TRUMP AND THE DEBATE OVER THE FIDUCIARY RULES AFFECTING RETIREMENT SAVINGS

CAMPAIGN PROMISES AND THE FIDUCIARY FIGHT

President Elect Trump's campaign website states that he intends to issue a moratorium on new regulations that are "not compelled by Congress or public safety." His stated goal is to make way for more jobs by suspending "wasteful and unnecessary regulation which kill[s] jobs and which does not improve public safety." After the election, Trump called for the removal of two regulations for every one kept.

The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and the federal tax code require the U.S. Department of Labor ("DOL") to protect consumers by regulating transactions involving retirement savings. Under that authority, the DOL published final regulations last April that are intended to protect primarily the middle class from high fee investments recommended by financial advisors for retirement accounts. The regulations, which affect $12 trillion held in individual retirement and 401(k) accounts, were subject to public review and comment for five years prior to becoming final this year.

Some pockets of the financial services industry have vigorously opposed the regulations, and have challenged them in various lawsuits. So far, two federal courts have ruled that the DOL did not exceed its regulatory authority in issuing the regulations, and would not invalidate them (*Nat'l Ass'n for Fixed Annuities v. Perez*, 2016 BL 391590 D.D.C. No. 1:16-cv-01035-RDM (11/23/16) and *Market Synergy Group v. USDOL* Case No. 16-CV-4083 DDC-KGS (11/28/16)). The five remaining lawsuits challenging the regulations are pending, with no other rulings to date.

While the future of the final fiduciary regulations under the Trump administration is unclear at this time, it is likely that they will remain in place for the near term, barring the passage of new law retracting or amending them. They cannot be withdrawn unilaterally by the new administration, because of the Congressional Review Act. Any new regulations must undergo a lengthy process before becoming effective.

Because the fiduciary regulations are designed to protect the public from predatory investment sales tactics that diminish retirement savings, they do not fall within Trump's stated target for a moratorium. In addition, the regulations provide the investment industry a means for keeping a reasonable and variable fee structure in exchange for its exercising a fiduciary duty of care toward consumers. Finally, conspicuous opposition to the fiduciary regulations may undercut the financial industry's customer base if viewed as an admission of overcharging consumers. For

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ABOUT THE AUTHOR

Evelyn Haralampu — Partner
Labor, Employment & Employee Benefits
617.345.3351 | eharalampu@burnslev.com

Evelyn advises on employee benefits, ERISA, executive compensation, medical privacy, federal health reform and related tax law. She writes and speaks extensively and has authored "ERISA Liability," in the MCLE treatise *Massachusetts Employment Law*.

She is a member of the Tax Section of the American Bar Association and has been a contributing member of its subcommittee on Government Submissions. Recently, Evelyn's article "Supreme Court's Evolution in Defining Equitable Remedies Under ERISA" was featured in Bloomberg's *BNA Benefits Practitioners' Strategy Guide*.

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these reasons it may be unwise to expect that the fiduciary regulations will be short-lived, notwithstanding a few vocal financial industry advocates for their repeal.

Rather, the prudent course is to prepare for the implementation of the fiduciary regulations, at least until the direction of the new administration becomes clear.

GENERAL BACKGROUND

Registered investment advisers, broker-dealers and insurance companies and their agents commonly receive variable levels of compensation from the sale of investments, through commissions, 12b-1 fees and revenue sharing payments. Historically, these dealers have not owed any legal duty to protect consumers' best interests when recommending investments for their retirement savings. As a result, dealers have been able to steer consumers toward investing their retirement savings in products that return greater revenues to the dealers, rather than prioritizing the consumers' best financial interests when investing their retirement savings.

The U.S. Department of Labor, concerned about the depletion of retirement savings by financial institutions and dealers with a bias toward selling high-cost investments to retirement funds, issued final regulations on April 8, 2016 designed to curb the variable compensation that dealers can take on sales of investments to retirement funds. The regulations assign fiduciary responsibility to dealers recommending investments to retail retirement accounts, and bar them from taking commissions or other variable compensation unless certain standards are met.

For example, if the Best Interest Contract Exemption is met, a financial institution can collect a commission or other type of variable compensation on the sale of an investment to a retirement plan account that would otherwise be prohibited. Similarly, variable compensation on the sale of certain debt securities, mutual funds and other instruments to retirement accounts is permitted if the Principal Transactions Exemption is met.

BEST INTEREST CONTRACT EXEMPTION

The Best Interest Contract Exemption requires the financial institution to:

1. Acknowledge its own fiduciary status in writing.
2. Adhere to standards of impartial conduct, including giving prudent advice in the customer's best interest, avoiding misleading statements and receiving no more than reasonable compensation.
3. Adopt policies and procedures designed to mitigate any harmful impact of conflicts of interest.
4. Disclose any conflicts, fees and the cost of advice.
5. Document these requirements in an enforceable contract if advice is being provided to an IRA or other non-ERISA plan. The enforceability of the contract gives consumers a private right of action and remedy for breaches of fiduciary duty involving their retirement savings.

Any adviser charging a level fee for investment advice is not required to have a contract but must provide a written statement of fiduciary status, adhere to fiduciary conduct and prepare written documentation for why recommendations were made.

PRINCIPAL TRANSACTIONS EXEMPTION

The Principal Transactions Exemption permits insurance agents and brokers to receive commissions for the sale of certain debt securities, mutual funds, fixed rate annuities (i.e. guaranteed lifetime income products) and certain other investments to retirement plans and IRAs without violating the prohibited transaction rules, provided that impartial conduct standards are met.

However, commissions on the sale of variable annuities, indexed annuities and similar products are not exempt from the fiduciary rules unless the Best Interest Contract Exemption is met. To preserve variable compensation of these non-exempt, high cost products, the dealers selling them must provide the fiduciary disclosures, a contract, and policy statements required under the Best Interest Contract Exemption. In addition, financial institutions must refrain from using compensation incentives that encourage dealers to act contrary to the consumer's best interests.

NEW DEFINITION OF FIDUCIARY INVESTMENT ADVICE

The new regulations broaden the definition of an ERISA fiduciary to include advisers, brokers, consultants and valuation firms that previously had no legal accountability toward retirement accounts. Fiduciaries giving investment advice, even once, are required to act for the best interests of those they serve. The following activities carry fiduciary responsibility under the regulations if retirement accounts are charged for them:

1. A recommendation on the advisability of buying, selling, holding or exchanging securities or retirement investments.
2. A recommendation to rollover, transfer or distribute retirement assets.
3. A recommendation on managing retirement assets, including policies or strategies, portfolio composition, selection of other persons to provide investment advice or management, selection of investment account arrangements, and rollover, distribution or transfer recommendations.
4. Recommending a person who is to receive a fee or other compensation for advice or investment management service.

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CARVE-OUTS FROM REGULATION

The regulations exempt certain activities from fiduciary status, as long as specific conditions are met. These activities generally include:

1. Communications regarding reporting and disclosure requirements of a retirement plan or IRA.
2. Uncompensated investment advice or sales pitches in connection with an arm's-length transaction between an expert plan investor and an independent counter-party. The counter-party may receive a fee for services other than investment advice.
3. Certain security-based swap transactions where the dealer in the swap is not advising the retirement plan.
4. Employees of a plan sponsor who give investment advice to the sponsor for no extra pay.
5. Record keepers and other third party administrators offering a platform or selection of investment vehicles to participant-invested retirement plans.
6. Educating plan participants about their retirement vehicles, giving general investment information and providing interactive investment materials, asset allocation models or hypothetical examples.

DOL CLARIFICATION OF REGULATIONS

The Department of Labor issued further guidance on October 27, 2016, clarifying the regulations. Here is a look at some of the major features.

Gradual Implementation of the Regulations

The Department of Labor introduced a transition period extending until January 1, 2018 during which the impartial conduct standards would apply to protect consumers. This standard requires the financial industry to give advice that is in the best interest of the retirement investor, charge no more than reasonable compensation, make no misleading statements, acknowledge their fiduciary status and disclose their material conflicts-of-interest. Full compliance with the Exemptions is required thereafter for advisers to receive variable compensation from the sale of investments to retirement funds.

Best Interest Contract Exemption Generally Available

As long as the Best Interest Contract Exemption is met, advisers recommending investments, rollovers or other advisers may receive variable compensation from the sale of those investments or other recommendations.

Escalating Compensation Grids

The DOL clarified that the financial industry can pay more productive advisers a greater proportion of revenues as long as the compensation is reasonable and the payment structure incorporates neutral factors that do not interfere with the fundamental obligation to provide advice that is in the consumers' best interests. For example, higher commissions may be paid based on neutral factors such as the time and complexity associated with recommending an investment rather than basing higher commissions on the investment category.

BOTTOM LINE

The fiduciary regulations are designed to protect the public from an unnecessary depletion of their retirement savings by limiting predatory practices of the financial industry designed to maximize its own revenues at the expense of consumers' best interests. As long as the investment industry meets standards promoting the consumers' best interests, it can continue to charge variable and reasonable compensation for its sale of investments to retirement accounts. Because the regulations' objective appears aligned with President Elect Trump's overarching intent of protecting the middle class, it is imprudent to count them out at this time.