
DOL's Proposed Prohibited Transaction Exemption: Best Interest Contracts

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This is the second in a series of client advisories regarding the U.S. Department of Labor's re-proposed regulations (Proposed Rule) defining who is a fiduciary under ERISA and the Code as a result of providing investment advice. This client advisory focuses on a new proposed prohibited transaction exemption published with the Proposed Rule that would allow persons who are deemed to be "investment advice fiduciaries" receive compensation for investment advice if certain conditions are met.

Background

The Proposed Rule would treat certain persons who provide investment advice for a fee or other compensation to an employer-sponsored retirement plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner as fiduciaries (investment advice fiduciaries) under the Employee Retirement Income Security Act of 1974 (ERISA), as amended or the Internal Revenue Code of 1986, as amended. (Please see our Client Advisory, "[Take Two: DOL Reproposes Changes to Definition of Fiduciary for ERISA Plans and IRAs](#)," published concurrently with this one, for more information on persons who would qualify as investment advice fiduciaries and the categories of advice covered by the Proposed Rule.)

Investment advice fiduciaries are generally prohibited from receiving payments from third parties or from receiving compensation that varies depending on the particular investments made or recommended by the fiduciary. Unless a prohibited transaction exemption applies, investment advice fiduciaries are prohibited from receiving brokerage and insurance commissions, 12b-1 fees, revenue sharing payments and certain other types of compensation resulting from their investment advice to plan sponsors, plan participants and beneficiaries, and IRA owners.

Proposed Best Interest Contract Exemption

The new proposed prohibited transaction exemption published with the Proposed Rule—the "best interest contract" exemption—would allow "advisors," "financial institutions," and their "affiliates and related

entities” to receive compensation for investment advice provided to “retirement investors” that would otherwise be prohibited as a conflict of interest. The exemption seeks to promote investment advice that is in the best interests of retirement investors by requiring the advisor and financial institution to enter into contracts in which they “acknowledge fiduciary status, commit to adhere to basic standards of impartial conduct, warrant that they have adopted policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest, and disclose basic information on their conflicts of interest and on the cost of their advice.”

The U.S. Department of Labor (DOL) has proposed a standards-based approach that is intended to preserve existing beneficial business models and broadly permit investment advice fiduciaries to continue to rely on common fee practices. This represents a departure from the DOL’s typical regulatory approach of creating highly prescriptive transaction-specific exemptions.

The proposed exemption would be limited to investment advice provided to individual participants who can direct their own investments in 401(k) and 403(b) plans and other plans governed by ERISA, to IRA owners, and to plan sponsors of plans covering fewer than 100 participants that do not allow participant-directed investments. Investment advice provided to plan sponsors who are picking a menu of investment funds for a participant-directed plan, or to sponsors of large pension plans that do not permit participant-directed investments, is not covered by the exemption. Investment advice for such plans may, however, be covered by other DOL exemptions, a number of which are being revised in conjunction with the Proposed Rule.

A summary of the material aspects of the proposed “best interest contract” exemption follows below.

Key Definitions

Advisers, Financial Institutions, and Their Affiliates and Related Entities

An “adviser” is an investment advice fiduciary of an employee benefit plan or IRA who:

- is an employee independent contractor, agent, or registered representative of a financial institution; and
- satisfies the applicable federal and state regulatory and licensing requirements of insurance, banking, and securities laws covering the transaction.

A “financial institution” is

- the entity that employs the adviser or otherwise retains such individual as an independent contractor, agent, or registered representative; and
- a registered investment adviser, bank, insurance company, or a registered broker-dealer.

An “affiliate” of an adviser or financial institution is any:

- person who is, directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the adviser or financial institution;
- officer, director, employee, agent, registered representative, relative, member of family of, or partner in, the adviser or financial institution; or
- corporation or partnership of which the adviser or financial institution is an officer, director or employee or in which the adviser or financial institution is a partner.

A “related entity” means any entity other than an affiliate in which the adviser or financial institution has an interest which may affect the exercise of its best judgement as a fiduciary.

Advisers, financial institutions and their affiliates and related entities are referred to in this Client Advisory as investment advice fiduciaries.

Retirement Investors

A “retirement investor” is:

- a participant or beneficiary of an ERISA-governed participant-directed individual account plan with authority to direct the investment of assets in his or her plan account or to take a distribution;
- a beneficial owner of an IRA acting on behalf of the IRA; or
- a plan sponsor of a non-participant directed ERISA-governed plan that has fewer than 100 participants, to the extent that it acts as a fiduciary with authority to make investment decisions for the plan.

Covered Transactions

The best interest contract exemption would permit investment advice fiduciaries to receive compensation for services performed in connection with the purchase, sale, or holding of certain assets by retirement investors in accordance with the advice of the investment advice fiduciary. “Assets” are defined to include bank deposits, CDs, shares or interests in registered investment companies (mutual funds), bank collective funds, insurance company separate accounts, exchange-traded REITs, exchange-traded funds, certain corporate bonds, agency debt securities and US Treasury securities, insurance and annuity contracts, and guaranteed investment contracts.

The exemption does *not* apply to the receipt of compensation in transactions involving the following:

- an ERISA-governed plan if the investment advice fiduciary is the employer of employees covered by the plan;
- an ERISA-governed plan if the advisor or financial institution (or an affiliate) is a named fiduciary or plan administrator that was selected to provide advice to the plan by a fiduciary who is not independent;
- an advisor acting on behalf of its own account or the account of the financial institution or its affiliate;
- investment advice that is generated solely by an interactive website in which computer software-based models or applications provide investment advice to retirement investors based on personal information each investor supplies through the website without any personal interaction or advice from an individual adviser; or
- an adviser who exercises any discretionary authority or discretionary control over ERISA plan assets or IRA assets, or the administration of the ERISA plan or IRA.

Contract Requirements

The exemption would require the investment advice fiduciary and retirement investor to enter into a written contract that incorporates the following terms:

Fiduciary Status

The written contract must affirmatively state that the advisor and financial institution are fiduciaries under ERISA or the Code, or both.

Impartial Conduct Standards

The advisor and financial institution must affirmatively agree to, and comply with, the following:

- to provide advice regarding assets that is in the “best interest of the retirement investor” under standards similar to the duties of prudence and loyalty under ERISA.
- to not recommend an asset if the total amount of compensation anticipated to be received exceeds reasonable compensation in relation to the total services provided to the retirement investor; and
- to not make any misleading statements about assets, fees, “material conflicts of interest,” and any other matters relevant to a retirement investors investment decisions.

A “material conflict of interest” exists when an adviser or financial institution has a financial interest that could affect the exercise of its best judgment as a fiduciary in rendering advice to a retirement investor regarding an asset.

Warranties

The advisor and financial institution must affirmatively warrant that they:

- will comply with all applicable federal and state laws governing the rendering of investment advice;
- have adopted written policies and procedures reasonably designed to mitigate the impact of material conflicts of interest and ensure that individual advisers adhere to the impartial conduct standards and, in formulating its policies and procedures, have identified any material conflicts of interest and adopted measures to prevent the material conflicts of interest from causing violations of the impartial conduct standards; and
- will not use quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives to the extent they would encourage individual advisors to make recommendations that are not in the best interest of the retirement investor.

Disclosures

The written contract must specifically:

- identify and disclose any material conflicts of interest;
- inform the retirement investor of its right to obtain complete information about all direct and indirect fees associated with the assets in which it is invested; and
- disclose whether the financial institution offers proprietary products or receives third-party payments with respect to the purchase, sale, or holding of any asset, and the address of a website that discloses the compensation arrangements entered into by the advisors and the financial institution.

Prohibited Contractual Provisions

The written contract may not contain:

- exculpatory provisions disclaiming or otherwise limiting liability of the adviser or financial institution for a violation of the contract's terms; and
- any provision requiring the retirement investor to agree to waive or qualify its right to bring or participate in a class action or other representative action in court in a dispute with the adviser or financial institution.

Disclosure Requirements

An adviser or financial institution must satisfy certain disclosure requirements in order to rely on the proposed "best interest contract" exemption.

Initial Transaction Disclosures

Certain disclosures must be made to a retirement investor before the initial purchase of an asset recommended by the investment advice fiduciary in the form of a chart:

- the total cost of investing in the asset—including acquisition costs, ongoing costs, and disposition costs—for 1-, 5-, and 10-year time frames expressed as a dollar amount; and
- reasonable assumptions about investment performance.

The disclosure chart need not be provided for subsequent recommendations to purchase the same investment product if the chart was previously provided to the retirement investor in the past twelve months and the total cost has not materially changed.

Annual Transaction Disclosures

The adviser or financial institution must provide the following information to retirement investors annually, within 45 days of the end of the applicable year:

- a list identifying each asset purchased or sold during the applicable period and the price at which the asset was purchased or sold;
- a statement that the total dollar amount of all fees and expenses paid by the plan, participant or beneficiary account, or IRA (directly or indirectly) for each asset purchased, held or sold during the applicable period; and
- a statement of the total dollar amount of all compensation received by the adviser and financial institution, directly or indirectly, for any party, as a result of each asset sold, purchased or held by the plan, participant or beneficiary, or IRA, during the applicable period.

Webpage

The financial institution must maintain a webpage, freely accessible to the public, which provides the following information:

- the direct and indirect material compensation payable to the adviser, financial institution, and any affiliate for services provided in connection with each asset that a plan, participant or beneficiary account, or an IRA
 - is able to purchase, hold or sell through the adviser or financial institution, or
 - has purchased, held or sold within the last 365 days;
- the source of the compensation; and
- how the compensation varies within and among assets.

The information above must be provided in a machine readable format.

Range of Investment Options

The proposed exemption generally requires the financial institution to offer for purchase, sale or holding, and the adviser must make available to the retirement investor, a broad range of assets to enable the advisor to make recommendations for all of the asset classes necessary to service the best interests of the retirement investor in light of its investment objectives, risk tolerance, and specific financial circumstances.

If the range of investment options is limited, a financial institution may still rely on the exemption, provided it satisfies certain requirements set forth in the proposed exemption.

DOL Notice and Recordkeeping

In order to rely on the exemption, the DOL would require financial institutions comply with the following notice and recordkeeping requirements:

- notify the DOL of its intention to rely on the exemption;
- maintain certain data for a period of six years from the date of the transaction subject to relief under the exemption; and
- maintain for a period of six years records necessary for the DOL or IRS to determine whether the conditions of the exemption have been met.

Relief for Insurance and Annuity Contracts

The exemption provides relief for the purchase of certain insurance or annuity contracts from an insurance company that has a preexisting fiduciary or other service relationship with a retirement investor. The transaction must be in the ordinary course of the insurance company's business, the insurance company's fees must be reasonable, the purchase must be for cash only, and the terms of the purchase must be at least as favorable for the retirement investor as the terms generally available in an arm's length transaction with an unrelated party.

Relief for Preexisting Transactions

The exemption also provides relief to investment advice fiduciaries for compensation received in connection with the purchase, sale or holding of an asset by a retirement investor that occurred as a result of the fiduciary's advice that was entered into before the effective date of the new fiduciary rules. The

investment advice fiduciary must not provide additional advice to the retirement investor regarding the purchase, sale or holding of the asset after the effective date.

Implications of the Proposed Exemption

The proposed exemption would permit investment advice fiduciaries to continue receiving compensation in connection with investment advice provided to retirement investors under existing beneficial business models, provided certain requirements are met. These requirements, however, are numerous and specific and will impose additional burdens on investment advice fiduciaries who wish to rely on the exemption. The cost of complying with these requirements may lead to increases in investment advisory fees if ultimately passed along by investment advice fiduciaries to retirement investors.

The Proposed Rule and “best interest contract” exemption, when implemented, may also lead to more “fixed fee” compensation arrangements and other arrangements under which the investment advice fiduciary’s fees do not vary based on the particular investments being recommended. Contracts with such types of compensation arrangements arguably would not need to comply with the “best interest contract” exemption unless the contract could give rise to third-party payments to the investment adviser (or an affiliate) or other potential conflicts of interest.

Sponsors and fiduciaries of ERISA-governed plans who wish to retain an investment advice fiduciary to advise participants on their plan investments would need to carefully review the contracts under which those services will be performed to determine if the compensation arrangements or other potential conflicts of interest require reliance on the “best interest contract” exemption. If so, then the plan fiduciaries would need to determine if the contract meets the requirements of the exemption and to monitor the investment adviser’s compliance with the exemption going forward. Failure of the plan fiduciaries to monitor compliance with the exemption could be viewed as a breach of fiduciary duty, in addition to giving rise to prohibited transaction sanctions.

The “best interest” standard required of investment advice fiduciaries may be particularly important to IRA owners. Fiduciaries under ERISA are already subject to the duties of prudence and loyalty, whereas IRA fiduciaries are not necessarily subject to similar standards under the Code. Requiring a “best interest” standard to be incorporated into a contract between an IRA owner and investment advice fiduciary would provide IRA owners with greater protections, including a private right of action if the fiduciary does not comply with the prescribed standards. This depends, of course, on the willingness of investment advisers to adopt contracts and procedures complying with the new rules. Some investment advisers may conclude that they would rather exit the business of advising IRAs than comply with the new rules.

The DOL’s past attempts to strengthen the fiduciary standards under ERISA and the Code have been met with significant criticism and pushback from industry groups representing investment advice fiduciaries. It is anticipated that the DOL will receive many comments and similar pushback in response to the Proposed Rule and the new proposed “best interest contract” exemption. It is possible, therefore, that significant changes could be made to both the Proposed Rule and the exemption before implementation by the DOL.

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