AIMCOR GROUP

The DOL Conflicts of Interest Ruling

Best Interest Contract Exemption (BICE)

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DEPARTMENT OF LABOR FIDUCIARY AND CONFLICT OF INTEREST REGULATIONS

> ***"The Department's conflict of interest final rule and related exemptions will protect investors by requiring all who provide retirement investment advice to plans and IRAs to abide by a "fiduciary" standard—putting their clients' best interest before their own profits."***
>
> \- U.S. Department of Labor

On April 6, 2016, the US Department of Labor (DOL) issued its final version of its new fiduciary and conflict of regulations that apply to most tax-qualified retirement plans. These new rules usher in significant changes to the regulations governing retirement plans covered under the Employee Retirement Income Security Act of 1974 (ERISA) and individual retirement accounts (IRAs), making this the first major overhaul since the passage of the ERISA over forty years ago.

For the first time since ERISA's passage, the new fiduciary rule will subject many of the investment and asset management recommendations from banks, broker dealers and other financial organizations to IRAs and other retail retirement investors to the fiduciary standards and remedies found in ERISA.

The new rules will impact a myriad of areas for financial institutions, including compensation practices, new client contracts, new "impartial conduct" policies and procedures, websites and additional disclosures to both investors and the DOL. Additionally, the rules also increase the litigation risks to financial institutions who are providing investment advice and other services to retail retirement clients.

While the implications of the new regulations will apply to a variety of investment products, this series will focus on the profound effect the DOL rule will have on the sale of annuities inside of retirement accounts and the funding of life insurance with premiums coming from required minimum distributions (RMDs) and other distributions from qualified retirement accounts to pay life insurance premiums.

Courtesy of **AimcoR Group, LLC**, we are publishing a series of papers to outline the main provisions and impacts of the new rules as they relate to financial institutions and their continuing efforts to provide annuity and life insurance solutions to clients.

A SUMMARY OF THE NEW REGULATIONS

In order to better understand the new regulations that will be in place, we should level set on the Department of Labor's role with respect to retirement plans and individual retirement accounts (IRAs) and what has changed under the new rules.

The Department of Labor (DOL) is responsible for ensuring that the retirement savings vehicles used by America's workers are secure and operated in accordance with federal pension laws and regulations. This responsibility includes setting the rules that govern conflicts of interest for both IRAs and employer-based plans and enforcing rules and regulations under the federal pension law, including the Employee Retirement Income Security Act of 1974 (ERISA).

The DOL is charged with interpreting the ERISA and Internal Revenue Code (Code) provisions relating to fiduciary status and prohibited transactions. Among other things, ERISA prescribes fiduciary standards applicable to those with responsibility for the maintenance and operation of employee benefit plans and the investment of plan assets. Also, ERISA prohibits certain transactions, called "prohibited transactions," which have been deemed to pose dangers to plans and participants. Prohibited transactions include "party in interest" transactions with, and fiduciary self-dealing with respect to ERISA-covered plans. The Code also has parallel provisions that apply similar prohibited transaction rules to transactions involving IRAs.

In April of 2016, the DOL issued new and amended regulations in an effort to better align the interests of financial advisers with those of plan participants and IRA owners. The new" Fiduciary Rule" effectively broadened the scope of entities and persons who are deemed as ERISA fiduciaries as a result of giving investment advice to an ERISA-covered retirement plan or its participants or beneficiaries and to IRAs. Also, the DOL introduced new prohibited transaction class exemptions meant to help preserve many existing compensation practices used by the financial services industry while managing conflicts of interest, and made amendments to a number of existing prohibited transaction exemptions.

The new and amended set of regulations included the following:

The Fiduciary Rule: A final regulation re-defining who is a "fiduciary" by reason of providing investment advice to a plan or an IRA.

Best Interest Contract Exemption (BIC Exemption): A new Prohibited Transaction Exemption (PTE) which allows financial institutions and advisers to retail retirement clients to receive forms of compensation that would otherwise be prohibited by ERISA and the Code, subject to compliance with a number of conditions.

Prohibited Transaction Exemption (PTE) 84-24: As amended, this PTE provides relief for certain transactions that occur when investment advice fiduciaries and other service providers receive compensation for recommendations that plans or IRAs purchase insurance and fixed rate annuity contracts.

Principal Transaction Exemption: A new PTE which allows a financial institution to purchase or sell certain assets in "principal transactions" or "riskless principal transactions" with plans, plan accounts or IRAs, and to receive a mark-up, mark-down or other similar payments as a result of the advice.

Prohibited Transaction Exemption (PTE) 75-1: As amended, this PTE permits broker-dealers that are investment advice fiduciaries to receive reasonable compensation when they extend credit to plans and IRAs solely for the purpose of avoiding a failed securities transaction.

Prohibited Transaction Exemption (PTE) 86-128: As amended, this PTE no longer allows fiduciaries to receive compensation from IRAs in connection with certain securities transactions and mutual fund transactions under PTE 86-128 and instead shifts that to the BIC Exemption.

The Fiduciary Rule, changes to existing class exemptions, and certain elements of the Best Interest Contract Exemption will be applicable to financial institutions and the financial advisers employed by them upon the DOL's implementation of the rule, no earlier than one year after the April 2016 effective date.

However, in response to implementation concerns raised by the financial services industry, the DOL has adopted a "phased" implementation approach for the Best Interest Contract Exemption and the Principal Transaction Exemption so that firms will have more time to come into full compliance. The full disclosure provisions, the policies and procedures requirements, and the contract requirement for these new exemptions go into full effect on January 1, 2018.

This report focuses on the details of the new Best Interest Contract Exemption, which will provide those providing fiduciary investment advice to retirement investors in situations where conflicts exist the ability receive compensation that would otherwise be prohibited by ERISA and the Code.

In the other reports in this series, we take a deeper dive into the Prohibited Transaction Exemption 84-24 and the Impartial Conduct Standards, as well as the Fiduciary Rule itself.

It is important to understand that the DOL ruling will have profound impact across the financial services industry and that while certain products may appear to be "exempt", any recommendations regarding retirement planning and funding can create an immediate fiduciary responsibility on any advisor with or without intent depending upon funding and recommendations. We will discuss this in greater detail in later pieces.

THE BEST INTEREST CONTRACT EXEMPTION

> ***"The Best Interest Contract Exemption permits firms to continue to rely on many current compensation and fee practices, as long as they meet specific conditions intended to ensure that financial institutions mitigate conflicts of interest and that they, and their individual advisers, provide investment advice that is in the best interests of their customers."***
>
> \- U.S. Department of Labor

As detailed in the first paper of this series (which can be accessed here), the DOL's new regulations for providing Fiduciary Investment Advice cast a much wider net in determining who is subject to being a fiduciary with respect to working with retirement accounts. At their essence, these new regulations are centered around the concept that as a fiduciary, one must provide investment advice that must be in the best interest of the client while managing and mitigating any conflicts of interest that could influence the advice provided.

Inherently, the manner in which most Advisers engage with clients comes with conflicts of interest that either must be avoided altogether or mitigated so that the conflicts present do not influence the advice provided while acting as a fiduciary. Consider the example of "self-dealing", where a fiduciary recommends that the client to invest into the fiduciary's own personal ventures— this type obvious conflict has long been banned under the rules pertaining to retirement plans and IRAs given that the conflict of interest is so great, that it is untenable and must be avoided altogether.

An additional example scenario

Adviser receives a payment from a third party related to the recommendation and sale of a product (i.e., a commission for the sale of an annuity or a 12b-1 fee). Both ERISA and IRS Code regulations related to IRAs have long considered the receipt of compensation by a fiduciary in which the compensation varies based upon the investment advice given and/or the receipt of compensation from third parties in connection with advice as prohibited compensation. While these forms of compensation are generally prohibited for fiduciaries, the DOL has the legal ability to create exemption rules, (known as "Prohibited Transaction Exemptions or PTEs"). A PTE allows fiduciaries, that provide advice to plans and IRAs, to receive certain forms of compensation that would otherwise be prohibited, provided that the conditions of the exemption are met. The concept of a PTE is not new, as these rules have been employed within ERISA and IRS Code regulations (for IRAs) for many years.

It is within this framework that the DOL has created a new Prohibited Transaction Exemption, called the Best Interest Contract Exemption (BIC Exemption or BICE as you may often hear it referred). The BIC Exemption is designed to promote the provision of investment advice that **is in the best interest of "retirement investors".** A "retirement investor" includes plan participants and beneficiaries, IRA owners, and certain plan fiduciaries, including small plan sponsors. The BIC Exemption is designed to allow investment advice fiduciaries, including RIAs, broker-dealers, and insurance companies, and their agents and representatives, to receive various forms of compensation that, in the absence of an exemption, would otherwise be prohibited under ERISA and the Code.

In a departure from the DOL's usual approach, involving highly prescriptive transaction-specific exemptions, the new BIC Exemption is a principles-based approach which accommodates a wide range of compensation practices while mitigating the impact of conflicts of interest on the quality of advice. While this may sound confusing, in basic terms is means that compensation can be paid on qualified plan investment advice if the advice is deemed in the best interest of the client and the requirements of the BIC Exemption have been satisfied. As a condition of receiving compensation that would otherwise be prohibited, individual Advisers and the Financial Institutions that employ or otherwise retain them must adhere to conditions outlined in the new exemption.

By taking a standards-based approach, the exemption permits firms to continue to rely on many common compensation and fee practices (including commissions), as long as they adhere to basic fiduciary standards aimed at ensuring that their advice is in the best interest of their customers and take certain steps to minimize the impact of conflicts of interest.

Important Note: the application of the BIC Exemption is not just limited to the ability of Advisers and their firms to receive commissions or other third-party payments.

While the ability to receive commissions and third-party payments while managing conflicts is an important component of the exemption, the DOL was very clear in its preamble that BIC Exemption has a broader application. In instances where Advisers make recommendations to retirement investors to move assets from a plan or IRA to an advisory account under the Adviser's care (where level compensation on AUM is paid to the Adviser), conflicts still exist due to the recommendation. In this scenario, the Adviser is "conflicted" in that he/she would then be paid on the account when he/she was not prior to the recommendation.

What does this mean?

In short, this means that the BIC Exemption will be required to be used even in the most basic of transactions, including the solicitation of new advisory accounts or relationships.

Even the most basic functions of an Advisor create an inherent nature of conflicts – soliciting clients to bring retirement assets under the Advisor's care – The BIC Exemption is expected to become the cornerstone of the new regulations for dealing with retirement accounts.

The remainder of this paper will outline where and under what circumstances the BIC Exemption applies, the exemption's requirements for compliance, and how the exemption will apply to accounts that were already in place prior to the new regulations. Finally, we will discuss some considerations for firms as they develop their plans to operationalize the BIC Exemption.

MAJOR PROVISIONS OF THE EXEMPTION

Covered Transactions

The final BIC Exemption exempts prohibited transactions that arise by reason of the payment of prohibited compensation in connection with the provision of "investment advice." Therefore, the final BIC Exemption applies to investment advice provided in connection with recommendations of distributions and rollovers, as well as of investment managers and investment advice providers.

In practical terms, requiring the BIC Exemption to receive compensation for recommendations of distributions and rollovers, the DOL has effectively made the BIC Exemption a requirement for even those Advisers and Financial Institutions who would receive forms of compensation that are typically associated with being free of conflicts (i.e., a flat percentage of AUM). Because the recommendation to move assets from a plan or IRA to an advisory account under the Adviser's care creates compensation that did not exist before, the DOL deems the transaction to be conflicted and the resulting compensation to be prohibited, requiring the Adviser and his firm to seek exemptive relief under the BIC Exemption.

Unlike the 2015 Proposed Rules, the final BIC Exemption is available to exempt prohibited transactions that arise by reason of the payment of otherwise prohibited compensation in connection the recommendation of **<u>any security or investment product</u>**. Also, the final BIC Exemption added the requirement for indexed annuities to be removed from Prohibited Transaction Exemption 84-24 (PTE 84-24) and placed under the BIC along with variable annuities.

Annuities that are not variable or indexed type products (called "Fixed Rate Annuities") remain covered under the newly amended PTE 84-24, which will be covered in more detail in a subsequent writing.

Important Note: because the BIC Exemption can now be used for any security or investment product, fixed rate annuities or life insurance could also be covered under the exemption, should the Financial Institution choose to do so.

The removal of a specific listing of which assets or product types were "approved" under the exemption from the proposed rules is generally seen as a welcome change, as it was viewed with much criticism. However, in the preamble to the final rule, DOL said that it "expects that Advisers and Financial Institutions providing advice will exercise special care when assets are hard to value, illiquid, complex, or particularly risky." Further, DOL stated that a Financial Institution "must give special attention" in its oversight of the policies and procedures "surrounding such investments." With respect to annuities, it is generally accepted that both variable and indexed annuity products are considered as "complex"— thus it is anticipated that the DOL will be looking closely at the policies and procedures that surround recommendations of these products during its investigations.

Covered Advice Recipients, Advice Providers & Exclusions

Reminder: the fiduciary obligation under the new DOL Regulations only apply in the case of advice provided to "Retirement Investors", who are defined as participants and beneficiaries of an ERISA plan, IRA owners, and those who are acting as fiduciaries for an IRA or ERISA plan (e.g., a plan sponsor). Thus, any advice outside the scope of retirement accounts is not subject to the new regulations.

In addition, the BIC Exemption is only available to Advisers and the "Financial Institutions" that employ or otherwise contract them— and their Affiliates and Related Entities. These entities are defined under the rule as follows:

- A **"Financial Institution"** is a registered investment adviser, bank, insurance company, or registered broker-dealer that employs an Adviser or otherwise retains the Adviser as an independent contractor, agent, or registered representative.
- An **"Adviser"** is an employee, independent contractor, agent, or registered representative of a "Financial Institution" who satisfies applicable law and licensing with respect to the receipt of the compensation.
- An **"Affiliate"** is (i) any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the Adviser or Financial Institution, (ii) any officer, director, partner, employee, or relative of the Adviser or Financial Institution; and (iii) any corporation or partnership of which the Adviser or Financial Institution is an officer, director, or partner.
- A **"Related Entity"** is any entity other than an Affiliate in which an Adviser or Financial Institution has an interest that may affect the exercise of its best judgment as a fiduciary.

Important Note: the new concept of the "Financial Institution" (which was not a part of the DOL 2015 proposed rules), has created some uncertainty for some in the independent insurance agent channel related to the future distribution of fixed indexed annuities in retirement accounts. Many of these individuals do not maintain securities licenses, are not employed by a bank, nor are they registered investment advisors (RIAs). As such, the only remaining candidate to be the "Financial Institution" for the purpose of the BIC Exemption is the insurance company.

The Financial Institution plays a critical role in the oversight of the Adviser and takes on serious liabilities for the fiduciary investment advice provided by them. The nature of the independent agent's "independence" is a significant stumbling block for insurance companies' willingness to assume the role of the Financial Institution and its associated liabilities for the independent agent.

While there are many potential outcomes that are being considered for this issue, including Insurance Marketing Organizations (IMOs) making application to the DOL to be deemed a Financial Institution, the final solution for independent agents who only maintain an insurance license remains unclear.

The BIC Exemption also points out specific circumstances under which the exemption would not cover the receipt of prohibited compensation and are therefore excluded.

These circumstances include:

- If the Adviser, Financial Institution, or Affiliate is the employer of employees covered by the ERISA Plan.
- If the Adviser or Financial Institution is a named fiduciary or plan administrator (or an affiliate) with respect to an ERISA Plan, unless the Adviser or Financial Institution was selected to provide advice by an independent fiduciary.
- If the compensation is received as a result of a principal transaction between the Financial Institution and the ERISA Plan, participant or beneficiary account, or IRA, unless the transaction is a riskless principal transaction.
- If the compensation is received by an Adviser or Financial Institution as a result of 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, unless the robo-advice provider is a Level Fee Fiduciary.
- If the Adviser has or exercises discretion with respect to the recommended transaction.

Conditions of the BIC Exemption

In general, the conditions required by the BIC Exemption to align the Financial Institution and its Advisers' interests with those of the Retirement Investor, include the following, where the Financial Institution generally must:

- Acknowledge fiduciary status with respect to investment advice to the Retirement Investor;
- Adhere to Impartial Conduct Standards, including giving prudent advice that is in the customer's best interest, avoiding making misleading statements, and receiving no more than reasonable compensation;
- Implement policies and procedures reasonably and prudently designed to prevent violations of the Impartial Conduct Standards;
- Refrain from giving or using incentives for Advisers to act contrary to the customer's best interest; and
- Fairly disclose the fees, compensation, and Material Conflicts of Interest, associated with their recommendations.

Within these general conditions, the specific requirements for compliance with the BIC Exemption vary, based on whether the Adviser is dealing with an ERISA plan investor (vs. a non-ERISA plan or IRA investor) and on what forms of compensation are received (i.e., level fees vs. other methods). In order, we will cover the generally applicable exemption and its variants for IRA or non-ERISA plan investors and ERISA plan investors, requirements for Proprietary Products and Third Party Payments, streamlined conditions available for "Level Fee Fiduciaries" and the rules for Pre-existing Transactions under the exemption.

Requirements of the Generally Applicable Exemption

A Written and Enforceable Contract. For investment advice that concerns an IRA or non-ERISA plan (meaning a plan not covered by Title I of ERISA), such advice is subject to the establishment of an **enforceable, written contract between the Financial Institution and the Retirement Investor.** ***Note: The Adviser is not a party to this contract.*** The contract, which must be entered into prior to or at the same time of the execution of a recommended transaction, may be a master contract that covers multiple recommendations. ***Note: an individual contract is not required for each individual recommendation.*** The terms of the contract may appear in a standalone document or or they may be incorporated into an investment advisory agreement, investment program agreement, account opening agreement, insurance or annuity contract or application, or other similar document. Both handwritten or electronic signatures are permitted.

The written contract must contain:

- affirmations that the Financial Institution and its Advisers are acting as Fiduciaries under ERISA, the Code, or both with respect to the advice provided,
- an affirmation that Financial Institution and its Advisers will adhere to and comply with the Impartial Conduct Standards and,
- provide warranties that the Financial Institution has:
  - adopted and will comply with written policies and procedures prudently designed to ensure that its Advisers adhere to the Impartial Conduct Standards,
  - identified and documented any Material Conflicts of Interest and adopted measures designed to prevent them from causing violations of the Impartial Conduct Standards, and that it has designated a person or persons responsible for managing those conflicts and monitoring its Advisers' adherence to the Impartial Conduct Standards.
  - policies and procedures require that neither the Financial Institution nor (to the best of its knowledge) any Affiliate or Related Entity use or rely upon 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 Advisers to make recommendations that are not in the Best Interest of the Retirement Investor.

A "Material Conflict of Interest" exists when an Adviser or Financial Institution has a financial interest that a reasonable person would conclude could affect the exercise of its best judgment as a fiduciary in rendering advice to a Retirement Investor.

Important Note: the BIC Exemption has no requirement for a written contract to be executed for recommendations about investments in Plans covered by Title I of ERISA. Because the remedial provisions of ERISA already give the plan's participants and beneficiaries the rights and remedies intended to be created under the BIC Exemption's contract requirements, (e.g., the right to bring a class action to recover damages), the DOL concluded that a separate contract was not necessary for these plans. However, even in the absence of an enforceable written contract, the financial institution and the adviser still must comply with the Impartial Conduct Standards, and provide to the ERISA client a written statement of its and its advisers' fiduciary status, adopt and comply with anti-conflict policies and procedures designed to ensure advisers adhere to Impartial Conduct Standards and provide the required disclosures related to services, fees and compensation and conflicts of interest.

The financial institution and adviser must not, in any contract, instrument or communication, disclaim or limit the liability of the adviser or financial institution if the disclaimer would be prohibited under ERISA, waive or qualify the right of the client to bring a class action or other representative action or require arbitration or mediation of individual claims in a venue that is distant or that limits the rights of the client to assert claims.

Disclosures. While not nearly as onerous as what was put forward in the proposed BIC Exemption, the disclosure obligations under the final BIC Exemption are substantial. The disclosures required for the exemption fall into three categories, which include: Contract Disclosures, Transaction Disclosures, and Web Disclosures.

Contract Disclosures. Whether in the written contract or in a separate single written disclosure, the Financial Institution must, prior to or at the same time as the execution of a recommended transaction, provide the Retirement Investor with a written disclosure that:

- states the Best Interest standard of care owed by the Adviser and Financial Institution to the Retirement Investor, informs the Retirement Investor of what services will be provided and describes how he will pay for those services,
- states whether the Financial Institution offers proprietary products or receives third party payments with respect to any recommended investment,
- describes Material Conflicts of Interest, discloses any fees or charges the Financial Institution, its Affiliates, or the Adviser impose upon the Retirement Investor or his account, and states the types of compensation that the Financial Institution, its Affiliates, and the Adviser expect to receive from third parties in connection with recommendations,
- informs the Retirement Investor that she has the right to obtain copies of the Financial Institution's written description of its policies and procedures, as well as the specific disclosure of costs, fees, and compensation regarding recommended transactions, to permit the Retirement Investor to make an informed judgment about the costs of the transaction and about the significance and severity of the Material

Conflicts of Interest, and describes how the Retirement Investor can get the information, free of charge,

- describes whether or not the Adviser and Financial Institution will monitor the Retirement Investor's investments and alert the Retirement Investor to any recommended change to those investments. If monitoring is part of the services provided, detail the frequency with which the monitoring will occur and the reasons for which the Retirement Investor will be alerted,
- includes a link to the Financial Institution's website and informs the Retirement Investor that model contract disclosures updated as necessary on a quarterly basis are maintained on the website, and the Financial Institution's written description of its policies and procedures are available free of charge on the website, and
- provides contact information for a representative of the Financial Institution that the Retirement Investor can use to contact the Financial Institution with any concerns about the advice or service they have received.

Transaction Disclosures. Prior to or at the same time as the execution of a recommended transaction, the Financial Institution must provide the Retirement Investor with a separate, point-of-sale written document that:

- states the Best Interest standard of care owed by the Adviser and Financial Institution to the Retirement Investor and describes any Material Conflicts of Interest,
- informs the Retirement Investor that she has the right to obtain copies of the Financial Institution's written description of its conflict mitigation policies, as well as specific disclosure of costs, fees, and other compensation including third party payments regarding the recommended transactions. The costs, fees, and other compensation described may be presented in the form of dollar amounts, percentages, formulas, or other reasonably calculated means, and
- includes a link to the Financial Institution's website, informs the Retirement Investor of the information available through the Web Disclosures, and that the information is available for free.

Web Disclosures. The Financial Institution must maintain a public webpage, which is freely accessible to the public (but that can require a user name and password) that is updated not less than quarterly, and provides the following information:

- a discussion of the Financial Institution's business model and the Material Conflicts of Interest associated with it,
- a schedule of typical account or contract fees and service charges,
- a model contract or other model notice of the contractual terms and certain required disclosures under the BIC Exemption,

- a written description of the Financial Institution's policies and procedures that describes key components of the policies and procedures relating to conflict-mitigation and incentive practices,
- a list of all product manufacturers and other parties with whom the Financial Institution maintains arrangements that provide third party payments to the Adviser or the Financial Institution with respect to specific investment products or classes of investments recommended, along with a description of the arrangements, including a statement on whether and how these arrangements impact Adviser compensation, and a statement on any benefits the Financial Institution provides to the product manufacturers or other parties in exchange for the third party payments (i.e., privileges of being on the "preferred list"), and
- disclosure of the Financial Institution's compensation and incentive arrangements with Advisers including, if applicable, any incentives (including both cash and non-cash compensation or other awards) to Advisers for recommending particular product manufacturers, investments, or categories of investments, or for Advisers to move to the Financial Institution from another firm or to stay at the Financial Institution, and a full and fair description of any payout or compensation grids (but not information that is specific to any individual Adviser's compensation or compensation arrangement).

Proprietary Product – a product that is managed, issued or sponsored by the Financial Institution or any of its Affiliates.

Third Party Payments - include sales charges that are not paid directly by the plan, participant or beneficiary account, or IRA; gross dealer concessions; revenue sharing payments; 12b-1 fees; distribution, solicitations or referral fees; volume-based fees; fees for seminars and educational programs; and any other compensation, consideration or financial benefit provided to the Financial Institution, or an Affiliate or Related Entity by a third party as a result of a transaction involving a plan, participant or beneficiary account, or IRA.

Additional Conditions for Proprietary Products and Third-Party Payments

Additional conditions apply if a Financial Institution limits, in whole or in part, its Adviser's investment recommendations to proprietary products or to investments that generate third party payments. In the preamble of the final BIC Exemption, the DOL clarified that Financial Institutions may limit the products their Advisers offer to Proprietary Products or those that generate Third Party Payments can still rely on the exemption while satisfying the Best Interest Standard— provided the additional conditions required are met.

In order to comply with the additional conditions, the Financial Institution must make additional disclosures to the Retirement Investor and document the limitations they place on their Advisers' investment recommendations, the Material Conflicts of Interest associated with proprietary or third party arrangements, and the services that will be provided both to Retirement Investors as well as third parties in exchange for payments.

Specifically within this topic, the BIC Exemption provides that if Financial Institutions and Advisers can comply with the general conditions of the exemption and the additional requirements outlined below, they shall be deemed to satisfy the Best Interest standard:

- Prior to or at the same time as the execution of a transaction based on the advice, the Retirement Investor is clearly and prominently informed in writing,
    - that the Financial Institution offers Proprietary Products or receives Third Party Payments with respect to the purchase, sale, exchange, or holding of recommended investments; and of the limitations placed on the universe of investments that the Adviser may recommend to the Retirement Investor, and
    - of any Material Conflicts of Interest that the Financial Institution or Adviser have with respect to the recommended transaction.
- The Adviser and Financial Institution comply with the disclosure requirements set forth in the general exemption.
- The Financial Institution must also document in writing:
    - its limitations on the universe of recommended investments;
    - any Material Conflicts of Interest associated with any contract, agreement, or arrangement providing for its receipt of Third Party Payments or associated with the sale or promotion of Proprietary Products;
    - any services it will provide to Retirement Investors in exchange for the Third Party Payments, as well as any services or consideration it will furnish to any other party, including the payor, in exchange for Third Party Payments;
    - its reasonable conclusions that the limitations on the universe of recommended investments and Material Conflicts of Interest will not cause the Financial Institution or its Advisers to receive compensation in excess of reasonable compensation for Retirement Investors, and reasonably determines, after consideration of the policies and procedures established in the general exemption, that these limitations and Material Conflicts of Interest will not cause the Financial Institution or its Advisers to recommend imprudent investments; and documents the bases for its conclusions;
- The Financial Institution adopts, monitors, implements, and adheres to policies and procedures and incentive practices that meet the terms of the general exemption, neither the Financial Institution nor (to the best of its knowledge) any Affiliate or Related Entity uses or relies upon 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 the Adviser to make imprudent investment recommendations, to subordinate the interests of the Retirement Investor to the Adviser’s own interests, or to make recommendations based on the Adviser’s considerations of factors or interests other than the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor;

- At the time of the recommendation, the amount of compensation and other consideration reasonably anticipated to be paid, directly or indirectly, to the Adviser, Financial Institution, or their Affiliates or Related Entities for their services in connection with the recommended transaction is not in excess of reasonable compensation within the meaning of ERISA or the Code.
    - It was noted by the DOL that elements of compensation include charges against the investment, such as commissions, sales loads, sales charges, redemption fees, surrender charges, exchange fees, account fees and purchase fees, as well as compensation included in operating expenses and other ongoing charges, such as wrap fees, mortality, and expense fees. However, "spreads" on annuities (the difference between the fixed return credited to the contract holder and the insurer's general account investment experience) are not included as compensation when determining reasonableness.
- The Adviser's recommendation with respect to the transaction reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor; and is not based on the financial or other interests of the Adviser or on the Adviser's consideration of any factors or interests other than the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor.

It is clear that the DOL's requirements in this area reflect its continuing concern about Financial Institutions' own conflicts of interest in limiting products available for investment recommendations. The additional conditions combined with other requirements of the exemption in general are designed to have Financial Institutions to carefully consider their business models and form a reasonable conclusion about the impact of conflicts of interest associated with these particular limitations on Advisers' advice. The exemption will be available only if the Financial Institution reasonably concludes that these limitations, in conjunction with the anti-conflict policies and procedures, will not result in advice that violates the standards set forth in the exemption.

Requirements for Level Fee Fiduciaries

Fiduciaries that will receive only a Level Fee in connection with advisory or investment management services may comply with more streamlined conditions of the BIC Exemption designed to target the conflicts of interest associated with such services. This streamlined option, known as "Level Fee Fiduciary", is available if the only fee received by the Financial Institution, the Adviser, and any Affiliate in connection with advisory or investment management services to the ERISA Plan, Other Plan, or IRA assets is a Level Fee that is disclosed in advance to the Retirement Investor. A "Level Fee" is defined as 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, rather than a commission or other transaction-based fee.

To be eligible as a "Level Fee Fiduciary", the Adviser does not have be an RIA receiving level AUM fees, but also could be a broker who receives level fees as compensation for a fee-based wrap account or annuity.

Among fiduciaries providing investment advice, it has long been accepted that level compensation which does not vary by the product being recommended (such as a flat percentage of AUM) is an effective way to mitigate many conflicts of interest. The Level Fee Fiduciary option within the BIC Exemption recognizes that the less-conflicted nature of the compensation paid under this option produces less in the way of material conflicts to manage. As such, the Level Fee Fiduciary option eliminates the need for many of the elements of the general BIC Exemption, most notably the written contract between the Financial Institution and the Retirement Investor (including the warranties and disclosures contained within) and the Transaction and Wed-based disclosures outlined in the general exemption.

While Level Fee Fiduciaries do not have to enter into a contract with Retirement Investors, they must provide a written statement of fiduciary status, adhere to standards of fiduciary conduct, comply with the Impartial Conduct Standards and prepare written documentation of the reasons for the recommendation. In addition, the "Level Fee" must be disclosed to the Retirement Investor in advance.

The DOL has stated that, by itself, the ongoing receipt of a Level Fee such as a fixed percentage of the value of a customer's assets under management, typically would not raise prohibited transaction concerns for the Adviser or Financial Institution. However, the DOL does acknowledge that there is a clear and substantial conflict of interest when an Adviser recommends that a participant roll money out of a plan into a fee-based account that will generate ongoing fees for the Adviser that he would not otherwise received, absent the advice to perform the rollover. It is due to this inherent "conflict" that all rollovers are included in the BIC Exemption.

In addition, the DOL also identified a scenario where a recommendation to switch from a low activity commission-based account to an account that charges a fixed percentage of assets under management on an ongoing basis. Again, in this example, Advisers are required to prepare written documentation of the reasons for the recommendation and why it would be in the best interest of the client.

Important Note: eligibility for the Level Fee Fiduciary exception is premised on the Adviser and the Financial Institution (including its Related Parties and Affiliates) must receive only a Level Fee, and not any other commissions or transaction-related compensation. As such, additional third-party payments, marketing allowances or 12(b)-1 fees on top of the Level Fee would effectively disqualify the arrangement from the streamlined Level Fee Fiduciary option.

Pre-existing Transactions & the BIC Exemption

As you may recall, the 2015 Proposed BIC Exemption left much be desired when it came to dealing with existing clients— effectively requiring new, signed contracts for all existing Retirement Investors. Needless to say, this was seen as a logistical nightmare and in certain cases, a possible incentive to abandon certain clients. The Department adjusted the final BIC Exemption on this point to permit amendment of existing contracts by negative consent. The negative consent procedure involves delivery of an amended contract to the Retirement Investor with clear notice that the Retirement Investor's failure to terminate the relationship within 30 days constitutes assent.

To be clear, for Retirement Investors with "existing contracts," the exemption permits assent to be evidenced either by affirmative consent (obtaining a signature— either electronic or wet— on a new contract) or by the negative consent procedure described in this section.

An existing contract is defined in the exemption as "an investment advisory agreement, investment program agreement, account opening agreement, insurance contract, annuity contract, or similar agreement or contract that was executed before the Applicability Date (April 10, 2017) and remains in effect."

If the Financial Institution elects to use the negative consent procedure, it may deliver the proposed amendment by mail or electronically, but it may not impose any new contractual obligations, restrictions, or liabilities on the Retirement Investor via the negative consent process. Any new obligations on the part of the Retirement Investor would have to be obtained through the same procedure for new contracts, where the Retirement Investor's assent must be demonstrated through a written or electronic signature.

Under the negative consent procedure, the Financial Institution delivers a proposed contract amendment along with the disclosures required of the Exemption to the Retirement Investor prior to January 1, 2018. If the Retirement Investor does not terminate the amended contract within 30 days, the amended contract becomes effective.

If for some reason the Retirement Investor does terminate the contract within that 30-day period, the exemption will provide relief for 14 days after the date on which the termination is received by the Financial Institution. In that event, the Retirement Investor's account generally should be able to fall within the provisions of Section VII of the BIC Exemption which describes the conditions required for the Adviser and the Financial Institution to continue to receive ongoing compensation for pre-existing transactions in place prior to the Applicability Date. Specifically, the exemption for a pre-existing transaction is conditioned on the following criteria:

- an agreement, arrangement or understanding that was entered into prior April 10, 2017 (the "Applicability Date") and that has not expired or come up for renewal since then;

- the purchase, exchange, holding or sale of the securities or other investment property was not otherwise a non-exempt prohibited transaction pursuant to ERISA or the Code on the date it occurred;
- the compensation is not received in connection with investments of additional amounts into the previously acquired investment vehicle
  - recommendations to exchange investments within a mutual fund family or variable annuity contract) pursuant to an exchange privilege or rebalancing program that was established before April 10, 2017, are permitted as long as it does not result in the Adviser and Financial Institution, or their Affiliates or Related Entities, receiving more compensation than they were entitled to prior to that date.
  - if a systematic investment program was in place prior to the Applicability date, then the additional compensation generated from those investments are permissible under the exemption
- The amount of the compensation paid, directly or indirectly, to the Adviser, Financial Institution, or their Affiliates or Related Entities in connection with the transaction is not in excess of reasonable compensation
- Any investment recommendations made after the Applicability Date by the Financial Institution or Adviser with respect to the securities or other investment property reflect the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, and are made without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.

Important Note: new advice (including advice related to the existing account) provided to these pre-existing accounts after the Applicability Date will require a new contract and compliance with the BIC Exemption, as applicable.

TIMING & CONSIDERATIONS

BIC Exemption Implementation Timing

In response to implementation concerns raised by the financial services industry, the DOL has adopted a "phased" implementation approach for the Best Interest Contract Exemption so that firms will have more time to come into full compliance. Parts of the new exemption's requirements will go into effect on April 10, 2017, otherwise known as "the Applicability Date". The full disclosure provisions, the policies and procedures requirements, and the contract requirement for the new BIC Exemption will go into full effect on January 1, 2018.

The BIC Exemption provides a transition period under which relief from the prohibited transaction provisions of ERISA and the Code are available for Financial Institutions and Advisers during the period between the Applicability Date and January 1, 2018 (the "Transition Period"). For the Transition Period, full relief under the exemption will be available for Financial Institutions and Advisers, however it is subject to lesser conditions than the full set of conditions required by the exemption starting in 2018.

The Transition Period is intended to give Financial Institutions and Advisers time to prepare for compliance with the full conditions of the BIC Exemption, while safeguarding the interests of Retirement Investors during that time. **During the Transition Period, the following requirements must be met:**

- Financial Institution and its Advisers are required to comply with the Impartial Conduct Standards when making recommendations to Retirement Investors.
- The Financial Institution must provide a written notice to the Retirement Investor prior to or at the same time as the execution of the recommended transaction (which may cover multiple transactions or all transactions taking place within the Transition Period) acknowledging its and its Adviser(s) fiduciary status under ERISA or the Code or both with respect to the recommended transaction.
- The Financial Institution must state in writing that it and its Advisers will comply with the Impartial Conduct Standards and disclose any Material Conflicts of Interest.
- The Financial Institution must disclose whether it recommends Proprietary Products or investments that generate Third Party Payments; and, if applicable, to the extent the Financial Institution or Adviser limits investment recommendations, in whole or part, to Proprietary Products or investments that generate Third Party Payments, the Financial Institution must notify the Retirement Investor of the limitations placed on the universe of investment recommendations.
- The Financial Institution must designate a person or persons, identified by name, title or function, responsible for addressing Material Conflicts of Interest and monitoring Advisers' adherence to the Impartial Conduct Standards.
- The Financial Institution must comply with the record keeping provision of the exemption regarding any transactions entered into during the Transition Period.

After the Transition Period, the limited conditions applicable to the Transition Period will no longer be available. After that date (starting on January 1, 2018), Financial Institutions and Advisers must satisfy all of the applicable conditions described in the BIC Exemption for the relief to be available for any prohibited transactions occurring after that date. This includes the requirement to enter into a contract with a Retirement Investor, where required.

Combined with the casting of a wider net with respect to determining who will be considered as providing fiduciary investment advice under the new Fiduciary Rule (see our recent writing on the topic here), the BIC Exemption introduces new liabilities for firms that have not previously been considered to be acting in the capacity of a fiduciary.

These new liabilities will force Financial Institutions to carefully review their approach to distribution strategy in order to craft programs to effectively serve their clients while protecting itself from financial harm and damage to its reputation.

For any fiduciary advice pertaining to ERISA plans, not much has changed. The Department of Labor will continue to enforce violations of fiduciary duties as it has in the past. Also, under ERISA today, plans covered under Title I already have the right to sue in court as well as participate in class action lawsuits allowing beneficiaries to recover any loss in value to the plan, or to obtain disgorgement of any wrongful profits or unjust enrichment. Also, firms must be aware that statutory penalties under ERISA section 502(l) can be up to 20% of the amount recovered by the DOL.

For fiduciary advice pertaining to IRAs, the Department of Labor itself cannot enforce the prohibited transaction rules directly; technically, the DOL is authorized to write the rules to define a "fiduciary" under both ERISA and the Code, but the enforcement of those rules falls to the IRS.

Given that the IRS has not been active in enforcing against fiduciary prohibited transactions in retirement accounts, the new BIC Exemption has required those providing fiduciary investment advice recommendations to IRAs to sign the Best Interest Contract. It is the presence of this new contract that creates the potential for Financial Institutions to be sued for failing to adhere to the contract as a fiduciary, ensuring that consumers have legal recourse by forcing Financial Institutions to leave the door open for the client's attorney or to participate in class action lawsuits.

In addition to damages from lawsuits, where the Financial Institution has been determined as to not met the necessary conditions of the BIC Exemption, receipt of common forms of compensation can trigger the Code's excise tax— which is generally equal to 15% of the amount involved.

The BIC Exemption requires that a Financial Institution cannot require consumers to fully surrender their rights to compensation for damages or require them to fully waive their rights to pursue action in court, including participating in class actions. However, the rules do allow the contract to require that individual disputes go to mandatory arbitration and waivers of punitive damages or rescission rights are also valid to the extent permitted under applicable laws.

Further increasing risk for Financial Institution, the requirements under the BIC Exemption (notably the Contract, Transaction, and Web disclosures) provide a proverbial “treasure map” for a class action if a Financial Institution systematically fails to implement and adhere to the fiduciary policies and procedures required by the new regulations.

In addition, the Department of Labor also retains the right to review and evaluate a Financial Institution’s policies and procedures. If the DOL determines a Financial Institution’s policies and procedures are not adequate, they can potentially declare that the Financial Institution has failed to meet the BIC Exemption requirements — causing all of its advisors and, due to not meeting the requirements of the exemption, its conflicted compensation to be in violation of DOL rules.

NEXT STEPS TO CONSIDER

Ultimately, the interpretations and clarifications of the new DOL regulations will likely continue for months. And, given the 2017 Applicability Date and the subsequent Transition Period, it may be years before we understand the full impact of the new regulations. That said, many decisions have to be made in order to be prepared the transition under the new rules, in part by April 10, 2017 and completely by January 1, 2018.

With respect to your firm's annuity business, we would like to offer a few suggestions of advice when considering your next steps with respect to the new and amended regulations from the DOL, including the BIC Exemption.

1. **Get comfortable with the full BIC Exemption**. For most firms, the simple realities of the existing annuity business that have been established under a commission based model and the current supply of fee-based annuity products available dictate that you will need to have the ability to receive commissions. With respect to your in-force book of annuities, it is often in the best interest of the client who wants to make additional contributions to do so into an existing policy, where the living or death benefit is likely more robust that what is currently available. Also, while the numbers are increasing, the choices available within fee based annuity options are still very limited, and will likely be so for some time.
2. **Level Fee Fiduciary**. Being able to operate under this standard is certainly attractive and will be gaining momentum as the years progress. Most firms are growing their share of firm revenues on the advisory side of the business, making this more streamlined option increasingly relevant for Financial Institutions. Firms should strongly consider adding fee based annuities to their menus and capabilities, which will take time both in terms of product availability and implementation. Fee based offers will ultimately align better with the direction that the overall business is going, as well as enable firms to operate under the more streamlined Level Fee Fiduciary process.
3. **Get comfortable with the new liabilities**. For most firms, about half of the client assets under their care come from qualified plans or IRAs. Absent an eleventh hour change or successful legal delay, the new rules from the DOL are here to stay. Also, the SEC will eventually catch up to the DOL with their uniform standards which will most likely be aligned with the new DOL rules. Clearly, the full BIC Exemption adds additional liabilities for Financial Institutions, however there are new, additional liabilities already present by reason of acting as a Fiduciary under the new Fiduciary Rule. Re-examine how you conduct your business, how you incent your advisers and put controls in place to monitor how they operate— in order to avoid systematic failures and the consequences that can arise from them. Obviously, the downstream impacts to Advisers will be disruptive, however the timing to make sweeping changes is ideal— as every other firm out there will be going through the same challenges and changes. **This is an opportunity to redesign how you conduct business, and a good time to consider implementing a comprehensive holistic planning approach incorporating life insurance, long-**

term care and disability coverage, mitigating client risk of AUM loss, increasing AUM retention and protecting you and your Advisors from potential breaches of fiduciary obligations and ultimately litigation.

4. **Decide how you will treat Fixed Rate Annuities**. Determine if you should run your fixed rate annuity business through the BIC Exemption, as opposed to PTE 84-24. Consider the benefits of uniformity of process for the Adviser and client experience balanced by the additional liabilities present in the BIC over that of PTE 84-24.
5. **Decide how your firm will handle non-retirement business**. As previously discussed, any advice outside the scope of retirement accounts is not subject to the new regulations— so technically that business does not need to comply with the new rules. However, for the sake of uniformity of process for the Adviser and the client experience, firms should carefully consider how they choose to handle non-retirement accounts. It may be hard to defend a separate process/standard of care for these assets and can possibly create more confusion of the part of the client— not to mention the Adviser.
6. **Develop a dialogue with the DOL**. The DOL has publicly stated that they stand ready to assist firms as they transition to new the requirements— so they are expecting your call. As in most endeavors, the earlier you start doing this, the better.
7. **Consider working with an institutional insurance provider and introducing your Advisors to experts that can become an extension of their and provide the protection / risk mitigation service offerings they need to be offering their clients.** There are many institutional insurance organizations and normally they come with no up-front cost to you or your advisors. Traditionally, Financial Institutions have a number of "aligned / approved" insurance relationships. While this may work well for some, most of the time finding an insurance provider with national reach, consistent rules of engagement and multiple carriers creates a better, more unified approach. This will become more important as these new regulations take effect and as due diligence and documentation requirements continue to increase.

NEXT IN THE SERIES

We have published a series of papers to outline the main provisions and impacts of the DOL's 2016 Final Fiduciary and Conflict of Interest Regulations as they relate to financial institutions and their continuing efforts to provide annuity and insurance solutions to clients. The series of papers include the following topics:

- The Fiduciary Rule
- The Best Interest Contract Exemption
- Prohibited Transaction Exemption 84-24
- The Impartial Conduct Standards

ABOUT

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