Fiduciary Definition Re-Proposal

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Executive Summary

On April 14, 2015, the DOL made available its long-awaited re-proposed regulation on the definition of "fiduciary" under section 3(21) of ERISA and accompanying prohibited transaction exemptions.

- http://www.dol.gov/ebsa/regs/conflictsofinterest.html

Executive Summary

- The package of materials proposed by the DOL included:
  - a regulation re-defining who is a “fiduciary” by reason of providing investment advice to a plan or an IRA;
  - two new prohibited transaction class exemptions;
    - The Best Interest Contract Exemption;
    - The Principal Transaction in Debt Securities Exemption; and
  - amendments to several existing prohibited transaction class exemptions.

“Investment Advice” & Scope of Fiduciary Status

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Current Rule	2010 Proposed Regulation	2015 Proposed Regulation
Types of Covered Advice: Recommendation on securities or other property. Functional 5 Part Test, applicable to any person: 1. Make investment recommendations on securities or other property; 2. On a regular basis; 3. Pursuant to a mutual understanding that the advice; 4. Will serve as a primary basis for investment decisions; and 5. Individualized to the particular needs of the plan.	Types of Covered Advice: 1. Advice, appraisal or fairness opinion concerning the value of securities or other property; 2. Investment recommendations on securities or other property; or 3. Advice or recommendations as to the management of securities or other property. Per Se Fiduciaries: Persons that provide Covered Advice if they or their affiliate fit in one of the following categories: 1. Acknowledge fiduciary status; 2. State or federally registered investment advisers; or 3. Discretionary fiduciary with respect to the plan. Functional Test: Applicable to persons who are not Per Se Fiduciaries and replaces the 5 Part Test: 1. Provides advice or makes investment recommendations on securities or other property; 2. Pursuant to an understanding that the advice may be considered in connection with making investment decision; and 3. Individualized to the needs of the recipient.	Types of Covered Advice: 1. Recommendations on securities or other property, including recommendation to take distribution and recommendation on rollover to another plan; 2. Recommendations on the management of securities or other property, including recommendation on the management of securities or other property to be rolled over or distributed; 3. Appraisal or fairness opinion, verbal or written, concerning value of securities or other property in connection with a specific transaction(s) involving plan; or 4. Recommendation of a person who provides advice in categories 1-3 above. Per Se Fiduciaries: Persons that provide Covered Advice if they or their affiliate acknowledge fiduciary status. Functional Test: Persons who directly or indirectly (through an affiliate): 1. Render advice; 2. Pursuant to written or verbal agreement or understanding; 3. Advice is: a. Individualized; or b. Specifically directed; 4. For consideration in making investment or management decisions. A "recommendation" is "a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action."

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Illustration: Current State

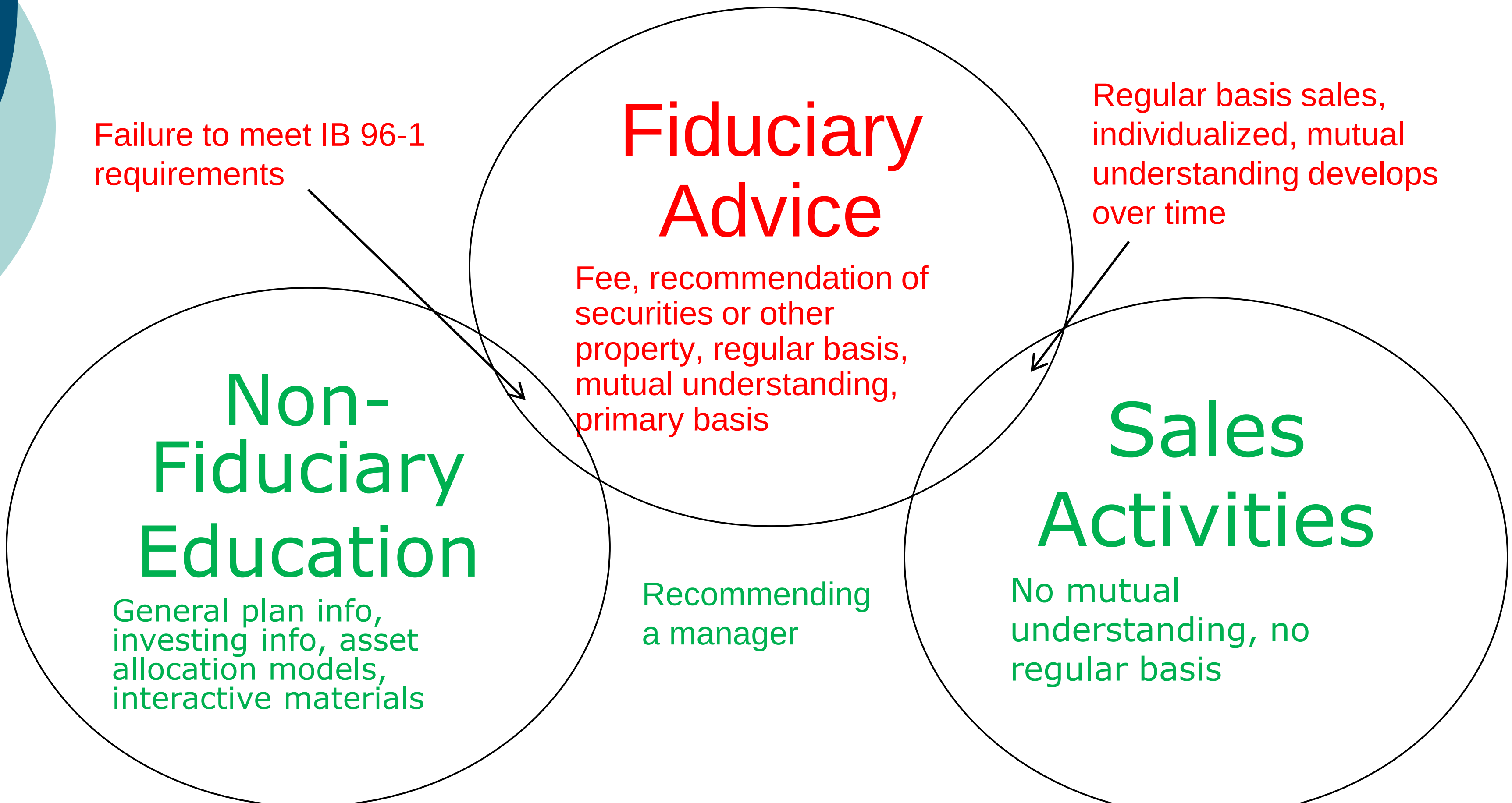
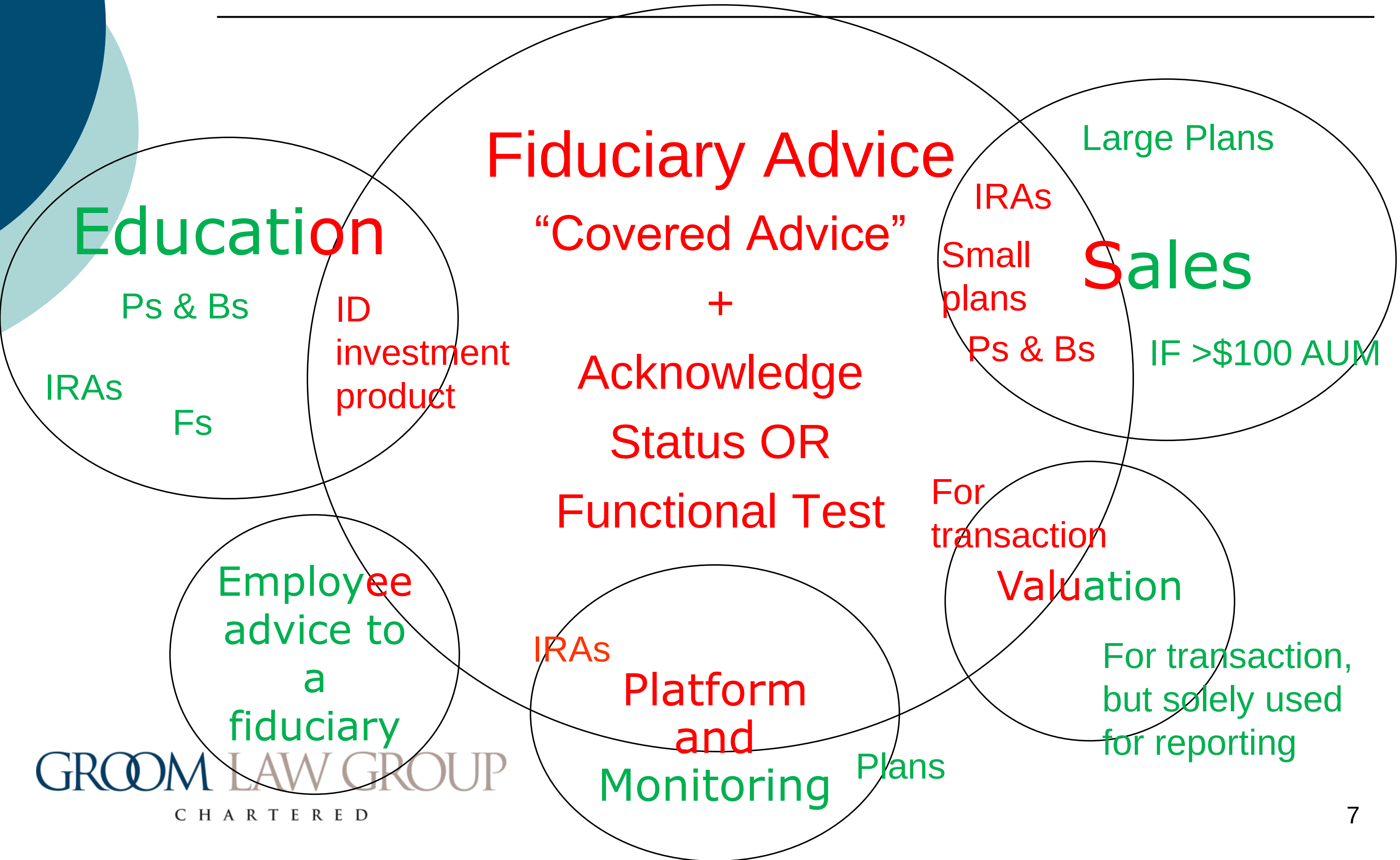


Illustration: Expansion of Fiduciary Definition



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Observations

- Rollovers recommendations clearly fiduciary.
- Recommendation to stay in plan (i.e. not take a distribution) is fiduciary.
- Virtually all sales activity is fiduciary.
- Recommendations to hire one's self as a fee only investment adviser may be considered fiduciary.

The Carve-outs

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Fiduciary Status Carve-Outs

The seven carve-outs are:

- Seller's Carve-Out;
- Swap-Based Carve-Out;
- Employee Carve-Out;
- Platform Provider Carve-Out;
- Selection and Monitoring Assistance Carve-Out;
- Financial Reports and Valuations Carve-Out; and
- Investment Education Carve-Out.

2010 Proposed Regulation	2015 Proposed Regulation
Education: Retains IB 96-1.	**Education:** Generally incorporates (but narrows - with regard to use of specifically identified investment alternatives in asset allocation models) IB 96-1 concepts and extends to IRAs.
ESOP Valuations: Includes valuation services as covered advice. But exception for valuations provided for ERISA & Code reporting.	**ESOP Valuations:** ESOP appraisals are carved out from appraisal advice. DOL states this will be addressed in separate guidance.
Seller's Exception: Requires that the "seller" demonstrate that the plan or participant knew or should know the person is acting in a sales capacity with adverse interest to the plan or participant or is not providing impartial investment advice.	**Counterparties:** Limited to: (1) large plan (100 or more participants) fiduciaries with financial expertise; or (2) to sophisticated fiduciaries with $100 MM under management. Requires understanding that impartial investment advice is not being provided. No fee can be received for the investment advice (as opposed to other services). **Swap Transactions:** Swap transactions with independent plan fiduciaries if in advance of the recommendations a written representation from the plan fiduciary states the fiduciary will not rely upon advice from the counterparty.
Platform Offering: Making available investment alternatives to a participant-directed plan if: (1) not individualized to plan, and (2) written disclosure is made to plan fiduciary that the person is not undertaking to provide impartial investment advice.	**Platform Offering:** Making available investment alternatives to a participant-directed plan if: (1) not individualized to plan, and (2) written disclosure is made to plan fiduciary that the person is not undertaking to provide impartial investment advice.
Investment Selection and Monitoring: The provision of general financial information to assist a plan fiduciary's selection or monitoring if disclosure in writing is made to the plan fiduciary that the person is not undertaking to provide impartial investment advice.	**Investment Selection and Monitoring:** In connection with the offering of a platform, the provision of information which (1) identifies alternatives that meet objective criteria set by the plan fiduciary or (2) provides objective financial data and comparisons with independent benchmarks.
Valuation and Reporting: Excluded valuations provided for purposes of compliance with the reporting and disclosure requirements of ERISA & Code, unless such report involves assets for which there is not a generally recognized market and serves as a basis on which a plan may make distributions to plan participants and beneficiaries.	**Valuation and Reporting:** Exempts appraisals, fairness opinions in connection with (1) ESOPs, (2) CITs and pooled separate accounts (with more than a single unaffiliated plan investor), and (3) complying with ERISA or Code or other reporting requirements. Appraisals connected to specific transactions involving a plan are fiduciary.
	Employees: Employees providing advice to a plan fiduciary if no fee or compensation is received beyond normal compensation.
Execution: Retains existing exemption for brokers executing securities transaction pursuant to specific directions from the plan fiduciary without any input from the broker-dealer.	**Execution:** Retains existing exemption for brokers executing securities transaction pursuant to specific directions from the plan fiduciary without any input from the broker-dealer.

Seller's Carve-Out

The seller's carve-out allows a person:

- acting as or on behalf of a counterparty;
- to provide covered advice to an independent plan fiduciary;
- in an arm's-length sale, purchase, loan or bilateral contract or proposal for such a transaction;
- if certain other conditions are met.

Seller's Carve-Out:
Plan Fiduciary Qualifications and Representations

With respect to plans represented by a fiduciary with responsibility for managing **at least** $100 million in employee benefit plan assets:

- The counterparty must confirm the fiduciary's "size" qualification by:
  - relying on the plan's most recently filed Form 5500; or
  - obtaining a written representation from the fiduciary regarding its assets under management.

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Seller's Carve-Out:
Plan Fiduciary Qualifications and Representations

With respect to plans represented by a fiduciary with responsibility for managing **less than** $100 million in employee benefit plan assets but **at least** 100 participants:

- The counterparty must obtain a written representation from the plan fiduciary that:

Seller's Carve-Out:

Plan Fiduciary Qualifications and Representations

- the fiduciary exercises authority and control with respect to the management and disposition of plan assets;
- the plan has 100 or more participants; **and**
- the fiduciary will not rely on the counterparty to:
  - act in the best interest of the plan;
  - provide impartial investment advice; or
  - give advice in a fiduciary capacity.

Seller's Carve-Out:

Required Disclosures and Other Compensation

The counterparty <u>must</u>:

- inform the fiduciary representing the plan of the existence and nature of the person's financial interests in the transaction; and
- reasonably believe that the fiduciary has sufficient expertise to evaluate the transaction and to determine whether the transaction is prudent and in the best interest of the plan participants.

The counterparty <u>may not</u>:

- receive any fee or other compensation directly from the plan or plan fiduciary for the provision of investment advice (as opposed to other services) in connection with the transaction.

Consumer Protection and Fragmentation

- The 2015 Proposal's "retail" / "institutional" distinction represents a new shift toward consumer protection

Retail Investors	Institutional Investors
Participants and Beneficiaries	Large Plans (>100 Ps)
IRA Owners	Plans managed by investment manager with more than $100 million AUM
Small Plans (<100 Ps)	

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Platform Provider Carve-Out

- The proposed regulation carves out from fiduciary status a person who merely markets and makes available to an employee benefit plan securities or other property through a platform or similar mechanism from which a plan fiduciary may select or monitor investment alternatives.

- The platform provider must acknowledge in writing that it is not providing investment advice to the plan.

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Platform Provider Carve-Out

- The securities or other property offered through the platform must be made available without regard to the individualized needs of the plan, its participants, or beneficiaries.
- The platform can provide limited information about the offerings on he platform.
- Does not apply to IRA platform.

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Investment Education Carve-Out

- DOL also attempted to exclude from the definition of fiduciary advice the provision of investment education.
- The carve-out would supersede and replace the commonly used Interpretive Bulletin 96-1 (29 CFR 2509.96-1).
- While DOL's investment education carve-out largely mirrors the provisions of IB 96-1, DOL added several new conditions that will need to be worked through.

Investment Education Carve-Out

- DOL added a new condition that the information and materials provided <u>not</u> include advice or recommendations regarding:
  - specific investment products;
  - specific investment managers; or
  - the value of particular securities or other property.
- The carve-out also specifically permits the furnishing of information to help participants assess their retirement needs past retirement and risks.

New PTE: "Best Interest Contract" Exemption

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Covered Transactions

- What is covered?
  - Receipt of compensation in connection with a purchase, sale or holding of an "Asset."
- Who may receive compensation?
  - Advisers
  - Financial Institutions
  - Affiliates and Related Entities of the above.
- To whom may advice be given?
  - "Retirement Investors"

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Retirement Investors

- Includes-
  - participant or beneficiary in participant-directed plan;
  - the beneficial owner of an IRA/HSAs; and
  - a plan sponsor of a non-participant-directed plan that has fewer than 100 participants.
- Does not include-
  - Plan sponsors of participant-directed plans

Advice & Assets

- Applies to advice programs
  - Does not cover discretionary programs
  - Need to find another exemption
- Applies to “Assets”
  - Includes common investments – publicly-traded equity and debt, MFs, ETFs, etc. (in general publicly traded, market determined value)
  - Excludes - future or put, call, straddle, or any other option or privilege of buying an equity security from or selling an equity security to another without being bound to do so.

Compensation

- Exempts “otherwise prohibited compensation”
  - Compensation that varies based on investment recommendations
  - Compensation from third parties in connection with their advice
- Implicitly, includes commissions, revenue sharing, 12b-1s, sub-TAs, shareholder servicing, marketing support payments, & other compensation
  - <u>However</u>, examples provided by the DOL call into question how and whether such compensation may be retained
- Proprietary products

Exclusions

- Adviser, Financial Institution or Affiliate is the employer of employees covered by the plan;
- Adviser or Financial Institution is a named fiduciary or plan administrator with respect to an ERISA plan;
- Principal transactions; and
- Computer generated advice (“Robo advice”)

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Conditions of Exemption

- Written contract - <u>prior</u> to advice
- Acknowledge fiduciary status
- Commit to adhere to “Impartial Conduct Standards”
  - Reasonable comp & no misleading statements
- Commit to provide advice in “Best Interest”
  - “act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and the needs of the Retirement Investor without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.”

Conditions of Exemption

- Provide certain warranties
  - Comply with all applicable federal and state laws (bootstrapping of claims)
  - Adopt written policies and procedures:
    - reasonably designed to mitigate the impact of material conflicts of interest; and
    - ensure that Advisers adhere to the Impartial Conduct Standards

Conditions of Exemption

- Other Contractual Disclosures
  - material conflicts of interest
  - right to obtain complete information about all of the fees
  - Offering of proprietary products or receives third party payments
- Contract MUST NOT contain-
  - exculpatory provision related to violations of the contract's terms; or
  - waiver or qualification regarding right to bring or participate in a class action
- Additional Disclosures
  - See below

Policies & Procedures

- In formulating policies and procedures:
  - Specifically identify material conflicts of interest and adopt measures to mitigate; and
  - Avoid use quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives to the extent they would tend to encourage Advisers to make recommendations that are not in the best interest of Retirement Investors.

Additional Disclosures

- Public website
  - direct and indirect material compensation within the last 365 days;
  - source of the compensation; and
  - how the compensation varies within and among Asset classes
- Point of Sale
  - All-in cost and anticipated future costs (sample chart).
  - “Total cost” to the Retirement Investor for 1-, 5- and 10- year periods expressed as a dollar amount, assuming an investment of the dollar amount recommended by the Adviser, and reasonable assumptions about investment performance, which must be disclosed
  - Additional conditions apply if a Financial Institution limits the investment products a Retirement Investor may purchase, sell or hold

Additional Disclosures

- Annual Disclosure
  - A list identifying each Asset purchased or sold during the applicable period and the price at which the Asset was purchased or sold;
  - Total dollar amount of all fees and expenses paid by the Retirement Investor, both directly and indirectly, with respect to each Asset; and
  - Total dollar amount of all compensation received by the Adviser and Financial Institution, directly or indirectly, from any party, as a result of each Asset sold, purchased or held.

DOL Requirements

- Disclose to DOL reliance on BIC.
- The Financial Institution must maintain and, upon request, disclose to DOL information related to “Inflows,” “Outflows,” “Holdings,” and “Returns.”

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Potential Sources of Liability for Advice Fiduciaries

Advice fiduciaries who fail to comply with the terms of the exemption may incur:

- contractual liability to IRA owners;
- liability under ERISA § § 502(a)(2) and (3) to plans, plan participants, and beneficiaries
  - *Note: The DOL also states, "Additionally, plans, participants and beneficiaries could enforce their obligations in an action based on breach of the agreement." 80 Fed. Reg. 21972. This could allow for state law claims.*

Example – IRA Rollover advice

- Broker recommends that a plan participant rollover to an IRA offered by the broker's firm
- Not clear that rollover advice is covered by the exemption
  - Arguably rollover advice is not advice about purchasing or selling "Assets"
  - But rollover would involve (i) selling "Assets" and taking a distribution, and (ii) purchasing "Assets" after the rollover

Changes to Current Exemptions

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PTE 84-24

- PTE 84-24 generally currently provides ERISA section 406(a)(1)(A)–(D) and 406(b) relief for the purchase and sale of mutual fund shares and insurance contracts to an ERISA covered plan and the receipt of commissions by an agent, broker or pension consultant in connection with the purchase of mutual fund shares or insurance contracts.
- The DOL significantly narrowed the definition of the term “commissions”. (excluding 12b-1 fees, revenue sharing, and other third party payments). ***Such payments would no longer be exempt under the revised exemptions.***
- DOL included the best interest/Impartial Conduct Standard as a condition of the exemption. The exemption will also require the adoption of some form of the best interest standard.
- The DOL also proposed changing PTE 84-24 to no longer cover advice to an IRA holder regarding the purchase or sale of an annuity contract that is a security (e.g., a variable annuity contracts) and regarding the purchase and sale of mutual fund shares by IRAs.
- These transactions involving IRAs must now obtain relief through the BIC.

PTE 86-128

- PTE 86-128 provides an exemption for transactions prohibited under ERISA section 406(b) that arise by reason of the fiduciary's use of its authority to cause a plan to pay a fee for effecting or executing securities transactions to itself or an affiliated broker-dealer.
- Like under PTE 84-24, the DOL proposes to significantly narrow the definition of "commissions" covered by PTE 86-128.
- DOL included the best interest/Impartial Conduct Standard as a condition of the exemption. The exemption will also require the adoption of some form of the best interest standard.
- DOL also proposed to subject IRAs to the full scope of that exemption's reporting and recordkeeping conditions, which currently only apply to ERISA-governed plans.

PTE 75-1, Part II

- The DOL also proposes to eliminate PTE 75-1, Part II into PTE 86-128. PTE 75-1, Part II currently provides ERISA section 406(a)(1)(D) and 406(b) relief for a plan's purchase of mutual fund shares from the fiduciary, acting as principal, and for the receipt of a commission by the fiduciary.

- Many brokers interpret PTE 75-1, Part II to provide exemptive relief for agency transactions involving mutual fund shares. However, the DOL now proposes to amend that exemption in such a way that it cannot be used for agency transactions.

- The definition of "commission" will also be narrowed.