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# Compliance With the ERISA Fiduciary Advice Rule: Beginning June 9, 2017

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On May 22, Secretary of Labor R. Alexander Acosta confirmed that the agency's "fiduciary advice rule" (the "Rule") would go into effect on June 9. At the same time, the US Department of Labor (DOL) published FAQs on the implementation of the Rule during the period between June 9 and December 31 (the "Transition Period") and updated its previously issued enforcement policy. This most recent guidance provides that during the Transition Period the DOL "will not pursue claims against fiduciaries who are working diligently and in good faith to comply with the fiduciary duty rule and the related exemptions . . ."

As described in Katten's earlier advisories, the Rule significantly expands the categories of persons who are deemed a fiduciary when dealing with retirement investors. It is therefore important that financial services entities (e.g., fund managers, advisers to managed accounts, broker-dealers) who deal with employee benefit plans and IRAs, consider the following in connection with compliance with the Rule:

- Do statements and communications with retirement investors create a fiduciary relationship?
- Are communications that would otherwise give rise to a fiduciary relationship eligible for safe harbor relief from application of the Rule?
- If a financial firm or adviser has a fiduciary relationship under the Rule, is the fee structure eligible for relief under a prohibited transaction exemption under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (the "Code") (such as the "Best Interest Contract Exemption")?

## Brief Review of the Rule

On April 7, the DOL extended the effective date of the Rule until June 9 (the "Extension Notice"). In addition, the effective date of the Prohibited Transaction Exemptions (PTEs) that were issued in connection with the Rule, as well as amendments to certain existing PTEs also were extended to June 9.

The effect of the Rule is to cause a person or entity to become a "fiduciary" under ERISA and the Code as a result of giving of certain types of investment advice to employee benefit plans, such as 401(k) or pension plans, or individual retirement accounts (IRAs) and receiving compensation for that advice.

*Importantly, <u>persons and firms that are already fiduciaries</u> under ERISA or the Code, because they are engaged in investment management of plan or IRA assets are generally not affected by the Rule, as they are already subject to ERISA's fiduciary duty provisions and the prohibited transaction provisions of ERISA and the Code. However, such a discretionary manager may be subject to the Rule with respect to its marketing activities if a specific investment recommendation is made by the manager in connection with the marketing activity (e.g., for a customer to invest in a particular investment fund or product).*[1]

Fiduciary status under the Rule is triggered by investment "*recommendations*."[2] In general, if a person (1) provides certain types of recommendations[3] to a plan or its participants and/or beneficiaries, or to an IRA owner (collectively, "Protected Investors"); and (2) as a result, receives a fee or other compensation (direct or indirect)[4], then that person is providing "investment advice for a fee" and therefore, in giving such advice, is a fiduciary to the Protected Investor.

## <u>Risk of Prohibited Transactions Under the Rule</u>

A fiduciary's use of its authority as such to obtain compensation that varies based on an investment recommendation may constitute a *conflict of interest or self-dealing* that is a prohibited transaction under ERISA and/or the Code. Therefore, a person or entity that would be a fiduciary under the Rule must (1) avoid communications with Protected Investors that would be treated as a "recommendation" under the Rule (which may, for example, include marketing activities to potential investors of an investment fund, or statements to existing managed account holders to continue to maintain the arrangement); or (2) ensure that any investment recommendation does not violate the prohibited transaction rules of ERISA and the Code.

- The Rule itself contains several specific examples of communications that will *not* be treated as recommendations, including furnishing or making available items such as *general marketing materials*, performance reports and prospectuses, or providing *generalized* "*investment education*" to Protected Investors.

- The Rule also creates *safe harbors* for recommendations that occur in certain contexts, including transactions with specifically defined "*independent fiduciaries*" who are acting on behalf of a Protected Investor.

- Along with the Rule, the DOL also provided a package of Prohibited Transaction Exemption (PTE) relief. It adopted a Best Interests Contract Exemption ("*BIC Exemption*") that can be utilized by advisers who are dealing with Protected Investors who are not represented by "independent fiduciaries," such as IRA holders or small plans. It also adopted a "Principal Transactions Exemption" for purchases of certain securities (primarily debt instruments) from a fiduciary and sales of securities and other investments to a fiduciary.

## Compliance With the Rule Beginning June 9

As of June 9, persons making investment "recommendations" under the Rule will be fiduciaries with respect to Protected Investors for transactions on and after that date. If an adviser's business includes making recommendations that could give rise to a prohibited transaction under ERISA or the Code, the adviser must determine the availability of one of the safe harbors in the Rule (to avoid designation as a fiduciary), or comply with one or more PTEs.

### ***Independent Fiduciary Safe Harbor***

To protect against inadvertently making recommendations in marketing or distribution to Protected Investors, financial firms, including investment fund sponsors and managers, could utilize the *safe harbor for communications with* "*independent fiduciaries*" to avoid fiduciary status for the financial firm. In general, for both existing and future investors, this involves incorporating provisions in account agreements or subscription documents, effective June 9, that contain the following:

- Representations from the party acting for the Protected Investor that it is (1) independent of the person that is making the recommendation; (2) capable of independently evaluating investment transactions; (3) a fiduciary as defined under ERISA or the Code and has the authority to exercise its judgement in evaluating the transaction; and (4) one of the following:
    - a bank subject to US federal or state regulation;
    - an insurance company qualified under a state's law to manage plan assets;
    - a registered investment adviser under the Investment Advisers Act of 1940;
    - a broker-dealer registered under the Securities Exchange Act of 1934; or
    - any other independent fiduciary with total assets under management of at least $50 million (such as the investment committee of a plan).
- A representation from the person making the recommendation that it is not providing impartial advice and is not giving advice as a fiduciary.
- Disclosure of the nature and extent of the financial interest of the adviser in the transaction and confirmation that the person is not receiving any fee or other compensation directly from the Protected Investor for providing the advice.

With respect to investors who cannot make the independent fiduciary representations, the financial firm or adviser could take the following actions:

- decline investments by potential investors or redeem the investment of current investors to avoid the risk of its communications being treated as investment advice;

- undertake to limit communications with current investors beginning on June 9 so that it is providing only general communications such as performance reports and prospectuses, and to agree with the investor that it will not provide any specific advice concerning the investor's continued investment or any other investment matters; and

- ensure compliance with a PTE such as the BIC Exemption (as discussed below).

***The BIC Exemption***

The BIC Exemption is a key exemption for investment advisers who deal with Protected Investors on a regular basis. Fiduciaries may rely upon the BIC Exemption beginning June 9, and have only have limited compliance obligations during the Transition Period. Specifically, fiduciaries are only required to adhere to the Impartial Conduct Standards (ICS) for covered transactions during the Transition Period, after which the remaining conditions will apply unless they are revised or withdrawn.

The ICS require advisers and financial firms to:

- Give advice that is in the "*best interest*" of the Protected Investor, which requires acting in accordance with the "prudent person" standard of ERISA and based on the investment objectives, risk tolerance, financial circumstances and needs of the Protected Investor, without regard to any financial interests of the adviser or firm;

- Receive *no more than* "*reasonable compensation*" as defined under ERISA and the Code; and

- Make *no materially misleading statements* about recommended transactions, fees, compensation, conflicts of interest or other relevant matters.[5]

Beginning January 1, 2018, those relying on the BIC Exemption must comply with the other conditions of the exemption, which include: a written statement of fiduciary status; specified disclosures; a written commitment to adhere to the ICS; designation of a person or persons responsible for addressing material conflicts of interest; monitoring advisers' adherence to the ICS; and compliance with certain recordkeeping requirements. Those relying on the limited compliance requirements under BIC for "Level Fee Fiduciaries" must comply with the ICS beginning June 9, and with the remaining applicable requirements on January 1, 2018, in each case unless those requirements are revised or withdrawn.

***The Principal Transaction Exemption***

The Principal Transaction Exemption provides relief from the prohibited transaction rules under ERISA and the Code for the purchase and sale of certain securities between a Protected Investor and a financial firm as a result of the advice of the firm or an adviser. During the Transition Period, an investment advice fiduciary is only required to comply with the ICSs to avail itself of the exemption.[6]

***The Revised Exemptions***

In connection with the Rule, the DOL amended certain existing PTEs (the "Revised Exemptions"), that are generally effective as of June 9, 2018. There is some adjustment as to which exemptions cover particular transactions and a general requirement of ICS compliance as an additional condition of each Revised Exemption.

- **PTE 84-24** permits insurance agents and other advisers to receive compensation in connection with the sale of insurance and annuity contracts and in certain other transactions. The DOL's amendments to this PTE make it no longer applicable to compensation from the sale of fixed indexed and variable annuity products, or from sales of mutual fund shares or principal underwriter transactions involving IRAs; however, such amendments are now delayed until January 1, 2018 (except that the ICS must be adhered to beginning on June 9).

- **PTE 86-128** permits fiduciaries to receive compensation (such as commissions from a related broker-dealer) for effecting or executing securities transactions or as agent in an agency cross transaction involving a plan and another party. For IRAs, PTE 86-128 waived the substantive conditions of the Exemption. Beginning June 9, persons who become fiduciaries by application of the Rule may no longer rely on PTE 86-128 for transactions involving IRAs—they must instead rely on the BIC Exemption. In order to rely on PTE 86-128 in transactions involving plans subject to ERISA, the fiduciary must comply with the ICS. Also beginning June 9, fiduciaries must rely on new provisions in PTE 86-128 (including ICS compliance) to sell mutual fund shares, as principal, to a Protected Investor and receive a commission, where the fiduciary acquired the shares solely to cover the Investor's order. (Section I(1) of PTE 75-1, which previously covered such transactions, is revoked.)

- **PTE 75-1** provides relief for several categories of common financial transactions. Part I, which permitted non-fiduciary parties in interest or disqualified persons to ERISA plans and IRAs to perform, and receive compensation for, services such as effecting securities transactions and related clearing, settlement or custodial functions is revoked effective June 9, and parties must rely on the ERISA § 408(b)(2)/ Code § 4975(d)(2) reasonable contract or arrangement exemption to provide such services for compensation. Part III (purchase of securities from an underwriting where a fiduciary or affiliate is a member of the underwriting or selling syndicate) and Part IV (purchase or sale of securities from a market maker that is a fiduciary) are subject to compliance with ICS as an additional condition, effective June 9.

- **PTE 77-4**, under which a fiduciary may cause an ERISA plan or IRA to purchase shares of a mutual fund of which the fiduciary or its affiliate is the investment adviser, **PTE 80-83** (purchase of securities where proceeds used to retire indebtedness of a party in interest) and **PTE 83-1** (purchase of mortgage pool certificates where a party in interest is sponsor, trustee or insurer of the pool) are subject to compliance with ICS as an additional condition, effective June 9.

## Enforcement and Litigation Following the Effective Date of the Rule

In the May 22 FAQs, the DOL indicated that it was aware that other compliance models to satisfy the

ICS and PTEs are being developed, and that such development may extend beyond the Transition Period, and it invited comments on the time necessary to develop such compliance solutions and whether an extension of the Transition Period was appropriate to permit such development and implementation. The DOL also stated that it "is broadly available to discuss compliance approaches and related issues with interested parties, and would invite interested parties to contact the Department if they have questions about planned compliance systems, policies and procedures, or other compliance-related issues." Interested persons may wish to submit comments or questions.

The Extension Notice reiterated the DOL's previously announced compliance-oriented policy concerning enforcement of the Rule, and this was reaffirmed in DOL Field Assistance Bulletin No. 2017-02, dated May 22, 2017:

Although the Department has a statutory responsibility and broad authority to investigate or audit employee benefit plans and plan fiduciaries to ensure compliance with the law, compliance assistance for plan fiduciaries and other service providers is also a high priority for the Department. The Department has repeatedly said that its general approach to implementation will be marked by an emphasis on assisting (rather than citing violations and imposing penalties on) plans, plan fiduciaries, financial institutions, and others *who are working diligently and in good faith to understand and come into compliance* with the fiduciary duty rule and exemptions. Consistent with that approach, the Department has determined that temporary enforcement relief is appropriate and in the interest of plans, plan fiduciaries, plan participants and beneficiaries, IRAs, and IRA owners. [Emphasis added.]

However, private litigants may also bring suits under ERISA, and the effect of the Rule will be to cause parties who are giving investment advice as described in the Rule to have fiduciary status, and fiduciary responsibility, for giving that advice. If, for example, a Protected Investor receives such advice, acts on it and suffers losses, there is the potential for a claim that the advice-giving fiduciary breached its duty of prudence, or gave conflicted advice, in recommending the investment, and the Protected Investor's losses were caused by that breach. In the Extension Notice, the DOL offered its view that:

Because the provisions requiring written representations and commitments about fiduciary compliance, execution of a contract, warranties about policies and procedures, and the prohibition on imposing arbitration requirements on class claims, would not go into effect during this period between June 9, 2017 and January 1, 2018, this approach eliminates or minimizes the risk of litigation, including class-action litigation, in the IRA marketplace, one of the chief concerns expressed by the financial services industry.

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[1] The DOL has indicated that an adviser or financial institution may recommend that a customer hire the adviser or firm without having these actions be covered by the Rule (the so-called "hire-me exception") provided that no specific investment recommendation is made to the potential customer.

[2] "Recommendations" include advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is based on the particular investment needs of the Protected Investor, or specific advice regarding the advisability of a particular investment or management decision

with respect to investments of a plan or IRA.

[3] The *types of recommendations* that can create fiduciary status are those that concern (1) the acquiring, holding, disposing of, or exchanging, securities or other investment property, or a recommendation as to how securities or other investment property should be invested after a rollover,

transfer or distribution from a plan or IRA; or (2) the management of securities or other investment property, including investment policies or strategies;

portfolio composition; selection of others to provide investment advice or investment management services; type of investment account to open (e.g., brokerage vs. advisory); or recommendations with respect to rollovers, transfers or distributions from a plan or IRA, including whether, in what amount, in what form, and to what financial firm such a rollover, transfer or distribution should be made.

[4] "Compensation" includes not only specific fees for giving the advice and "any other fee or compensation received from any person" including, but not limited to items such as commissions, revenue sharing, finder's fees, and marketing or distribution fees.

[5] *In order to* "*adhere to*" *the ICS*, an adviser or financial firm must not only adopt them as a policy, but also undertake *compliance, education and monitoring* to ensure that they are being followed when dealing with Protected Investors. In the May 22 FAQs, the DOL stated that it "expects financial institutions to adopt such policies and procedures as they reasonably conclude are necessary to ensure that advisers comply with the [ICS]" and that "financial institutions retain flexibility to choose precisely how to safeguard compliance with the [ICS], whether by tamping down conflicts of interest associated with adviser compensation, increased monitoring and surveillance of investment recommendations, or other approaches or combinations of approaches."5 Importantly, the DOL provided in the FAQs that, *during the Transition Period*, a financial institution or adviser that is complying with the ICS in order to rely upon the BIC Exemption *may receive commissions or other variable compensation* that would no longer be available if the other conditions of the BIC were in place.

the ICS, including identifying and mitigating potential conflicts of interest and modifying compensation structures to avoid providing incentives to give advice that was not in the best interest of Protected Investors.

[6] In the Principal Transactions Exemption, the ICS specifically refers to the fiduciary's obligation to seek to obtain the best execution reasonably available under the circumstances with respect to the transaction, rather than to receive no more than "reasonable compensation." Accordingly,

references to "reasonable compensation" in the context of the Principal Transactions Exemption should be read to refer to this best execution.



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