

# Best Practices Arising from the DOL Fiduciary Rule

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In light of the various twists and turns that have taken place in 2017, it would be foolhardy to speculate about what changes, if any, will be made to the U.S. Department of Labor (DOL) Fiduciary Rule<sup>1</sup> and related prohibited transaction exemptions, which include the Best Interest Contract Exemption<sup>2</sup> (BICE or BIC Exemption), or whether additional prohibited transaction exemptions will be added. With DOL's recent request for information published on July 6, 2017,<sup>3</sup> and its August 9, 2017, announcement of its submission to the Office of Management and Budget (OMB) of a proposal to postpone full implementation until July 1, 2019,<sup>4</sup> a delay of the January 1, 2018, applicability date of the exemptions' full requirements looks increasingly likely. Furthermore, recent actions by government attorneys appear to be putting the prohibition against class action waivers on thin ice. In early July, government attorneys stated in a brief filed in the *Chamber of Commerce of U.S.* case that they would no longer defend the feature<sup>5</sup> and on August 23, 2017, they advised the court in *Thrivent*<sup>6</sup> the class action waiver challenge by the plaintiffs "will likely be mooted in the near future."<sup>7</sup> "On August 30, 2017, the DOL published guidance that to the extent a financial institution has a contract with a retirement investor that contains a provision requiring arbitration and limiting the investor's right to participate in class actions, it will not take any enforcement action solely because the contract fails to comply with the current conditions of the exemptions

that forbid such provisions."<sup>8</sup> To date, financial institutions have invested significant time and resources into preparing for compliance. The expenditure of these resources was not in vain, however. This article examines the manner in which the fiduciary rule, and in particular the BIC Exemption, affect business best practices regardless of whether any changes are made to the fiduciary rule and related exemptions.

## CHANGE IN FIDUCIARY STATUS

Parties that previously were reasonably able to take the position that they were not ERISA<sup>9</sup> fiduciaries by virtue of providing investment advice under the five-part test (promulgated by DOL in regulations issued in 1975) no longer will be able to maintain that position under the fiduciary rule.

## BEST PRACTICE: EDUCATION OF NEW FIDUCIARIES

Newly minted fiduciaries need to educate themselves on all the implications, complexities, and responsibilities of their new fiduciary status. Among the immediate consequences of such a change in status is providing updated disclosures required by the regulations under ERISA Section 408(b)(2) to the responsible plan fiduciary. Among other things, the regulations require that compensation (direct and indirect), a description of services, and fiduciary status be disclosed, and that updated information be provided as soon as practicable but no later than 60 days after the firm is "informed of" the change. Where the advisory agreement is used to satisfy 408(b)(2) requirements

(in lieu of a stand-alone disclosure), it may need to be revised. Note that DOL recently provided 408(b)(2) disclosure guidance during the transition period until full implementation.<sup>10</sup> So long as a financial institution's services as of June 9, 2017, are described accurately in the disclosure (even if the change in fiduciary status is not mentioned), no update is required. If the existing disclosure does not accurately describe services as of June 9, 2017, the updated disclosure should be made as soon as practicable, even if more than 60 days after June 9, 2017.

New fiduciary advisors also need to understand the duties of prudence and loyalty under ERISA. Although co-fiduciary liability under ERISA is difficult to establish, new ERISA fiduciaries need to be aware of this potential liability, as well as the need to obtain a fiduciary bond if they are handling plan assets and the need to obtain fiduciary liability insurance.

## BEST INTEREST STANDARD

The cornerstone of the BIC Exemption is the Best Interest Standard of Care. It requires that fiduciary investment advice be provided (1) with the care, skill, prudence, and diligence that a prudent person who is familiar with such matters would use, (2) based on the investment objectives, risk tolerance, financial circumstances, and needs of the client, and (3) without regard to the financial or other interests of the advisor, financial institution, or any affiliate, related entity, or other party.<sup>11</sup>

### BEST PRACTICE: EMBRACE BEST INTEREST ADVICE

Despite the uncertainty around the fiduciary rule and the exemptions, and regardless of whether they are replaced or modified, the policy discussions on this topic in recent years have raised the profile of best interest investment advice. Heightened fiduciary standards with respect to retirement investing are now squarely in the public arena. In our view, the BIC Exemption's Best Interest Standard of Care, or a standard substantially similar to it, will continue to be relevant to firms and their advisors after the dust settles.

### ROLLOVER FACTORS

Under BICE, advisors must ensure that a recommended activity is in the best interest of plan participants. With respect to the issue of determining whether a rollover from a tax-qualified plan, such as a 401(k) plan to an individual retirement account (IRA), is in the best interest of a plan participant, the level-fee advisor must take into account many factors and internally document the consideration of those factors. DOL has stated that the determination should consider (1) the client's alternatives to a rollover, including leaving the money in the current employer's plan, if permitted, (2) the fees and expenses associated with both the plan and the IRA, (3) whether the employer pays for some or all of the plan's administrative expenses, and (4) the different levels of investments and services available under each option.<sup>12</sup> BICE describes the aforementioned considerations, but it does not set forth a comprehensive "safe harbor" list of factors that the advisor is required to consider. Failure by an advisor to take into account all relevant factors in a particular client's circumstances may be an area of great litigation risk.

### BEST PRACTICE: MAXIMIZE THE FACTORS TAKEN INTO ACCOUNT

Financial institutions should develop a thorough and comprehensive checklist that identifies as many pertinent

factors as possible. Some factors might include whether the plan permits a self-directed brokerage window, differences with respect to potential withdrawal penalties, protection from creditors, protection of assets in the event of divorce, and application of the required minimum distribution rules with respect to individuals who intend to continue in active employment past the age of 70½, but can permissibly make in-service distributions after attaining age 59½, or some later age. Also, if a participant is concerned about estate planning, IRAs generally provide greater flexibility than tax-qualified plans.

As an aside, the consideration and documentation of the retirement investor's individual needs and circumstances under BICE's level-fee exemption are similar to the requirements of Notice 13-45 issued by the Financial Industry Regulatory Authority (FINRA). In fact, DOL believes Notice 13-45 should be the basis for evaluating an individual's needs.<sup>13</sup> Conformity with Notice 13-45 means that the advice must be reasonably based on the suitability of the investment for the plan participant. This, in turn, requires the advisor to consider the impact of a rollover decision on the participant's investment profile, including the participant's: (1) age, (2) investments outside of the plan, (3) financial situation, (4) tax status, (5) investment goals and experience, (5) investment time horizon, (7) liquidity needs, and (8) risk tolerance, as well as other information that the participant may disclose.

However, as an illustration of the more robust implementation efforts required under BICE, if, after making diligent efforts to obtain information from the plan with respect to fees, expenses, investment options, and services, the financial institution is unable to obtain the information or the investor is unwilling to provide such information, even after disclosure of its significance, the financial institution may rely upon

alternative sources of data, such as the most recently filed Form 5500 or reliable benchmarks on typical fees and expenses for the type and size of the plan. If a financial institution is relying upon such alternative data, DOL has indicated 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.<sup>14</sup>

### COMPLIANCE AND THE BICE OFFICER

Two of the alternative forms of the BIC Exemption require the financial institution to designate a BICE Officer: a person (or persons), identified by name, title, or position, responsible for addressing material conflicts of interest and monitoring the institution's advisors' adherence to the Impartial Conduct Standards.<sup>15</sup> DOL provides a great deal of flexibility as to the manner in which this regulatory condition should be satisfied. For example, should the responsibility rest with a single individual or with a committee? If a committee, which individuals should be on the committee, and to whom should the committee (or, if applicable, the relevant individual) report? If a financial institution offers both securities and insurance products, should there be separate committees for each of these products? Should the individual(s) operate pursuant to a charter, in the same manner that plan administrators of employee benefit plans under ERISA operate?

### BEST PRACTICE: SPECIFY RESPONSIBILITIES

Regardless of whether an individual or a committee is appointed to oversee adherence to the Impartial Conduct Standards, the BICE Officer's responsibilities should be spelled out in a governing document and procedures for receiving and reviewing information should be implemented that will allow the responsible individuals (or members, in the case of a committee) to monitor whether advisors are in fact complying with the Impartial Conduct Standards.

### BEST PRACTICE: CONSIDER THE BICE OFFICER'S LIABILITY

The BICE Officer is a new concept created under the BIC Exemption and there is no formal guidance of judicial interpretation on the legal liability attached to the person, function, or title that constitutes this position. Unlike a "fiduciary," "named fiduciary," "plan administrator," "trustee," or "investment manager," each of which is a defined and recognized term under ERISA and charged with specific fiduciary responsibilities to the plan and its participants and beneficiaries, the BICE Officer is not charged with fiduciary functions or fiduciary liability per se. However, that lack of legal guidance will not prevent a plaintiff in a civil action from naming the BICE Officer as a defendant. For this reason, as part of implementation of BICE, the financial institution should consider adding the BICE Officer to the fiduciary liability policy, errors and omissions policy for officers and directors, and/or indemnifying the BICE Officer for the discharge of his or her duties, one of which involves monitoring and enforcing BICE compliance.

### WEB DISCLOSURE

For certain alternative forms of the BIC Exemption, the financial institution is required to establish and maintain a web page that is freely accessible to the public on which information including the firm's business model, material conflicts of interest, a schedule of typical account or contract fees and service charges, model contracts and model notices, and a list of product manufacturers are disclosed.<sup>16</sup> The purpose of the web-page requirement is to promote comparison shopping and overall transparency of the marketplace for retirement investment advice. To the extent information required to appear on the web page is provided in other disclosures (including those required by the Securities and Exchange Commission (SEC) and/or DOL such as Form ADV, Part II), the BIC Exemption permits the financial institution to post such disclosures to the web page with an explanation that the information can be

found in the disclosures and a link to where it can be found.<sup>17</sup>

### BEST PRACTICE: REVIEW FORM ADV

Form ADV is the uniform form used by investment advisors to register with both the SEC and state securities authorities. Part II of the form requires investment advisors to prepare narrative brochures that contain information such as the type of advisory services offered, the advisor's fee schedule, disciplinary information, and conflicts of interest. A summary of material changes to the brochure must be delivered to clients annually and either deliver a complete updated brochure or offer to provide the client with an updated brochure. When reviewing web disclosures that linked to Form ADV, Part II, we often found numerous statements in the narrative that were out-of-date with respect to current compensation practices and statements that, if true, are not permitted under the BIC Exemption. As part of the BICE Officer's responsibilities to ensure that disclosures under the BIC Exemption are accurate and up-to-date, the BICE Officer should coordinate with the party at the firm who is responsible for preparing SEC filings, including Form ADV, to ensure that the narrative accurately reflects current compensation practices and any conflicts of interest and that the web page is linking to the most recent Form ADV.

### REASONABLE COMPENSATION

Perhaps in no other way did the fiduciary rule and the BIC Exemption have a more profound effect upon service providers than with respect to compensation practices. The requirement that compensation received needs to be reasonable is not new. Reasonable compensation has been a concept under ERISA since its enactment, but, except in egregious cases, had not been a DOL enforcement priority. Therefore, clients are not unfamiliar with the concept of reasonableness of fees under ERISA, but the burden of confirming that compensation received by the service

provider was reasonable rested with the responsible plan fiduciary reviewing the ERISA Section 408(b)(2) disclosure. Now, with the advent of the fiduciary rule, if a fiduciary investment advisor is relying on a prohibited transaction class exemption like BICE, that fiduciary now has the responsibility of demonstrating that the compensation received is reasonable. The reasonable compensation standard, as one of the components of the BICE Impartial Conduct Standards, requires that compensation not be excessive as measured by the market value of the particular service rendered or benefits delivered by the firm and advisor.

### BEST PRACTICE: BENCHMARKING

From an implementation perspective, the key element is benchmarking to demonstrate reasonable compensation. Reasonableness of compensation represents a range of fees rather than a point, but if the fee charged is substantially above average, it will be necessary for the firm to establish that such a fee is proper, either because of exceptional performance or the performance of additional non-fiduciary services, such as participant education.

### BEST PRACTICE: MONITORING NEUTRAL FACTORS

Another consideration in determining reasonable compensation is neutral factors. Neutral factors, as discussed in the preamble to the BIC Exemption, permit higher compensation to be received by service providers so long as such higher compensation can be justified through neutral factors. DOL has provided only limited guidance with respect to identifying neutral factors, indicating that the complexity of the product, the additional training that the advisor must spend learning about the product, and the additional time necessary to explain the product to the client are all neutral factors. Neutral factors such as these, for example, justify why advisors can receive greater compensation for the sale of variable annuities than for the sale of mutual funds.

When a firm is relying on neutral factors to justify differential compensation, the BICE Officer must monitor and confirm that the advisor actually is spending more time on the product. The BICE Officer also will need to determine if the incentive for selling variable annuities has in fact caused the advisor to be selling more variable annuities. Documentation by the advisor as to why the variable annuities were selected as an investment option will be critical, although it is unclear how extensive the review by the BICE Officer needs to be.

### REVERSE CHURNING

The SEC and FINRA were ahead of DOL in one respect, namely, reverse churning. Reverse churning is the practice of an advisor placing a client who trades infrequently into a fee-based account, charging an ongoing advisory fee, and then receiving payment for doing little or nothing thereafter. This has been a priority issue of the SEC for some time. In 2016, for example, the SEC fined broker-dealers for failing to monitor wrap-fee accounts on a quarterly basis to prevent reverse churning. Although the firms had policies in place for that purpose, on at least two occasions SEC examiners found that the firms did not conduct their “inactive account review” on a timely basis. This also serves as an illustration of the types of policies and procedures that the BICE Officer will need to implement.

### BEST PRACTICE: ESTABLISH PROCEDURES TO PREVENT REVERSE CHURNING

DOL’s preferred approach under the fiduciary rule and more particularly BICE is the receipt of level fees rather than variable compensation. However, transitioning a client from a commission-based to a fee-based arrangement may not be appropriate in all cases. If the investments in an IRA, for example, have been largely static and require little oversight, it may be in the client’s best interest if the assets remain in the current commission arrangement

rather than shifting to a higher cost level-fee arrangement.

### SOLICITATIONS AND REFERRALS

Although it has not received the same level of publicity or commentary as other aspects of the fiduciary rule, a gray area concerns whether a simple referral constitutes a recommendation, thus causing the person recommending the service provider to be treated as a fiduciary if he or she receives compensation (either directly or indirectly) for such referral. In the preamble to the fiduciary rule, DOL stated that “whether a referral rises to the level of a recommendation ... depends on the content, context, and manner of presentation. If, in context, the investor would reasonably believe that the service provider is recommending that the plan base its hiring decision on the specific list provided by the advisor, and the service provider receives compensation or referral fees for providing the list, the communication would be fiduciary in nature.”<sup>18</sup> Even for investment advisors who enter into solicitation agreements with third parties, those agreements might describe the activities of the solicitor as merely introducing the investor to the investment advisor and not fiduciary in nature. Under the fiduciary rule, it is possible although difficult to maintain that position based on the subjective “facts and circumstances” standard described above, which takes into consideration “the content, context, and manner” of presentation of the referral. It places the solicitor in an uncertain position where the line between fiduciary and non-fiduciary status can easily be crossed.

In the event a solicitor’s statements rise to the level of a fiduciary recommendation under the fiduciary rule, the difficulty is that solicitors will be unable to take advantage of the more streamlined level-fee exemption and will need to comply with the full BIC Exemption.<sup>19</sup> Under these circumstances, even with the promise of documentation and support from the financial institution and the investment advisor, some solicitors simply may

wish to terminate their agreements, essentially saying the solicitor’s fee is not worth the concerns associated with being a provider of fiduciary investment advice.

### BEST PRACTICE: CLIENT ACKNOWLEDGMENT

For a solicitor to avoid fiduciary investment advisor status under the fiduciary rule, conversations with potential clients of the investment advisor need to be tightly scripted and limited to providing neutral statements about the investment advisor. As mentioned above, however, there is a risk that a statement intended to be neutral might be treated as a recommendation. Take, for example, a solicitor who states: “These guys have been in business for more than 20 years.” Such a statement could be treated as a neutral comment evidencing the experience level of the investment manager. However, it could also be perceived, depending upon the manner of presentation, as an implicit recommendation, that the solicitor has worked with them for more than 20 years. Thus, although a script may be a useful tool in guiding a solicitor’s neutral statements, it can also be difficult to adhere to when a prospective client asks about the investment advisor’s past performance.

Steps can be taken to support the solicitor’s position, such as having the prospective client execute an acknowledgment stating that the client agrees and understands that this is a referral and not a recommendation, and that nothing that has been said during the conversation with the solicitor could reasonably lead the client to conclude that the solicitor is recommending any party be hired as an investment advisor. Although not dispositive, such an acknowledgment may prove helpful if the solicitor’s referral is later challenged.

What, if any, steps taken to re-enforce the solicitor’s position depend upon the solicitor’s risk tolerance. Financial institutions and advisors will take different positions as well. For some firms and their advisors, referrals are a significant

source of business and they may be unwilling to risk the loss of that particular pipeline, in which case they may assist the solicitors in satisfying an applicable exemption to avoid the prohibited transaction of a fiduciary using his authority to receive compensation.

## CONCLUSION

As noted at the outset, the final chapter of the fiduciary rule and related exemptions may not yet have been written, and may not be written until sometime in 2018. Nevertheless, the types of implementation efforts described above will have been beneficial in any event. In light of DOL's recently issued Request for Information, as well as the substantial legal difficulties that it would have under the Administrative Procedure Act, there appears very little likelihood that DOL would totally rescind the fiduciary rule and return to the definition of fiduciary under the five-part test promulgated by DOL in regulations issued in 1975. Even if that were to occur, it

would be very difficult for those entities that could take advantage of the 1975 regulations to walk back their fiduciary status under the fiduciary rule. ●

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## ENDNOTES

1. 81 Fed. Reg. 20946 (April 8, 2016).
2. 81 Fed. Reg. 21002 (April 8, 2016).
3. 82 Fed. Reg. 31278 (July 6, 2017).
4. The DOL's submission to the OMB does not constitute a formal proposal to delay

5. *Chamber of Commerce of U.S. et al. v. Acosta, Secretary of Labor.*
6. *Thrivent Financial for Lutherans v. Acosta, Secretary of Labor.*
7. Thrivent, letter to judge filed August 23, 2017.
8. Field Assistance Bulletin 2017-03.
9. The Employee Retirement Income Security Act of 1974, as amended.
10. Conflict of Interest FAQs (August 2017).
11. Section VIII(d) of the BIC Exemption, 81 Fed. Reg. 21083 (April 8, 2016).
12. *Id.*
13. See preamble to the BIC Exemption, 81 Fed. Reg. 21012 (April 8, 2016).
14. Conflict of Interest Exemption FAQs, Q&A14 (October 2016).
15. See Section II(d)(2) and II(g)(3) of the BIC Exemption, 81 Fed. Reg. 21077, 21079 (April 8, 2016).
16. Section III(b) of the Best Interest Contract Exemption, 81 Fed. Reg. 21079, 21080 (April 8, 2016).
17. Section II(b)(2) of the Best Interest Contract Exemption, 81 Fed. Reg. 21080 (April 8, 2016).
18. See preamble to Fiduciary Rule, 81 Fed. Reg. 20968 (April 8, 2016).
19. Conflict of Interest Exemptions FAQs, Q&A-18 (October 2016). DOL seems to be taking the position that any third-party payments are, by nature, variable and their receipt, in this case, requires adherence to the full BIC Exemption by the solicitor.