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The DOL Issues “Investment Advice” FAQs – Continues to Try to Find an Ideal Balance for the Brave New Fiduciary World

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The U.S. Department of Labor (the “DOL”) released its first set of FAQs (the “FAQs”) regarding the DOL’s recently finalized “investment advice” regulation and various related exemptions (collectively, the “Final Rules”) on October 27, 2016. Dechert previously published an in-depth discussion of the Final Rules in its May 2016 *OnPoint*, [The Brave New Fiduciary World Has Arrived – The DOL Tries to Find a More Ideal Balance in the Final “Investment Advice” Rules](#), and followed that with three related industry-focused *OnPoints*.¹

Those dealing with retirement investors (including retirement plans and individual retirement accounts) will either have to steer clear of giving advice covered by the Final Rules or operate in compliance with them. As the DOL stated in the FAQs, “Firms and advisers [that give advice covered by the Final Rules] must either structure their compensation arrangements to avoid prohibited transactions or they must rely on [a prohibited transaction] exemption.”²

Many of the FAQs focus on the application of Prohibited Transaction Exemption (“PTE”) 2016-01 (the “BIC Exemption”), a critical new class exemption designed to permit certain compensation arrangements and fee structures for advisers and financial institutions that otherwise would be prohibited, while at the same time protecting covered retirement investors. The FAQs also address the application of the new PTE 2016-02 (the “Principal Transactions Exemption”), which allows advisers and financial institutions to engage in certain principal transactions with retirement investors, and amended PTE 84-24, which generally allows fiduciaries to receive compensation in connection with retirement investors’ purchase of certain insurance products.³ In the absence of these exemptions, and in particular the BIC Exemption, a wide range of conduct by those considered “investment advice” fiduciaries under the Final Rules could be prohibited under Section 406(b) (and possibly Section 406(a)) of the Employee Retirement Income Security Act of 1974 (“ERISA”) and Section 4975 of the Internal Revenue Code of 1986.

¹ See Dechert *OnPoints*, [The New DOL Fiduciary Rule: Impact on Mutual Fund Distribution](#) (August 2016), [Navigating the DOL’s New Fiduciary Rules: A Game Plan for Broker-Dealers](#) (August 2016), and [Mutual Fund Sales by Intermediaries – Fall-Out from DOL Fiduciary Rule and FINRA Enforcement](#) (October 2016).

² In this *OnPoint*, we use the term “adviser,” as used by the DOL in the Final Rules and FAQs, to describe a person or entity that gives investment advice to a retirement investor. Accordingly, this term may refer to entities, such as dually-registered broker-dealers and investment advisers, banks, insurance companies and other financial institutions as well as to natural persons, such as financial advisors and other associated persons of these organizations, as the case may be.

³ The DOL has indicated that it intends to release further sets of FAQs that cover other aspects of the Final Rules and PTEs. See [Your Conflicts of Interest Questions Answered](#) and [First set of FAQs on fiduciary rule coming ‘very soon,’ but deadline extension ‘not likely’: DOL’s Borzi](#).

In many respects, the FAQs do not break new ground. In some cases, however, they do provide useful clarifications, and, in others, there is some new information and guidance. The following is a summary of certain aspects of the FAQs.

The BIC Exemption

Scope of the BIC Exemption

The FAQs confirm that a decision to roll over plan assets to an IRA or other individual account is potentially within the scope of the Final Rules if there is a covered recommendation regarding that decision, and that the adviser or financial institution making the recommendation might in that case need to satisfy the conditions of the BIC Exemption specifically with respect to the rollover decision. Although there were indications of this result in the Final Rules themselves, it appears as though some confusion on the point had developed in the market. Q&As 6 and 7 clarify that the relief provided by the BIC Exemption is required in such a situation even though it might relate only to the rollover recommendation, and not to any subsequent discretionary activity (which is not covered by the BIC Exemption). The FAQs confirm that the BIC Exemption generally does not provide relief for an adviser with actual discretionary authority over plan investment, noting that a discretionary adviser has long been treated as a fiduciary under ERISA. Thus, the FAQs repeatedly emphasize that the BIC Exemption may be needed in connection with rendering discrete investment advice, but not in the case of discretionary investment management.⁴ However, it is important to note that the Final Rules could have significant impact even on discretionary managers – for example, if the manager becomes an “investment advice” fiduciary during the rollover process or otherwise during the marketing or client intake process (often, before there is an intent to accede to fiduciary status) – and as a result, even discretionary managers dealing with retirement investors may wish to take steps to minimize or otherwise address this risk.

So-called robo-advice⁵ is not covered under the BIC Exemption, but robo-advice providers that are level fee fiduciaries may rely on the streamlined provisions of the BIC Exemption for certain discrete transactions requiring an exemption. The streamlined provisions of the BIC Exemption and examples of their application are discussed further below (see below under the heading of “BIC Lite”).

Adviser Compensation

The FAQs contain a fairly detailed discussion of the types of internal incentive compensation (e.g., compensation paid to individual advisers or other service providers to financial institutions) that may raise issues under the Final Rules. The FAQs discuss at some length specific compensation arrangements, distinguishing front-end from back-end awards, and indicating that the latter can create “acute conflicts of interest.” Further, the FAQs discuss in some detail several factors that should be considered in designing commission structures, including escalating grids, and factors that the DOL considers neutral. For broker-dealers and other financial institutions that have incentive

⁴ In this regard, Q&A 8 states: “[T]he BIC Exemption does not provide relief for a recommended transaction if the adviser has or exercises any discretionary authority or control with respect to the transaction. Persons with such discretionary investment authority have long been treated as fiduciaries [for these purposes]. As such, they have been and continue to be subject to a regulatory regime that specifically addresses the issues raised when a fiduciary is given the discretionary authority to manage plan assets. . . . The conditions of the BIC Exemption are tailored to the conflicts that arise in the context of the provision of investment advice, not the conflicts that could arise with respect to discretionary money managers.”

⁵ Robo-advice generally refers to advice generated by interactive software-based models that provide investment recommendations based solely on personal information supplied by the investor, and without any interaction or advice from an individual adviser.

compensation arrangements tied to the solicitation of retirement assets or the manner in which those assets are invested, it may be appropriate to review specific sections of the FAQs (in particular, Q&As 9 and 12) in detail.⁶

Discounts

The FAQs clarify that the BIC Exemption permits broker-dealers and other financial institutions and advisers to discount prices paid by individual clients, provided that the price or price schedule meets the reasonable compensation standard and the discounts do not re-introduce conflicts of interest.

“BIC Lite”

The BIC Exemption provides streamlined relief (referred to by some as “BIC Lite”) for “level fee fiduciaries” whose compensation is based on a fixed percentage of the value of the assets or a set fee that does not vary with the particular investment recommended. As discussed in the FAQs, transactions for which BIC Lite is designed include, for example, an adviser recommending that a plan participant roll money out of an ERISA plan and into a fee-based account that would generate ongoing fees for the adviser that the adviser would not otherwise receive, or an adviser recommending that an investor transfer assets from a commission-based account to a fee-based account.

Some confusion seems to have developed in the market over why a level fee fiduciary needs relief at all. While the FAQs clarify that certain level fee arrangements might not involve a prohibited transaction at all, the Final Rules nonetheless made clear that the intake process could still implicate conflicts and that, even after intake, conflicts may be reduced but not necessarily eliminated. The FAQs reemphasize this point and expressly reaffirm the need for satisfying BIC Lite if no other route to compliance is available.

BIC Lite requires advisers and financial institutions to document the reasons why a particular piece of advice was in the best interest of the retirement investor, which, in the context of a rollover recommendation, would involve taking into account, among other things, the fees and expenses associated with both the existing plan and the new IRA. In performing this analysis, the FAQs state that the DOL will not be sympathetic to claims regarding the difficulty of obtaining information regarding a plan’s fees and expenses. The FAQs suggest that such information be obtained from the investor, who can provide the plan’s required ERISA disclosures or, if despite diligent and prudent efforts the financial institution cannot obtain the relevant information, it could rely on alternative data sources, such as the plan’s Form 5500 or reliable benchmarks for fees and expenses for plans of similar size and type.

Two of the FAQs (Q&As 5 and 17) state that neither BIC Lite nor any other exemption would provide relief for certain types of “abusive conduct,” such as recommending a fee-based account to an investor with low trading activity and no need for monitoring or advice, or recommending a mutual fund with a front-end sales load and then, shortly thereafter, recommending that the customer move the shares into an advisory account with asset-based fees. The FAQs reference the Financial Industry Regulatory Authority “Report on Conflicts of Interest” (Oct. 2013) (“FINRA Report”), which outlines certain circumstances in which an adviser, at the expense of the investor, seeks to increase the adviser’s compensation. The FAQs specifically note that, “[i]n making [the recommendations delineated in the FINRA Report], financial institutions and advisers should consider whether the type of account is appropriate in light of

⁶ Q&A 12 provides relief for certain existing loan arrangements between financial institutions and financial advisors, including certain back-end recruitment award arrangements entered into prior to the date of the FAQ guidance, subject to satisfying specific criteria, including the adoption of policies and procedures designed to mitigate the conflicts of interest introduced by such arrangements.

the services provided, the projected cost to the customer, alternative fee structures that are available, and the customer's fee structure preferences, in addition to non-price factors.”

In an important confirmation, the FAQs also clarify that BIC Lite is not available for advisers and financial institutions that receive third-party payments, such as 12b-1 fees and revenue sharing payments, even if those payments are level or otherwise uniform. If a broker-dealer or other financial institution receives third-party payments and seeks coverage by the BIC Exemption, the arrangement must comply with the more stringent provisions of the full BIC Exemption. In addition, the FAQs confirm that BIC Lite is not available if the adviser or financial institution receives commissions or other transaction-based compensation, even if the adviser exclusively offers proprietary products and receives the same commission and/or other transaction-based compensation regardless of the investment selected.

BIC Lite provides relief for certain “bank networking arrangements,” which involve compensation generated from referrals by banks and their employees to non-affiliates who are providers of retail non-deposit investment products. The FAQs clarify that referrals to affiliates are merely in the nature of marketing oneself or an affiliate, which, without more, would not constitute covered “investment advice” (and, therefore, would not need the protection of the BIC Exemption). Although the Final Rules may have contained indications of this result, apparently some concern had developed on this point in the market.

The FAQs also clarify and confirm that advisers and financial institutions can offer to the same investor both level fee advisory services, for which they can rely on BIC Lite, and commission-based accounts for which they must comply with the full BIC Exemption.

Disclosures under the BIC Exemption

The BIC Exemption requires that a financial institution maintain, on its website, an electronic copy of the best interest contract required to be entered into by retirement investors. In the DOL's view, the best practice is to maintain an executed copy of each individual contract on the website (or, if negative consent to amend an existing contract is used, an executed copy of each contract amendment). Nevertheless, the Final Rules permit financial institutions to post a model contract that applies to a class of customers, or a model contract amendment that applies to a class of customers with existing contracts. The FAQs caution, however, that the BIC Exemption will not be satisfied if the model contract does not include all the mandatory terms with respect to the particular customer, does not express the terms that were executed at the time of the transaction, or is subsequently disclaimed.

The BIC Exemption also includes transaction-based disclosure requirements, which the FAQs clarify only apply to recommendations to buy (i.e., not to hold or sell) an investment product. In addition, with respect to investors' rights to request disclosure of costs, fees and compensation, the FAQs clarify that the relevant information should generally be provided as of the date of the recommendation.

Insurance Contracts and Annuities

A significant number of the FAQs are dedicated to the treatment of annuities under the Final Rules, specifically how amended PTE 84-24 and the BIC Exemption relate to annuities. In general, many of the annuity provisions were late additions to the Final Rules, further contributing to their controversial nature. Those advisers and financial institutions that deal with covered annuities may want to review the applicable FAQs (Q&As 21 through 23 and 32 and 33) in detail.

Compliance Dates and Enforcement

Consistent with the DOL's timeline set out in the Final Rules, the FAQs confirm that the Final Rules will apply starting on April 10, 2017. On that date, the BIC Exemption and the Principal Transactions Exemption will also become available. However, during a transition period through January 1, 2018, the DOL will relax full implementation of these new PTEs so that fewer conditions will apply. By contrast, the new restrictions imposed by the Final Rules on the availability of the pre-existing exemptions (notably, PTEs 75-1, 77-4, 80-83, 84-24 and 86-128) will generally become effective April 10, 2017.

In addition, if an adviser made a recommendation to purchase an investment product before the applicability date, and recommends purchasing more of the same investment product after the applicability date, the investment of "new money" does not taint the "old money" that is otherwise eligible for grandfathering relief. Extending this principle, the FAQs state that a recommendation made after the applicability date to remain invested in a systematic purchase program entered into before the applicability date qualifies for the exemption even if the adviser received compensation as a result. While sales recommendations made before the applicability date may qualify for grandfathering, advice relating to the re-investment of proceeds from a sale must comply with the requirements of an exemption, such as the BIC Exemption.

The DOL noted that compliance assistance is its "high priority" during the period when financial institutions and advisers are coming into compliance with the Final Rules. In what is perhaps a sign of some flexibility, the DOL stated that its general approach will be to provide assistance to the market participants affected by the Final Rules rather than citing violations and imposing penalties.

Conclusion

The FAQs are welcome as additional guidance under the wide-ranging and extremely significant Final Rules, and the DOL has indicated that additional Q&As are planned. Those affected should be prepared to digest and react to the new guidance in light of the quickly approaching compliance dates.

If you wish to discuss the Final Rules or the FAQs or their impact on your business, please contact one of the attorneys below or any Dechert attorney with whom you regularly work.

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