GODFREY KAHN S.C.

Investment Management Flash

May 2016

Investment Management Team Contact

Susan M. Hoaglund
262.951.7136
shoaglund@gklaw.com

Tax & Employee Benefits Team Contact

John E. Donahue
414.287.9422
jdonahue@gklaw.com

The information contained herein is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

Department of Labor's Final Fiduciary Rule and Best Interest Contract Exemption

Secretary of Labor Thomas Perez unveiled the Department of Labor's (DOL) long-anticipated final fiduciary rule and best interest contract exemption to the public on April 6, 2016, at the Center for American Progress in Washington, D.C. In addition, the DOL tweeted messages about the rule using the hashtag #saveyoursavings, posted videos on YouTube, and photos on Instagram. The White House also issued a fact sheet on the rule called "Middle Class Economics: Strengthening Retirement Security by Cracking Down on Conflicts of Interest in Retirement Savings."

The New Definition of Fiduciary

Background

Beginning in 2009, the DOL undertook a multi-year regulatory project to address problems with conflicts of interest in investment advice. The DOL published two separate proposals in 2010 and 2015, held multi-day hearings on the proposals, held hundreds of individual meetings with a wide range of stakeholders, and published public comments it received from consumer groups, plan sponsors, financial service companies, academics, elected government officials, trade and industry associations, and others, both in support of and in opposition to the proposals.

1975 Rule. Currently, a person is a fiduciary to an employee benefit plan or IRA to the extent he or she renders investment advice to such plan or IRA for direct or indirect compensation. Existing regulations adopted in 1975 apply a five-part test to determine if a person is rendering investment advice for a fee (fiduciary investment advice). A person renders fiduciary investment advice if he or she renders advice (1) as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property; (2) on a regular basis; (3) pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary; (4) that will serve as a primary basis for investment decisions with respect to plan assets; and (5) that will be individualized based on the particular needs of the plan or IRA. The 1975 regulation was adopted prior to the existence of participant-directed 401(k) plans, the widespread use of IRAs, and the now commonplace rollover of plan assets from Employment Retirement Income Security Act (ERISA)-protected plans to IRAs. The existing regulation allows some advisers, brokers, consultants and valuation firms to play a central role in shaping employee benefit plan and IRA investments without being subject to fiduciary obligations under ERISA or the Internal Revenue Code (the Code).

Final Rule. The final rule amends the regulatory definition of fiduciary investment advice to replace the restrictive five-part test with a new definition. The rule treats persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of a plan or IRA as fiduciaries in a wider array of advice relationships. The rule first describes the kinds of communications that constitute investment advice and then describes the types of relationships in which such communications give rise to fiduciary investment advice responsibilities. The compliance date for the rule is April 10, 2017, although certain provisions, such as the Best Interest Contract Exemption (discussed below), have a transition period ending on January 1, 2018.

What is Investment Advice under the Rule?

A person gives investment advice if he or she provides, for a fee or other compensation (direct or indirect), the following types of advice:

- Recommendations regarding the advisability of buying, holding, selling or exchanging securities or other investment property (collectively, securities), including recommendations as to the investment of securities after the securities are rolled over or distributed from a plan or IRA;
- Recommendations as to the management of securities, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., brokerage versus 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 destination such a rollover, transfer, or distribution should be made.

Recommendations. The fundamental threshold element in establishing the existence of fiduciary investment advice is whether a "recommendation" occurred. A recommendation is a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the recipient engage in or refrain from taking a particular course of action. The more individually tailored the communication is, the more likely the communication will be viewed as a recommendation. Providing a selective list of securities as appropriate would be a recommendation as to the advisability of acquiring securities even if no recommendation is made with respect to any one security. It makes no difference whether the communication was initiated by a person or a computer software program.

Relationships/Circumstances under which Advice is Provided. The types of relationships that must exist for recommendations to give rise to fiduciary investment advice responsibilities include recommendations made either directly or indirectly (e.g., through or together with any affiliate) by a person who:

- Represents or acknowledges that it is acting as a fiduciary within the meaning of ERISA or the Code;
- Renders advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is based on the particular investment needs of the advice recipient; or
- Directs the advice to a specific recipient regarding the advisability of a particular investment or management decision with respect to securities of the plan or IRA.

IRA Rollovers. As noted above, investment advice includes recommendations whether a person should take a distribution from a plan and set up a rollover IRA, as well as recommendations on how to invest assets in the rollover IRA. The DOL believes that decisions to take a benefit distribution or engage in rollover transactions are among the most, if not the most, important financial decisions many persons make concerning retirement savings.

What Is Not Covered Investment Advice Under the Rule?

Not all communications with financial advisers will be covered fiduciary investment advice. Specific examples of communications that would not rise to the level of a recommendation and therefore would not constitute fiduciary investment advice include:

- ***Investment Education.*** The DOL believes that education about retirement savings and general financial and investment information is not only beneficial and helpful to plans, plan participants, and IRA owners, but may not rise to the level of recommendations. There are four broad categories of non-fiduciary educational information and materials, including:
    - Information and materials that describe investments or plan alternatives without specifically recommending particular investments or strategies;
    - General financial, investment and retirement information;
    - Asset allocation models (provided they do not cross the line to making specific investment recommendations or referring to specific products); and
    - Interactive investment materials (e.g., questionnaires, worksheets, software and similar materials that enable retail investors to estimate future retirement needs).

  Asset Allocation Models and Interactive Investment Materials in Plan Context. In the plan context, the education provision allows specific investment alternatives to be included as examples in presenting hypothetical asset allocation models or in interactive investment materials intended to educate participants and beneficiaries as to what investment options are available under the plan so long as they are designated investment alternatives selected or monitored by an independent plan fiduciary and other conditions are met. In contrast, because there is no similar independent fiduciary in the IRA context, the investment education provision in the rule does not treat asset allocation models and interactive investment materials with references to specific investment alternatives as merely "education" in the IRA context.

- ***General Communications.*** General communications that a reasonable person would not view as an investment recommendation include:
    - General circulation newsletters;
    - Commentary in publicly broadcast talk shows;
    - Remarks and presentations in widely attended speeches and conferences;
    - Research or news reports prepared for general distribution;
    - General marketing materials; and
    - General market data, including data on market performance, market indices, or trading volumes, price quotes, performance reports, or prospectuses.

- ***Platform Providers.*** Service providers, such as recordkeepers and third-party administrators, often offer a platform or selection of investment alternatives to plan fiduciaries who choose the specific investment alternatives that will be made available to participants for investing funds in their individual accounts. Simply making available a platform of investment alternatives without regard to the individualized needs of the plan, its participants, or beneficiaries would not be considered recommendations under the final rule, provided that

the plan fiduciary is independent of such service provider and the provider represents in writing to the plan fiduciary that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

- ***Transactions with Independent Plan Fiduciaries with Financial Expertise.*** ERISA fiduciary obligations are not imposed on advisers when communicating with independent plan fiduciaries if the adviser knows or reasonably believes that the independent fiduciary is a licensed and regulated provider of financial services (banks, insurance companies, registered investment advisers, broker-dealers) or has responsibility for the management of at least $50 million in assets, and other conditions are met. The conditions are designed to make sure this exclusion is limited to true arm's length transactions between advisers and investment professionals, large asset managers or plan fiduciary committees who do not have a legitimate expectation that they are in a relationship where they can rely on the other adviser for impartial advice.

- ***Swap and Security-Based Swap Transactions.*** Communications made by advisers to ERISA-covered employee benefit plans in swap or security-based swap transactions do not result in the advisers becoming investment advice fiduciaries to the plan if certain conditions are met.

- ***Employees of Plan Sponsors, Affiliates, Employee Benefit Plans, Employee Organizations, or Plan Fiduciaries.*** Employees working in a company's payroll, accounting, human resources, and financial departments who routinely develop reports and recommendations for the company and other named fiduciaries of the sponsors' plans are not investment advice fiduciaries if the employees receive no fee or other compensation in connection with any such recommendations beyond their normal compensation for work performed for their employer. Further, this exclusion also covers communications between employees, such as human resources department staff who communicate information to other employees about the plan and distribution options in the plan, as long as they meet certain conditions (e.g., they are not registered or licensed advisers under securities or insurance laws).

The Best Interest Contract Exemption

In addition to adopting an amended definition of what constitutes a fiduciary, the DOL also issued a new exemption from prohibited transactions, the Best Interest Contract Exemption (BICE), to promote the provision of investment advice that is in the best interest of retail investors, such as plan participants and beneficiaries, IRA owners and small plans. ERISA and the Code generally prohibit fiduciaries from receiving payments from third parties and from acting on conflicts of interest, including using their authority to affect or increase their own compensation, in connection with transactions involving an employee benefit plan or IRA. Certain types of fees and compensation common in the retail market, such as brokerage or insurance commissions, trailing commissions, sales loads, Rule 12b-1 fees and revenue sharing payments, fall within these prohibitions when received by fiduciaries as a result of transactions involving advice to plan participants and beneficiaries, IRA owners and small plan sponsors. To facilitate continued provision of advice to such retail investors and under conditions designed to safeguard the interest of these investors, the exemption allows investment advice fiduciaries, including investment advisers, broker-dealers and insurance companies, and their agents and representatives, to receive these various forms of compensation that, in the absence of an exemption, would not be permitted under ERISA and the Code.

The Best Interest Contract Exemption permits financial advisers (i.e., an individual who is a representative of an investment adviser, broker-dealer, insurance company, or bank or similar financial institution) and the financial institutions that employ them to continue to rely on many current compensation and fee practices, as long as they meet specific conditions intended to ensure that financial institutions mitigate conflicts of interest and that they, and their financial advisers, provide investment advice that is in the best interests of their customers. Specifically, in order to rely on the exemption, a financial institution generally must:

- Acknowledge fiduciary status for itself and its financial advisers;
- Adhere to basic standards of impartial conduct, including:
  - Giving prudent advice that is in the customer's best interest (i.e., based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investors, without regard to financial or other interests of the financial institution or financial adviser);
  - Avoiding making misleading statements; and
  - Charging no more than reasonable compensation;
- Commit to the impartial conduct standards in an enforceable contract when providing advice to an IRA owner;
- Implement policies and procedures reasonably and prudently designed to prevent violations of the impartial conduct standards;
- Refrain from giving or using incentives for financial advisers to act contrary to the customer's best interest; and
- Fairly disclose the fees, compensation, and material conflicts of interest associated with their recommendations.

Website Disclosure. A website must be maintained and updated regularly that includes information about the financial institution's business model and associated material conflicts of interest; a schedule of typical account fees; a model contract; a written description of the financial institution's policies and procedures that mitigate conflicts of interest; a list of all product manufacturers and other parties that provide third party payments with respect to specific investment products or classes of investments; a description of the third party arrangements, including a statement on whether and how these arrangements impact financial adviser compensation, and a statement on any benefits the financial institution provides in exchange for the payments; and disclosure of compensation and incentive arrangements with financial advisers. Individualized information about a particular adviser's compensation is not required to be included on the website.

Notice to DOL. All financial institutions relying on the exemption must notify the DOL in advance, and retain records that can be made available to the DOL and retirement investors for evaluating compliance with the exemption.

Enforceable Right to Best Interest Advice. The exemption provides for enforcement of the standards it establishes. When providing advice to an IRA owner, the financial institution must commit to the impartial conduct standards in an enforceable contract. The exemption does not similarly require the financial institution to execute a separate contract with ERISA investors (which includes plan participants, beneficiaries, and fiduciaries), but the financial institution must acknowledge its fiduciary status and that of its financial advisers, and ERISA investors can directly assert their rights to proper fiduciary conduct under ERISA's statutory protections. If financial advisers and financial institutions do not adhere to the standards established in the exemption, retirement investors will have a way to hold them accountable—either through a breach of contract claim (for IRAs and other non-ERISA plans) or under the provisions of ERISA (for ERISA plans, participants, and beneficiaries).

According to the DOL, investors will not be able to use this enforcement mechanism simply because they did not like how an investment turned out. Consistent with long-existing ERISA jurisprudence, financial institutions and financial advisers can usually prove they have acted in their clients' best interest by documenting their use of a reasonable process and adherence to professional standards in deciding to make the recommendation and

determining it was in the client's best interest, and by documenting their compliance with the financial institution's policies and procedures required by the Best Interest Contract Exemption.

Exculpatory Clauses. The exemption prohibits contracts from including provisions disclaiming liability for compensatory remedies, waiving or limiting retirement investors' right to pursue a class action or other representative action in court, or requiring arbitration or mediation of individual claims in locations that are distant or otherwise unreasonably limit the ability of retirement investors to assert claims. However, the exemption does permit provisions waiving the right to punitive damages or recession based on violation of the contract.

Negative Consent. The exemption permits reliance on a negative consent process for existing clients.

Level Fee Fiduciaries. The exemption provides streamlined conditions for level fee fiduciaries - that is, fiduciaries whose only fee or compensation is a level fee (e.g., a fee based on a fixed percentage of assets under management) that is disclosed in advance to the retirement investor. The DOL recognizes that receipt of a level fee typically would not raise prohibited transaction concerns. However, there is a conflict of interest when a financial adviser recommends that a participant transfer money out of a plan into an IRA that will generate ongoing fees for the financial institution. Similarly, the prohibited transaction rules could be implicated by a recommendation to switch from a low activity commission-based account to an account that charges a fixed percentage of assets under management on an ongoing basis.

Because the prohibited transaction in these examples is relatively discrete and the provision of advice thereafter generally does not involve prohibited transactions, the final exemption includes streamlined conditions to cover the discrete advice that requires the exemption. Although robo-advice providers are generally carved out of the Best Interest Contract Exemption, this streamlined exemption is available to them. The exemption for level fee fiduciaries requires the financial institution and/or the financial advisers to:

- Give the retirement investor a written fiduciary statement;
- Comply with the impartial conduct standards described above;
- Document the reasons why the level fee arrangement was considered to be in the best interest of the retirement investor when recommending a rollover from an ERISA plan to an IRA, a rollover from another IRA, or a switch from a commission-based account to a fee-based account; and
- Document their consideration of the alternatives to a rollover, including leaving the money in the current employer plan, if permitted.

It is important to note that this streamlined exemption is not available if either the financial institution or the financial advisers or their affiliates receive any other remuneration (e.g., commissions, Rule 12b-1 fees or revenue sharing) beyond the level fee.

Proprietary Products and Third Party Payments. Although the DOL has a "deep and continuing concern" regarding limiting products, the exemption is available to financial institutions that restrict their financial advisers' investment recommendations, in whole or in part, to investments that are proprietary products or that generate third party payments, provided all of the applicable conditions of the exemption are satisfied. The BICE deems the financial institution and financial adviser to be acting in the best interest of the retirement investor if they meet certain heightened disclosure and documentation requirements, in addition to receiving no more than reasonable compensation, satisfying the ERISA standard of care, and otherwise taking steps to mitigate conflicts of interest.

Compliance Date. The DOL has adopted a phased implementation approach for the Best Interest Contract Exemption. During a transition period, from the April 2017 applicability date to January 1, 2018 compliance date, fewer conditions apply. This period is intended to give financial institutions time to prepare for compliance with all the conditions of the exemption while safeguarding the interests of retirement investors. During this period, firms and financial advisers must adhere to the impartial conduct standards, provide a notice to retirement investors that, among other things, acknowledges their fiduciary status and describes their material conflicts of interest, and designate a person responsible for addressing material conflicts of interest and monitoring advisers' adherence to the impartial conduct standards. Full compliance with the Best Interest Contract Exemption will be required as of January 1, 2018.

If you have any questions or would like more information, please contact John Donahue, Susan Hoaglund or any other member of Godfrey & Kahn's Investment Management practice group.

Investment Management Team

Christopher M. Cahlamer
414.287.9338
ccahlamer@gklaw.com

Leah N. Cry
608.284.2232
lcry@gklaw.com

Julie A. D'Angelo
608.284.4622
jdangelo@gklaw.com

Ellen R. Drought
414.287.9517
edrought@gklaw.com

Carol A. Gehl
414.287.9255
cgehl@gklaw.com

Susan M. Hoaglund
262.951.7136
shoaglund@gklaw.com

Kristen A. Irgens
414.287.9308
kirgens@gklaw.com

Pamela M. Krill
608.284.2226
pkrill@gklaw.com

Jacqueline R. Roush
414.287.9354
jrousch@gklaw.com