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DOL Issues (Some) Additional Guidance on the Fiduciary Investment Advice Rule and Best Interest Contract Exemption

The US Department of Labor (DOL) has issued its first set of FAQs under the fiduciary investment advice rule (the "Rule") and related prohibited transaction exemptions.[1] In general, the Rule provides that parties providing "investment advice" (as defined under the Rule) to plan sponsors or fiduciaries, plan participants, or IRA owners are not permitted to receive payments that would create conflicts of interest without complying with a prohibited transaction exemption. The purpose of the Rule is to require advisers to put their clients' interests before their own financial interests.

The key exemption under the Rule is the "Best Interest Contract" exemption ("BICE"). The BICE is available to advisers and financial institutions that provide investment advice to retail investors such as plan participants and beneficiaries and IRA owners ("retirement investors"). It is intended by the DOL to be the primary exemption for investment advice transactions involving retirement investors. The BICE covers recommendations to such retirement investors, including recommendations with respect to all categories of assets, advice to roll over plan assets, and recommendations on persons the retirement investor should hire to serve as investment advisers or managers. The BICE requires advisers to adhere to "impartial contract standards" and certain disclosure and other requirements (this full compliance is sometimes called the "full BICE"). However, "level fee fiduciaries" may rely on the BICE while complying with the impartial contract standards, but few of the additional requirements. The FAQs provide for clarifications under the BICE, level fee arrangements and other items. The following is a summary of important guidance contained in the FAQs.

Level Fee Fiduciaries

Level Third-Party Payments and Level Commissions

For purposes of the Rule, a level fee fiduciary is one whose only compensation is a fixed percentage of the value of a customer's assets under management, where such values are determined by readily available independent sources or independent valuations. In the FAQs, the DOL explained that, to satisfy this test, the fee received must be independent of any specific transactional activity.

Thus, the FAQs state that receipt of third-party payments, such as 12b-1 fees and revenue sharing payments, *even if they provide the same amount or percentage for each investment offered*, are transaction-based fees that depend on particular investments so that a fiduciary

[1] The FAQs are available here. The DOL indicated that it intends to issue at least two more sets of FAQs under the Rule.

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receiving them is not a level fee fiduciary. In addition, the FAQs state that where a financial institution pays the same commission to its advisers on proprietary investments, regardless of the investment selected, the level fee fiduciary provisions are not available. Advisers must rely on the full BICE to receive such compensation.

The DOL also clarified that a financial institution can offer both level fee accounts as well as accounts under which the adviser can earn commissions or third-party compensation. The latter type of account would have to rely on the full BICE. In connection with such a structure, financial institutions must keep in mind that advising retirement investors on level fee versus commission-based accounts is itself investment advice subject to the Rule. The FAQs note that certain practices may result in inappropriate recommendations, such as recommending a fee-based account to an investor with low trading activity and no need for ongoing monitoring, or advice, or first recommending a mutual fund with a front-end sales load, and shortly later, recommending that the customer move the shares into an advisory account subject to asset-based fees. In making recommendations, the DOL stresses that the adviser should consider if the type of account is appropriate in light of the services provided, the projected cost to the customer, the alternative fee structures that are available, and the customer's fee structure preferences, in addition to non-price factors.

Rollovers and Transfers

The FAQs clarify that the level fee exemption is available for investment advice to roll over a plan account to an IRA, even if the adviser will serve as a discretionary investment manager with respect to the IRA, as long as the adviser does not exercise any discretionary authority or control with respect to the decision to roll over assets of the plan to the IRA. However, the exemption is not available for any prohibited conflicts of interest arising from the discretionary manager's conduct after the assets are rolled over to the discretionary account.

When the advice to roll over assets from an ERISA plan to an IRA is made by a level fee fiduciary, the BICE requires written documentation of the reasons why the rollover advice was considered to be in the best interest of the retirement investor. This documentation must take into account the fees and expenses associated with both the existing plan and the IRA; whether the employer pays for some or all of the existing plan's administrative expenses; and the different levels of services and investments available under each option. If after making diligent efforts to get the information from the plan, the financial institution is unable to obtain the information or the investor is unwilling to provide the information, even after disclosure of its significance, the financial institution may rely on alternative data sources, such as the most recent form 5500 or reliable benchmarks on typical fees and expenses for the type and size of the plan. If the financial institution relies on such alternative data, it should explain the data's limitations and the written documentation should include an explanation of how the financial institution determined that the data was reasonable.

Full BICE

Discounted Fee Schedules

Acknowledging that financial institutions and advisers currently discount fees and commissions based on factors including the size of a client's account, size of a particular transaction, desire to attract a new client, the FAQs clarify that financial institutions that have established a price or pricing schedule for services that satisfies the reasonable compensation standards under ERISA, are permitted to discount such prices for individual clients under the full BICE, so long as the discounts are not used in a manner that re-introduces conflicts of interest. However, the FAQs do not specifically address whether a level fee fiduciary could utilize such an approach, for example, by charging a flat fee of x% for accounts up to a certain size and a lower flat fee for larger accounts.

Commission Grids

In response to financial industry questions, the FAQs clarify that paying higher commission rates to advisers based on volume (e.g., by using an escalating grid under which the percentage of the commission paid to the adviser increases at certain thresholds) is permissible under the BICE if the structure is not expected to cause advisers to make recommendations that are not in the best interest of plan investors. For developing a grid of escalating commissions, the FAQ provides the following guidance.

- ***Neutral Factors.*** Firms can pay different commission amounts for different broad categories of investments based on neutral factors. For example, one commission structure might be developed for mutual funds, another for annuities (assuming there is a neutral basis for the distinction). "Neutral factors" are factors that are not based on the financial interest of the firm (e.g., the profitability of the investment) but rather on significant differences in the work that justify drawing distinctions between categories and compensation. This must be monitored to ensure that advisers are not focusing their recommendations on a category with the higher commission amount. Additionally, if the justification for the higher commission is due to additional work necessary to make a recommendation for that category, the firm should pay careful attention to whether its advisers are, in fact, performing additional work.
- ***Size of Steps.*** Grids with one or several modest or gradual increases are less likely to create impermissible incentives than grids characterized by large increases. An appropriately structured grid would not rely on compensation thresholds that enable an adviser to disproportionately increase his or her compensation as the adviser reaches a threshold.
- ***Retroactivity.*** As the adviser reaches a threshold on the grid, any resulting increase in the adviser's compensation rate should generally be prospective—the new rate should apply only to new investments made once the threshold is reached.
- ***Oversight.*** Financial institutions employing escalating grids must have a system in place to monitor and supervise adviser recommendations, both at or near compensation thresholds and at a greater distance.

"Robo-Advice"

The FAQs reiterated that the BICE does not cover advice solely through an interactive website in which computer software-based models or applications provide recommendations based on personal information that the investor supplies without any personal interaction or advice from an individual adviser, based on the DOL's view that the robo-advice market is still evolving and the availability of the separate exemption in ERISA Sections 408(b)(14) and 408(g). The FAQs clarify that the BICE does provide relief for robo-advisers that comply with the requirements for "level fee fiduciaries."

Recruitment Bonuses to an Adviser

The FAQs also address recruitment bonuses that financial institutions use to recruit advisers. The DOL notes that "front-end" or signing bonuses are typically not tied to the adviser moving accounts or assets to the financial institution or upon the achievement of particular asset or sales targets. The FAQs indicate that such signing bonuses are permissible under the BICE because the payments do not turn on the adviser's particular recommendations or create inappropriate incentives.

Financial institutions also provide "back-end" awards that are contingent on the adviser's achievement of sales or asset targets. The FAQs note that such back-end awards can create conflicts of interest that are inconsistent with the BICE requirement that financial institutions adopt policies and procedures designed to ensure that individual advisers adhere to the exemption's impartial conduct standards. Recognizing that financial institutions may have existing back-end recruitment award arrangements that would otherwise be prohibited under this guidance, the DOL has provided that the financial institution may continue to rely on the BICE for transactions involving an adviser with such a back-end arrangement, provided that: 1) the financial institution has concluded in good faith that it is contractually bound to continue the arrangement after October 27, 2016; 2) that it engages in stringent oversight of the adviser during the period of the arrangement; 3) the period of time remaining under the arrangement is reasonable and consistent with general industry practices; and 4) the arrangement does not otherwise violate the conditions of the BICE, ERISA or the Code. The FAQs also provide general guidance on screening and monitoring practices in connection with recruitment practices.

Grandfathered Compensation Arrangements

The BICE provides an important exemption for specified compensation received in connection with investments that were made before the April 10, 2017, as well as compensation for recommendations to continue to adhere to a systematic purchase program established before the applicability date. The exemption is available for advice to continue to adhere to the grandfathered program, but does not extend to investment advice to make any changes to the program.

The FAQs clarify that the grandfathering relief is not available for compensation received in connection with the investment of additional amounts in a previously acquired investment vehicle. However, the investment of additional money does not cause the grandfathered amounts or vehicle to lose its grandfathered status.

The BICE provides that grandfathering relief applies to compensation received in connection with the purchase, sale, or exchange of securities or other investment property acquired before April 10, 2017. Accordingly, compensation received as a result of investment advice to sell a grandfathered investment is covered by the grandfathering relief. The FAQs clarify that advice regarding the investment of proceeds of the sale of the grandfathered investment, however, must be made in accordance with the BICE or another exemption.

Effective Dates

The FAQs also discuss the two-stage implementation of the rule and the BICE. The Rule is effective for investment recommendations made on or after April 10, 2017. The FAQs clarify that effective April 10, 2017, Prohibited Transaction Exemptions 75-1, 77-4, 80-83, 83-1, 84-24, and 86-128 will require compliance with the impartial conduct standards and, in some cases, more tightly restrict their availability for transactions subject to significant conflicts of interest. For IRAs and non-ERISA plans that were already customers of a financial institution as of April 10, 2017, the fiduciary engaging in a transaction under PTE 86-128 need not obtain affirmative written consent for such transactions as would otherwise be required, but instead may rely on negative consent as long as the fiduciary gave the required disclosures and consent termination form to the customer by that date.