  - Restructure revenue-sharing as flat dollar payments
  - Jettison proprietary products such as a sweep vehicle (or provide fee credit)
  - Get rid of any remaining variable compensation

“Disclosure BIC” for ERISA Plans

- Requirements of the Disclosure BIC mirror those for Fully Leaded BIC (please see slide 31)
- No written contract required

Transition Rules for BICs

- <u>Temporary relief period from full compliance with BICs: April 10, 2017 to January 1, 2018</u>
  - Helps Financial Institutions that can't comply with Fully Leaded BIC/BIC Lite/Disclosure BIC by April 10, 2017
  - BIC requirements such as compliance policies and some disclosures are waived for this transition period
  - Financial Institution must still (1) comply with the Impartial Conduct Standards, (2) acknowledge fiduciary status in writing and (3) make certain other disclosures such as conflicts of interest
  - As of January 1, 2018, all the BIC rules go into full effect

IRA Rollovers

- In a retirement plan, an advisor often develops relationships with the plan sponsor and plan participants
- Some participants seek advice such as whether to roll their assets out of the plan and/or what assets to roll them into
- Some advisors providing such advice exploit the trust they've created with participants by selling them high-cost investments
- As a result, an advisor's fees on rollover assets may be higher than its fees on plan assets
- This creates a possible conflict of interest
- The Rule repeals DOL Advisory Opinion 2005-23A, the DOL's former guidance on IRA rollovers
- Under the Rule, any rollover advice with respect to a plan/IRA is fiduciary investment advice
- Three kinds of rollover advice automatically are prohibited transactions (which can be cured by the BICE):
- Recommendation to a plan participant to take a distribution and roll it over into an IRA;
- Recommendation to an IRA owner to transfer its IRA to the advisor; and
- Recommendation to a participant or IRA owner to move from a transaction-based account to a fee-based account.

Impacts on Fee-Based Advisors?

- The Rule will affect substantially all advisors because of its reach to IRA assets including fee-based advisors offering IRA rollover advice

- If level fee fiduciaries, RIAs might need to use the BIC Lite in order to provide conflict-free IRA rollover advice since IRA compensation bound to be greater than plan compensation

- The BIC Lite may also be used when offering rollover advice to “off the street” investors

Impacts on Commissioned-Based Advisors?

- The Rule will affect substantially all advisors because of its reach to IRA assets including commissioned-based advisors offering IRA rollover advice.
- Variable compensation between product categories (e.g., mutual funds vs. variable annuities) is permissible, but it must be based on "neutral factors" tied to services such as the time, effort or expertise needed to sell an investment product.

- Possible responses of commissioned-based advisors to the Rule:
- Migration to a fee-based service model
- Levelize commissions
- Structure revenue-sharing as flat dollar payments

- Edward Jones: retirement investors invested in commission-based accounts won't be able to access mutual funds.
- State Farm: Beginning in April 2017, will only sell and service mutual funds, variable products and tax-qualified bank deposit products through a self-directed customer call center. Call center reps will make information and resources available to investors who will then make their own decisions regarding their investments.

PTE 84-24 and Annuities

- Commission-earning advisors are fiduciaries under the Rule so exemption from prohibited transaction rules is needed for insurance companies/insurance agents and brokers to receive commissions for selling annuities to plans/IRAs.
- Two available exemptions:
- <u>BICE</u>: covers commissions on all annuity types including fixed annuities, fixed indexed annuities and variable annuities
- <u>PTE 84-24</u>: covers commissions on <u>fixed annuities</u> only
- <u>Requirements of PTE 84-24</u>
- Disclosures of conflicts
- Disclosure of commissions (must be done annually for on-going deposits)
- Commission disclosure must segregate compensation paid to Financial Institution and advisor
- Commissions expressed as flat dollar figure, if possible, and if not, as a percentage
- Investor must provide written authorization for purchase of the annuity and acknowledge receipt of disclosures
- <u>Comments about PTE 84-24:</u>
- Easier to comply with than the BICE
- No written contract or compliance policies needed; BUT -
- While fewer compliance conditions than the BICE, unlike the BICE it doesn’t cover commissions on sales of VAs/FIAs
- No relief for revenue-sharing

The Grandfathering Provision of the BICE

- The BICE's grandfathering provision is applicable to contracts existing before April 10, 2017. Its purpose is to allow advisors to receive variable compensation such as commissions, 12b-1 fees and revenue-sharing for any post-April 10, 2017 recommendations:

- On assets sold before April 10, 2017; or
- On assets sold pursuant to a purchase program established before April 10, 2017.

- On or after April 10, 2017, compensation cannot be paid for any <u>new</u> investment recommendations

- A grandfathered recommendation cannot have violated prohibited transaction rules when it was initially executed
- Compensation must be reasonable

Enforcing the Rule

- <u>DOL</u> (IRAs) - legally unable to enforce the Rule against advisors to IRAs so the Rule allows retirement investors to enforce it through breach of contract actions (either on their own or through class actions).
- <u>IRS</u> (IRAs) - not likely to enforce the Rule against advisors to IRAs given its long history of not imposing excise taxes on those engaging in prohibited transactions.
- <u>Attorneys/class action lawsuits</u> (Plans and IRAs) - mass numbers of investors; must prove that an investment is defective, marketed incorrectly or shows systemic violations of the Rule.
- <u>Arbitrations</u> (IRAs) - one investor at a time; most investors alleging loss of IRA assets will opt for FINRA arbitration and plead that the investments were unsuitable. FINRA arbitrators seem to see themselves as fact-finders, not judges; their decisions are rendered based on a cut-and-dried <u>rules</u>-based <u>suitability</u> mentality, not a flexible <u>principles</u>-based <u>fiduciary</u> mentality.
- <u>The marketplace</u> – trend towards level fee compensation, away from variable compensation.

Important Dates

- The Rule's effective date was June 7, 2016
- The Rule's "Applicability Date" is April 10, 2017

- For level fee fiduciaries: the BIC Lite requires certain disclosures and a BICE Officer designation by April 10, 2017

- For IRAs and Non-ERISA plans: the Fully Leaded BIC is allowed to be phased-in more slowly by January 1, 2018 (negative consent permitted)

- BUT between April 10, 2017 and January 1, 2018, the Financial Institution/advisor must (1) comply with the Impartial Conduct Standards, (2) acknowledge fiduciary status in writing and (3) meet certain other disclosure requirements

- PTE conditions: Some are phased in by April 10, 2017 while others not effective until January 1, 2018