THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 49 No. 13 July 20, 2016

THE DEPARTMENT OF LABOR'S NEW CONFLICT-OF-INTEREST REGULATIONS

In its new regulations, the Department of Labor has replaced the five-part test for fiduciary status with the threshold question — whether the adviser makes a "recommendation." The authors explore the new regulations including the important Best Interest Contract Exemption. They find that the regulations will greatly expand the number of market participants that are deemed ERISA fiduciaries, and explore the effects this may have on the accumulation and drawdown phases for retirement accounts.

By Robert Sichel, Kristina Zanotti, and Ruth Delaney *

With great effort, in April the Department of Labor finalized regulations that will result in sweeping changes to the U.S. retirement landscape.[1] The regulations define who is acting as a "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA") as a result of providing investment advice to retirement plans and individual retirement accounts ("IRAs"), and will have the effect of greatly expanding the number of market participants that are deemed ERISA fiduciaries. The regulations also include new prohibited transaction exemptions and amend (and, in some cases, partially revoke) several existing prohibited

[1] The regulations were several years in the making. The Department of Labor initially proposed the regulations in October 2010. The proposal attracted significant bipartisan criticism for its potential impact on individual investors, particularly those with modest investments and minorities. In light of a heated public debate, the Department of Labor withdrew the proposed regulation. In April 2015, the Department of Labor re-proposed the regulation. Following the re-proposal, the Department of Labor held hearings and received thousands of comment letters from stakeholders. The

footnote continued from previous column…

Department of Labor issued the final regulations on April 6, 2016. 81 Fed. Reg. 20946 (Apr. 8, 2016).

* *ROBERT SICHEL is a partner in the New York office of K&L Gates LLP and is a member of the firm's Investment Management Practice Group. He leads the firm's ERISA Fiduciary Practice Group. KRISTINA ZANOTTI is a partner in the Washington D.C. office of K&L Gates LLP and is a member of the firm's Investment Management and ERISA Fiduciary Practice Groups. RUTH DELANEY is an associate in the Los Angeles office of K&L Gates LLP and is a member of the firm's Investment Management and ERISA Fiduciary Practice Groups. Their e-mail addresses are robert.sichel@klgates.com, kristina.zanotti@klgates.com, and ruth.delaney@klgates.com.*

IN THIS ISSUE

● **THE DEPARTMENT OF LABOR'S NEW CONFLICT-OF-INTEREST REGULATIONS**

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. Copyright © 2016 by RSCR Publications LLC. ISSN: 0884-2426. All rights reserved. Reproduction in whole or in part prohibited except by permission. For permission, contact Copyright Clearance Center at www.copyright.com. *The Review of Securities & Commodities Regulation* does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions, or for the results obtained from the use of such information.

transaction exemptions.[2] The centerpiece of the new and revised prohibited transaction exemptions is a principles-based exemption called the Best Interest Contract Exemption.

FIDUCIARY STATUS

When providing services to retirement plans and IRAs, if one is acting as an ERISA fiduciary, there are many complexities to navigate. ERISA fiduciaries are subject to duties of prudence and loyalty, and strict prohibited transaction restrictions. A violation of these duties can have severe consequences.

A firm can become an ERISA fiduciary "to the extent" it (a) exercises discretionary authority or discretionary control with respect to management of a plan or its assets, or has discretionary authority over the administration of a plan (*discretionary fiduciaries*) or (b) renders nondiscretionary investment advice to a plan for a fee or other compensation, or has any authority or responsibility to do so (*investment advice fiduciaries*).[3] In 1975, the Department of Labor issued regulations that defined the scope of the investment advice fiduciary definition.[4] Under those regulations, for advice to constitute fiduciary investment advice, each of the following five elements had to be satisfied:

1. render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property;

2. on a regular basis;

3. pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary that;

4. the advice will serve as a primary basis for investment decisions with respect to plan assets; and that

5. the advice will be individualized based on the particular needs of the plan.

As the retirement space changed over the years, the Department of Labor expressed concern that some service providers that should be ERISA fiduciaries constructed their business models to eliminate one or more of the five elements. This allowed these service providers to avoid fiduciary status and the associated responsibilities. For example, some advisers asked their clients to sign an agreement that included an acknowledgement that there is no "mutual agreement" that the advice serves as "a primary basis for investment decisions" — no matter how much the client actually relied upon the advice. In addition, because advice had to be "on a regular basis," one-time advice (such as often is the case for rollovers from plans to IRAs) would not meet the definition. According to the Department of Labor, the original regulation erected "a multi-part series of technical impediments to fiduciary responsibility."[5]

To address these concerns, in the new regulations, the Department of Labor replaced the five-part test, notably eliminating the regular basis, primary basis, and mutuality requirements, and specifically expanded the types of advice that trigger fiduciary status. Under the new regulations, the threshold question is whether an advice provider makes a "recommendation."[6] The

[2] A prohibited transaction exemption is authority in ERISA or issued by the Department of Labor ("Administrative Exemptions") that allows plans to engage in transactions and hire service providers without running afoul of ERISA's and the Internal Revenue Code's prohibited transaction rules. The new regulations include two new Administrative Exemptions: the Best Interest Contract Exemption and an exemption for principal transactions.

[3] ERISA § 3(21). Internal Revenue Code § 4975(e)(3) defines "fiduciary" for purposes of the prohibited transaction excise tax rules in the same fashion.

[4] Department of Labor Regulation § 2510.3-21(c).

[5] 81 Fed. Reg. 20946 at 20955 (Apr. 8, 2016).

[6] "Recommendation" means "a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action." The Department of Labor further attempts to clarify that "[t]he determination of whether a 'recommendation' has been made is an objective rather than subjective inquiry. In addition, the more

definition of recommendation broadly includes statements that would reasonably be viewed as "suggestions" to take (or refrain from taking) a particular course of action. The regulations also contain a number of "examples" of communications that generally are not recommendations and therefore are not fiduciary in nature.[7] These examples effectively may serve as safe harbors from fiduciary status. Overall, the regulations will have the effect of greatly expanding the number of market participants that are deemed ERISA fiduciaries.

BEST INTEREST CONTRACT EXEMPTION

The Best Interest Contract Exemption is a new prohibited transaction exemption that may play an important role in shaping advisory services in the retail retirement space.[8] The Best Interest Contract Exemption allows registered investment advisers and broker-dealers that are ERISA fiduciaries on account of providing investment advice to retirement clients to be compensated in ways that would otherwise constitute a prohibited transaction.

The exemption is intended to help firms that, as new fiduciaries, wish to continue their existing compensation structures, which would be impermissible without the exemption. These structures may include the receipt of:

- 12b-1 fees;
- brokerage commissions;
- sales loads; and
- revenue-sharing payments.

In crafting the Best Interest Contract Exemption, the Department of Labor indicated that it sought to balance protecting retirement accounts from conflicts of interest without being too disruptive of existing business models. To do this, the Department of Labor used a principles-based approach to exempt a variety of transactions and compensation models from the prohibited transaction restrictions as long as certain conduct standards are followed. This is a departure from the Department of Labor's normal approach of granting highly prescriptive transaction-specific exemptions. A principles-based approach should be a more flexible mechanism for firms to determine the best way to serve clients, rather than having the Department of Labor dictate precisely what service providers must do. However, the subjectivity inherent in that approach may make it more difficult for firms to be comfortable that they are complying with all of the Best Interest Contract Exemption's requirements, particularly since the burden of demonstrating compliance falls upon the party claiming the exemption.[9] The requirements of the Best Interest Contract Exemption include:

- *Written Contract* – A written contract is required for IRAs only. The contract must include an acknowledgment regarding fiduciary status. Certain types of contractual provisions are impermissible (e.g., exculpatory provisions disclaiming liability for a violation of the contract's terms and agreements to arbitrate claims in distant venues).
- *Impartial Conduct Standards* – Advice must be in the client's best interest and compensation to individual advisers must be reasonable and structured to avoid incentives that would cause advisers to make recommendations not in a client's

footnote continued from previous page…

individually tailored the communication is to a specific advice recipient or recipients about, for example, a security, investment property, or investment strategy, the more likely the communication will be viewed as a recommendation. Providing a selective list of securities to a particular advice recipient as appropriate for that investor would be a recommendation as to the advisability of acquiring securities even if no recommendation is made with respect to any one security. Furthermore, a series of actions, directly or indirectly (e.g., through or together with any affiliate), that may not constitute a recommendation when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program." Department of Labor Regulation § 2510.3-21(b)(1).

[7] The examples include investment education and general communications, such as newsletters and research, or news reports prepared for general distribution.

[8] Other options to avoid prohibited transactions include (i) the independent financial expert approach described in Department of Labor Advisory Opinion 2001-09A, known as the "SunAmerica Letter"; (ii) the complete offset method to ensure the fiduciary and its affiliate do not receive any additional fees as a result of the advice described in Department of Labor Advisory Opinion 97-15A, known as the "Frost Letter"; and (iii) the statutory exemption that includes a fee-leveling approach and a computer model approach for investment advice to plan participants in ERISA § 408(b)(14) and 408(g), as implemented by Department of Labor Regulation § 2550.408g-1 & 2.

[9] 81 Fed. Reg. at 21033.

best interest. Financial institutions are required to adopt policies and procedures that are reasonably designed to ensure that advisers adhere to the impartial conduct standards.

- *Disclosures* – Financial institutions must disclose information about material conflicts of interest and costs.
- *Rights of Action* – After January 1, 2018, IRA owners will have a private, contract-based, right of action to enforce the standard of care under this exemption. While contracts may require arbitration for individual claims, contracts cannot restrict the right to bring a class action. Contracts may limit damages to "make whole" amounts, however.

The Best Interest Contract Exemption has streamlined conditions for financial institutions that are "level fee fiduciaries." A financial institution is a level fee fiduciary if the only fees or compensation received by the financial institution, adviser, and any affiliate in connection with advisory or investment management services is a "level fee" that is disclosed in advance to the client. A "level fee" is a fee or compensation that is provided on the basis of a fixed percentage of the value of the assets or a set fee that does not vary with the particular investment recommended. The Department of Labor included this concept in the exemption because it believes less protection is necessary in situations where the prohibited transaction is relatively discrete and the provision of advice thereafter generally does not involve a prohibited transaction.

The relief for level fee fiduciaries is helpful for firms that recommend a client switch from a commission-based account to a fee-based account where the client is charged a fixed percentage of assets under management on an ongoing basis. The relief is also helpful for firms that recommend a rollover from a plan into a fee-based IRA. In both cases, the level fee fiduciary must document the reasons why the level fee arrangement was considered to be in the best interest of the client.

The Best Interest Contract Exemption specifically states that differential compensation is permissible, subject to policies and procedures designed to prevent advisers from acting on conflicts of interest to the detriment of the client. Compensation structures should be designed to avoid a misalignment of the interests of advisers and their retirement clients. For example, different compensation based on "neutral factors," such as the difference in time and analysis necessary to provide prudent advice with respect to different types of investments, is permissible. According to the Department of Labor, "The [Best Interest Contract Exemption's] goal is not to wring out every potential conflict, no matter how slight, but rather to ensure that Financial Institutions and Advisers put Retirement Investors interests first, take care to minimize incentives to act contrary to investors' interests, and carefully police those conflicts that remain."[10]

Under the new regulations, providing advice to take a distribution or to roll over assets from a plan or IRA for a fee is fiduciary advice.[11] Since advisers stand to earn compensation as a result of a rollover that they would not be able to earn if the money remained invested in an ERISA plan (e.g., fees in connection with the investment of the assets), a prohibited transaction exemption is needed to engage in this activity. The Best Interest Contract Exemption is a prohibited transaction exemption advisers will consider. "Level fee fiduciaries" may find their streamlined requirements make the Best Interest Contract Exemption an appealing approach.[12]

Recommendations may be restricted to proprietary products (or products that generate third-party payments). The Best Interest Contract Exemption includes a specific test for satisfying the best interest standard in this situation. The test includes the following requirements: (i) prominent disclosure of the limited universe of investments and the inclusion of proprietary products; (ii) documentation of a reasonable determination that the limitations and conflicts of interest will not cause advisers to recommend imprudent investments; and (iii) incentives such as bonuses, contests, special awards, and differential compensation are not used to cause an adviser to make imprudent recommendations. While these requirements are extensive, the Department of Labor has made it clear that such platforms are permissible.

---

[10] 81 Fed. Reg. at 21037.

[11] Advisers, however, can educate plan participants on the various distribution options that are available without becoming an ERISA fiduciary. Department of Labor Regulation §2510.3-21(b)(2)(iv).

[12] It should be noted, however, that advisers including investment recommendations as part of the marketing of their services may well be considered fiduciary advisers under the new regulations. In such cases, advisers seeking to be hired by new clients, and thereby obtaining asset-based level fees that would result from being hired, would need to rely on an exemption — probably the Best Interest Contract Exemption—in order to do so.

While market participants are still analyzing the requirements of the Best Interest Contract Exemption in order to understand the costs of compliance (in terms of time and money), the exemption may play an important role in shaping the retail retirement landscape in the years to come.

RETIREMENT CRISIS

The retirement landscape has changed dramatically since President Gerald Ford signed ERISA into law in 1974. At that time, 401(k) plans did not exist and IRAs were new. Defined benefit pension plans, where employers are primarily responsible for investment decisions and funding benefits, dominated the retirement landscape. Today, 401(k) plans and other individually directed retirement accounts, such as IRAs, are replacing defined benefit plans as the main retirement savings vehicles for private-sector workers.[13]

Millions of workers in the United States do not have access to a workplace retirement plan or do not participate in a plan. Many of the workers that have access struggle to handle their responsibility to prudently invest their retirement assets and then manage the drawdown of the assets in retirement so as to not outlive them. A high level of financial literacy is needed to understand the confluence of matters that are relevant for financial decision-making and retirement-planning, including expectations regarding survival probabilities, discount rates, investment returns, earnings, Social Security benefits, tax consequences, and inflation. 401(k) plan participants and IRA owners face daunting challenges in managing their retirement assets without external advice.

Baby boomers, the youngest of whom are now in their 50s, are retiring in waves and half of them have no retirement savings.[14] The younger generation that is entering the workforce may have even greater difficulties. It is estimated that in five years, Millennials, generally defined as those born in the early 1980s to the early 2000s, will comprise half the workforce. These workers generally do not have access to traditional defined benefit pension plans and switch jobs frequently, which leads to leakage from retirement accounts. The greatest retirement hardship is expected for women as, on average, women outlive men by three to four years, have fewer years of work, and lower earnings.[15]

REGULATION'S IMPACT ON RETIREMENT OUTCOMES

The Department of Labor expects compliance with the regulations to deliver large gains for retirement investors.[16] Achieving this result would help avert a retirement crisis. Below, we consider whether the regulations will help workers do a better job of investing their retirement assets during the accumulation phase and drawing assets down during retirement years so as to not outlive them.

Accumulation Phase

The amount of retirement assets accumulated during working years in individual account plans is impacted by a number of factors, including service provider fees (e.g., investment management fees and recordkeeping fees). Even a small fee deducted today from a worker's retirement assets can represent a large amount of money years later had the money remained invested. For example, a one-percentage-point difference in fees can significantly reduce the amount of money saved for retirement. Assume an employee 45 years old with 20 years until retirement changes employers and leaves $20,000 in a 401(k) account until retirement. If the average annual net return is 6.5 percent — a 7 percent investment return less a 0.5 percent fee — the $20,000 will grow to about $70,500 at retirement. If the fees are instead 1.5 percent, the average net return is reduced to 5.5 percent and the $20,000 will grow only to about $58,400. The additional 1 percent annual fee would reduce the account balance by about 17 percent.[17]

The Best Interest Contract Exemption includes a requirement that the adviser adhere to impartial conduct standards that include the requirement to provide advice that is in the client's best interest and to charge no more than reasonable compensation.[18] Advisers subject to

[13] In recent years, a large number of sponsors of defined benefit plans have closed plans to new participants, frozen participant benefits, shrunk plans through lump-sum payments, or simply terminated plans.

[14] Government Accountability Office Report 15-419, "*Most Households Approaching Retirement Have Low Savings*" (May 2015).

[15] Society of Actuaries, "*Impact of Retirement Risk on Women*" (2014).

[16] 81 Fed. Reg. at 20951.

[17] Government Accountability Office Report 07-21, "*Private Pensions – Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*" (Nov. 2006).

[18] 81 Fed. Reg. at 21077.

these legal standards may favor less expensive investment options and service providers thereby increasing the downward pressure on fees in the retirement space, which may exacerbate the current trend toward passive investment options.

The impact on retirement outcomes remains to be seen. Downward fee pressure on investment managers and other service providers such as recordkeepers has the potential to improve retirement outcomes. However, the pressure to offer lower cost investment options could limit the range of investment options available to retirement savers, such as actively managed options that, notwithstanding their generally higher costs, can play an important role in an investment portfolio and can be a prudent investment option.

Drawdown Phase

Effectively managing the drawdown phase of retirement is essential for the long-term well-being of the millions of workers whose retirement security will depend on a combination of Social Security and the assets accumulated in their 401(k) plans. It is challenging, however, for most workers to manage the drawdown phase.[19] A worker can shift risks, such as longevity,[20] investment, sequence of return,[21] and cognitive risk[22] to an insurance company by purchasing an annuity that guarantees lifetime income. Annuities are financial instruments that pay a stream of benefits over time. A simple life annuity pays fixed benefits until death.

The Department of Labor and the Department of the Treasury have taken steps to promote lifetime income. In February 2010, these regulators published a request for information titled, "Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans." As stated in the summary to the request for information the regulators are reviewing the rules under ERISA and the plan qualification rules under the Internal Revenue Code to determine whether and, if so, how they could or should enhance, by regulation or otherwise, the retirement security of participants in employer-sponsored retirement plans by facilitating access to, and use of, lifetime income products or other arrangements designed to provide a lifetime stream of income after retirement.[23]

Despite the regulatory support, annuities are not commonly purchased in 401(k) plans. The reasons for this include the following:

- most plan fiduciaries have not embraced having fiduciary responsibility for picking an annuity provider and

- annuities purchased through 401(k) plans are priced on a unisex basis, not recognizing that at retirement age women on average outlive men. Accordingly, it may be beneficial for men to purchase the annuity outside the plan to get single-sex mortality table pricing.

The new regulations may have the effect of keeping more assets in 401(k) plans. There are several reasons for this. First, the new regulations make an adviser's discussion with a plan participant about whether to roll over assets to an IRA an ERISA fiduciary discussion. While the new regulations include an exception to the fiduciary definition for the provision of "education," this

[19] Jeffrey R. Brown, Arie Kapteyn, Erzo F.P. Luttmer & Olivia Mitchell, "*Cognitive Constraints on Valuing Annuities*," Pension Research Council, The Wharton School, University of Pennsylvania (Mar. 2015).

[20] Longevity risk is the risk of outliving one's assets.

[21] Sequence of return risk is risk of having poor investment performance at the wrong time (e.g., right before retirement).

[22] Cognitive risk is the risk associated with loss of decision-making capacity. Cognitive risk should not be overlooked when evaluating the overall risk profile. A recent study on long-term care insurance found that more than one-third of individuals with long-term care insurance at age 65 let their policies lapse before death thereby forfeiting all benefits. The lapse often occurs because of deterioration in cognitive ability. Wenliang Hou, Wei Sun & Anthony Webb, "*Why do People Lapse Their Long-Term Care Insurance?*" Center for Retirement Research at Boston College (October 2015).

[23] In recent years, these regulators have taken steps to promote lifetime income, including: (i) in 2013, the Department of Labor published an advanced notice of proposed rulemaking on lifetime income illustrations in defined contribution benefit statements; (ii) in 2014, the Department of Treasury issued final regulations regarding longevity annuities; (iii) in 2014, the Department of Labor issued an information letter on whether a series of target date funds could serve as the qualified default investment alternative in light of the funds' investment in unallocated deferred annuity contracts; (iv) in 2014, the Department of Treasury issued Notice 2014-66 on lifetime income provided through target date funds in 401(k) plans; and (v) in 2015, the Department of Labor issued Field Assistance Bulletin 2015-02 on selecting and monitoring under the annuity selection safe harbor for defined contribution plans.

exception is extremely narrow in the IRA context. For example, if information on a specific investment option is provided, the information is deemed to be fiduciary in nature. Some providers may decide they do not want to be ERISA fiduciaries and may stop providing information to clients about rollovers, particularly those with smaller balances. Other service providers may try to structure their services to fit within the education exception. In either case, there is a risk that workers will be ill-informed on investment matters at a critical time, as many believe the decision on whether to roll assets over to an IRA is the biggest investment decision one makes in a lifetime. Because of inertia, these workers may simply leave their retirement assets in a retirement plan rather than take affirmative steps to rollover to an IRA.

The second reason why the new regulations may have the effect of keeping more assets in retirement plans is that service providers that are subject to ERISA fiduciary responsibility and advise clients in connection with rollovers must act in the best interest of the client. Inevitably, there will be situations where it will be in the best interest of the client to leave his or her assets in the retirement plan. For example, the plan may have lower institutionally priced investment options than the retail options generally available in IRAs.

In the near term, it is likely that there will be disruption in the IRA rollover space as market participants such as recordkeepers (and their call centers) and advisers digest the new rules. If the new regulations cause more assets to stay in 401(k) plans, purchasing annuities may become less frequent, notwithstanding their potential benefits. As a result, retirement outcomes may be adversely impacted as workers will continue to be responsible for managing their retirement assets during their retirement years.

The marketplace is in the early stages of interpreting the new rules. The market could adapt further to promote products and strategies intended to decrease the likelihood of outliving one's savings. For example, insurance companies may develop products that plan fiduciaries are more comfortable making available in their plans. Further, investment managers may continue to develop asset allocation, withdrawal, and other strategies and approaches designed for retirement assets in the drawdown phase. Ultimately, efforts to improve retirement outcomes will depend on a combination of factors, including favorable regulatory developments, innovative products and solutions from the industry, a healthy economic environment, greater workplace education, and planning and savings initiatives directed at retirement savers. ■