# In Plain English

A publication of THE SECURITIES LAW GROUP | James E. Grand | September 2016

*The following blog is the first of a 3-part series on this topic. Parts Two and Three should be read in conjunction with this overview.*

## NEW FIDUCIARY RULE—WHAT INVESTMENT ADVISERS *MUST* KNOW

**FACT ONE**: Investment advisers generally earn a substantial portion of their fee income managing funds for retirement plan investors.

**FACT TWO**: At present, many advisers do everything possible to avoid being deemed an "ERISA fiduciary" under the Employee Retirement Income Security Act.

**FACT THREE**: Under the new Fiduciary Rule, investment advisers will be deemed ERISA fiduciaries, profoundly changing the way services will be delivered to retirement plan investors; (e.g., IRA owners and 401(k) plan participants).

It is important to understand the impact of the new rules because advisers, as ERISA fiduciaries, will become subject to many new duties and responsibilities and strict prohibitions on common types of transactions and compensation. Basically, the new rules apply to any "private sector employee benefit plan." In plain English—this means just about all 401(k) plans and individual retirement accounts ("IRAs").

## THE "FIDUCIARY RULE" — Who is now an ERISA Fiduciary?

At the outset, you should know that the new Fiduciary Rule is being phased in over 20 months with full compliance required by the end of next year. However, **substantial changes will be required in the meantime**.

Under the Rule, advice to a plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner for a fee or other compensation, direct or indirect, is now "fiduciary investment advice" if the following conditions in **both** columns (1) and (2) are met:

| **(1)**<br><br>**Advice in one of the following categories**: | **(2)**<br><br>**An advice provider that either:** |
|---|---|
| Investment management recommendations | (i)<br>Renders the advice pursuant to an |

| | |
|---|---|
| Recommendations regarding acquiring, holding, disposing of, or exchanging securities or other investment property, including recommendations about how proceeds should be invested after a rollover | agreement, arrangement or understanding that the advice is based on the particular investment needs of the advice recipient, or (ii)<br>directs advice to a specific advice recipient regarding the advisability of a particular investment or management decision regarding plan assets<br><br>**OR** |
| Investment recommendations<br><br>Recommendations regarding the management of investment property, the selection of persons to provide investment advice or management services, the selection of investment account arrangements and recommendations regarding rollovers, transfers or distributions | Represents or acknowledges that it is acting as a fiduciary under ERISA or the Internal Revenue Code |

Under the Fiduciary Rule, the question is whether you are making a "recommendation." The definition of recommendation is complicated but, in sum, it comes down to whether you are giving advice that would reasonably be viewed as a "suggestion" to take (or refrain from taking) a particular course of action. In the Rule's preamble, the DOL likened it to a "call to action."

## A WORD ABOUT "HIRE ME" PRESENTATIONS

The new Rule does NOT cover general presentations about the adviser's capabilities and services. You can still have a "hire me" discussion with a prospective client, extolling on the quality of your services without triggering fiduciary status. **Be careful, though!** The line is blurred. This exception does NOT apply to any investment recommendations you may make in connection with your "hire me" presentation. For example, if you recommend that the recipient of the advice rollover into your programs or a particular security, under the new Rule that advice is almost certainly fiduciary investment advice notwithstanding its context.

## THE "BIC" EXEMPTION

For advisers, perhaps the centerpiece of the new Rule is the new Best Interest Contract Exemption—the so-called "BIC Exemption" (or just "BICE"). In brief, it allows advisers who are willing to enter into a written contract meeting certain strict requirements (discussed below) to continue being compensated for "conflicted advice." In other words, if you are willing to disclose to

your retirement account client in writing that you will be receiving compensation that would otherwise be prohibited, the BICE will allow you to continue being compensated by that client in ways that would otherwise constitute a prohibited transaction under the new Rule. **It bears restating—the intent of the BIC Exemption is to allow advisers to continue their existing compensation structures even though such compensation would be impermissible under the new Rule**.

As you might imagine, the BIC Exemption is not without its burdens. Its requirements include:

- The contract must be in writing and it must contain a clear acknowledgement of the adviser's fiduciary status. This will require a clear description of best-interest standard of care and a description of the adviser's material conflicts of interest and any fees and compensation that the adviser expects to receive.

- The contract must inform the retirement investor of his or her right to obtain copies of the adviser's written policies and procedures and specific disclosures of costs, fees and compensation associated with the recommended transaction.

- The adviser must provide a link to its website and inform the retirement investor that the website includes model contract disclosures and copies of the adviser's policies and procedures to ensure that its advisers are meeting the best-interest standard of care.

- The contract must state whether the adviser offers proprietary products or receives third-party payments.

- The contract must provide contact information for a representative of the of the adviser with responsibility for implementing the new Rule and describe whether or not the adviser will monitor the recommended investments. (Ongoing monitoring of recommended investments is not required but may be agreed to by the parties.)

Perhaps the most onerous thing about the BICE is the required contract creates a new private right of action for IRA owners to enforce the standard of care under this exemption—in other words, a new and somewhat expedited avenue through which you may be sued by IRA owners. This includes the right to bring a class action suit against you on behalf of all your retirement plan investor/clients.

## A WORD ABOUT "LEVEL-FEES"

The BIC Exemption has streamlined conditions for advisers that are so-called "level-fee fiduciaries." An adviser is a level-fee fiduciary if its only fees or compensation is a "level fee" that is disclosed in advance to the investor—i.e., 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 investment recommended. This will benefit fee-only advisers. Note, however, that the exemption still requires a written contract containing an acknowledgement of your fiduciary status and the reasons why you consider the level fee arrangement to be in the client's best interest.

## WHAT THIS MEANS FOR YOUR ADVISORY BUSINESS

The new Fiduciary Rule applies equally to both advisers and brokers. However, advisers are likely to be winners here. To some extent advisers already have experience with the old fiduciary rules on account of having discretion over "plan assets," so they are further along the learning curve than brokers. Also, advisers are more likely to be able to take advantage of the streamlined "level-fee fiduciary" scheme. The new Fiduciary Rule presents brokers with especially significant challenges. For example, brokers will have to carefully consider whether they are willing to upset the compensation structure they have historically used to pay their registered representatives. If not, to the extent brokers wish to continue advising retail retirement investors (e.g., IRA owners or 401(k) plan participants), they likely are going to have to get comfortable with reliance on the BIC Exemption.

Advisers should be making strategic decisions ***now*** on how to best position your business and ensure compliance with the new Fiduciary Rule. Among other things, this means you should be thinking about how you are going to manage the the tasks and responsibilities set forth in our companion piece: **COMPLIANCE WITH THE "BEST INTEREST CONTRACT EXEMPTION" UNDER THE NEW FIDUCIARY DUTY RULE — "TO DO" LIST.**

## CONCLUSION

The voluminous new Fiduciary Rule will fundamentally change the way advisers deliver investment recommendations to retirement plan participants and IRA holders. To be certain, it presents fundamental challenges for advisers, brokers and insurance agents alike—although far more so in the case of brokers and agents. This presents significant opportunities for those advisers who are smart enough to spot them.

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## COMPLIANCE WITH THE "BEST INTEREST CONTRACT EXEMPTION" UNDER THE NEW FIDUCIARY DUTY RULE — "TO DO" LIST

This "TO DO" list is for investment advisers that intend to start or continue providing fiduciary investment advice to retirement plan investors in reliance on the new Best Interest Contract Exemption ("BIC Exemption" or just "BICE").

**FIRST: Determine whether can properly rely on the BIC Exemption**

- Is the "advice" being given within the scope of the BIC Exemption? The exemption generally is not available for advice by an employer, named fiduciary, or plan administrator to their own plan.

- Who is the recipient of the advice? The BIC Exemption may only be used for advice to IRA owners, plan participants and beneficiaries, and "retail" fiduciaries (generally plan or Individual Retirement Account ("IRA") fiduciaries that hold, manage, or control less than $50 million in assets).

**SECOND: Determine whether you are eligible to use the streamlined provisions as a "level fee" fiduciary**

- Document in writing the reasons that you believe the particular level fee arrangement is in the client's best interest.

**THIRD: Determine whether particular investment programs should be modified**

- Identify all payments from third parties. Are they reasonable in relation to total services they provide to the retirement plan investor?
- Analyze the structure of particular investment programs. Do they conflict with the adviser's duty to provide advice that is in the client's best interest?
- Draft a model client notice describing any such conflicts.
- Review compensation and incentives to individual advisers, such as quotas, employment agreements, awards, performance bonuses, differential compensation or similar incentives. Is such compensation intended, or reasonably likely, to encourage giving advice that runs counter to the best interest of the client?

**FOURTH: Produce or amend written policies and procedures**

- Develop procedures for determining what is in a client's best interest.
- Develop procedures for documenting the basis for "recommendations" to retirement plan investors.
- Determine whether your current policies and procedures are sufficient to prevent conflicts from causing violations of the new "best interest standard."
- Notify the Department of Labor of the intention to rely on the BIC Exemption.

**FIFTH: Produce a written contract in compliance with the BICE**

- Are existing agreements "grandfathered?"
- Amend standard investment advisory agreements to include required acknowledgements and disclosures. Have you removed all impermissible contractual provisions?

**FINALLY: Post the required disclosures to your website**

- Upload model contract disclosures
- Upload copies of your written policies and procedures relating to the "best interest standard" and handling of retirement plan investors' accounts
- Post contact information for the person with responsibility for implementing the new Rule.

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## DRAFTING BICE CONTRACTS

Under the new Fiduciary Rule, when relying on the Best Interest Contract Exemption ("BIC Exemption" or "BICE"), a written contract is required. The contract may be a separate agreement or its required terms may be incorporated into the adviser's standard investment management agreement. Either way, the contract must meet various explicit requirements contained in the new Rule.

### The Parties; Execution

The correct parties to the contract are the IRA owner and the registered investment adviser (the "Firm") (not the individual adviser). The IRA owner must sign the contract manually (electronic signatures are acceptable). Until Jan. 1, 2018, negative assent is permitted for *existing* clients—in other words the contract requirements may be satisfied by sending the existing IRA customer a written notice including certain contractual undertakings and requirements. However, negative assent is not permitted for *new* clients. The contract must be executed prior to or at the same time the recommended transaction is executed

### Conduct Standard; Fiduciary Acknowledgement

**Impartial Conduct Standards.** The contract must state that the Firm and its advisers will provide advice that is in the best interest of the retirement investor (discussed below) at the time of the recommendation; (2) they will not cause the adviser, affiliates or related entities to receive compensation for their services that would exceed reasonable compensation within the meaning of ERISA; and (3) statements about the recommended transaction, fees and compensation, material conflicts of interest, and any other matters related to the retirement investor's investment decisions will not be misleading at the time they are made.

**Fiduciary Acknowledgment.** The contract must acknowledge in writing that the Firm and its advisers act as fiduciaries with respect to the investment advice subject to the contract.

### Contract Terms

**Warranties.** The contract must warrant that (1) the Firm has adopted and will comply with written policies and procedures reasonably and prudently designed to ensure that its advisers adhere to

the impartial conduct standards; (2) that in formulating the policies and procedures, the Firm identified and documented any material conflicts of interest and adopted measures to prevent the material conflicts of interest from causing violations of the impartial conduct standards, with a designated person responsible for addressing and monitoring these issues; and (3) that the Firm's policies and procedures require that neither the Firm nor (to the best of its knowledge) its affiliates use or rely on quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that are intended or would reasonably be expected to cause its advisers to make recommendations not in the best interest of the retirement investor.

**Exculpatory Provisions.** The contract cannot include any provisions disclaiming or limiting liability of the Firm or its advisers for violations of the contract's terms or of the fiduciary rules under ERISA.

**Waivers.** The contract may include a waiver of the investor's right to obtain punitive damages under contract law or rescission of recommended transactions based on a violation of the contract if such waivers are permitted under applicable state or federal law.

**Pre-dispute Arbitration.** The contract may require pre-dispute binding arbitration of disputes with the Firm or its advisers, provided that the chosen venue is not distant and does not unreasonably limit the ability of the investor to assert claims against the Firm or its advisers. Further, the investor's right to bring a class action or other representative action in court must be preserved.

## IN PRACTICE

If a standalone BICE agreement is favored, care should be taken to ensure that the terms of the standalone agreement conform to the provisions of the Firm's other, standard advisory agreements and disclosures. Special care should be taken when drafting exculpatory and pre-dispute resolution provisions in the BICE agreement. Also, advisers may, and should, employ conventional terms that are designed to provide protections to the Firm, where appropriate; e.g., provisions covering attorneys' fees, waivers of jury trials, time limits on claims, punitive damages or costs, etc.

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