CORE COMPLIANCE & LEGAL SERVICES, INC.

Risk Management Update
April 2016

THE DOL CONFLICTS OF INTEREST RULE AND HOW IT MAY AFFECT YOU (PART I)

The DOL Conflicts of Interest Rule

The final adopting release of the Department of Labor's ("DOL") Conflicts of Interest rule (the "Rule"),[1] along with the separate releases of two new and four amended prohibited transaction exemptions ("PTE") are now published in the Federal Register as of April 8, 2016.

Despite the name of the Rule, the main crux revolves around changes to the definition of the term "fiduciary" under the Employee Retirement Security Act of 1974 ("ERISA"). Upon effectiveness, the definition will include a variety of recommendations made to retirement investors[2] that previously had not been considered fiduciary advice. To help lessen the ramifications of the Rule that will affect financial institutions, including investment advisers, broker-dealers, and insurance firms and their representatives ("Retirement Advisors"), the DOL adopted the new "Best Interest Contract Exemption" ("BICE") and "Class Exemption for Principal Transactions." The DOL also made amendments to three current exemptions. While two were a bit technical in nature due to the expansion of the fiduciary definition, the changes to PTE 84-24 outline an exemption for Retirement Advisors and certain other service providers to get compensation when retirement investors purchase fixed rate annuity contracts (as defined in the revised exemption), securities registered under the Investment Company Act of 1940 and certain other transactions.

Due to the complexities of the Rule and related exemptions, this Risk Management Update is Part 1 of 2 and provides an overview of the Rule, including how to determine fiduciary status and an outline of certain core steps for consideration. In Part 2 (which will be issued in June 2016), Core Compliance & Legal Services, Inc. ("CCLS") will address the exemptions in more detail.

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[1] *See* https://www.federalregister.gov/agencies/employee-benefits-security-administration.

[2] "Retirement Investors" includes the sponsor, owner, participant and/or beneficiary of ERISA plans, SIMPLE, SEP and solo-participant plans including IRAs. Also included are Health Savings Accounts ("HSAs"), Medical Savings Accounts ("MSAs"), and Coverdell Education Savings Accounts ("CESAs"). The list of accounts not subject to the Rule is lean, and includes church plans, state pensions, deferred compensation plans and 529 plans.

Change in the Definition of an ERISA Fiduciary

The DOL communicates in both the Rule and their fact sheet[3] that the DOL's main purpose for changing the definition of "ERISA fiduciary" is to address conflicts of interest inherent in certain recommendations made by Retirement Advisors to retirement investors so as to ensure that the investment advice given is in retirement investors' best interest.

There are two new primary elements in the ERISA fiduciary definition under the Rule. One is the expansion of who is considered an ERISA fiduciary and the second is the timing of when a firm becomes an ERISA fiduciary. Also included is clarification on certain recommendations that are not considered to be fiduciary advice.

1. Who Is Considered an ERISA Fiduciary

There are certain factors that must be considered when determining ERISA fiduciary status under the Rule, namely: (i) are you dealing with a retirement investor, (ii) what recommendations are provided, and (iii) is the Retirement Advisor receiving direct or indirect compensation.

The determination of fiduciary status can be complex depending on facts and circumstances, so CCLS has created this flow chart[4] to assist financial firms in maneuvering the new tenants of the Rule pertaining to fiduciary status.

2. When Does a Firm Become an ERISA Fiduciary

Upon confirmation of fiduciary status, a Retirement Advisor is required to make all recommendations in the best interest of the retirement investors. However, the definition of a "recommendation" under the Rule is broad and applies to both prospective and actual clients and does not need to encompass advice regarding any investments. For example, a discussion with a prospective client regarding the rollover or transfer of their retirement account is considered a recommendation under the Rule, even when there is no advice provided regarding the investment of the assets within the retirement account.

This type of discussion is considered fiduciary advice since the firm is dealing with a retirement investor and the rollover will result in the firm, representative, and/or affiliate receiving compensation.

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[3] *See* http://www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html.

[4] Please note that the flow chart is provided as guidance only and does not take the place of considering the Rule in its entirety. For more information, *see* https://www.federalregister.gov/agencies/employee-benefits-security-administration.

3. What is Not Considered a "Recommendation"[5] Under the Rule

The Rule includes a non-inclusive list of communications that do not meet the definition of "recommendation" and therefore are not considered fiduciary advice. This includes communications pertaining to:

- Certain types of educational advice and impersonal investment advice;
- Information provided by unaffiliated third-party platform providers;
- Transactions with certain independent ERISA plan fiduciaries;
- Recommendations and transactions for swap and security based swaps; and
- Reports and recommendations provided by certain plan sponsor employees.

Each of the above carries certain conditions and thresholds that must be met in order to qualify; please refer to the Rule[6] its entirety for specific requirements.

ERISA Fiduciaries Are Subject to the Prohibited Transaction Rules

Fiduciaries have options for dealing with prohibited transactions, with the most common being qualifying and relying on a DOL PTE. As previously mentioned, accompanying the Rule are two new PTEs and four amended PTEs.

The determination as to which PTE(s), if any, applies will be facts and circumstances based. Importantly, an ERISA Fiduciary claiming the safe harbor of a PTE must continually follow all requirements outlined in the PTE until such time that the firm no longer relies on the PTE.

Applicability Date

The New Rule becomes effective 60 days after publication in the Federal Register, which is June 9, 2016, and has a compliance date of April 10, 2017. The compliance date for the four amended PTEs will be the same; however, the two new exemptions will be phased in from April 10, 2017 to January 1, 2018. For more information about the phase-in and steps firms must take during this period, please refer to the DOL's fact sheet.

Conclusion

The DOL Conflicts of Interest Rule will have a profound effect on most Retirement Advisors that deal with retirement investors. Although it may appear that the DOL has provided ample time to comply with the Rule, affected firms should begin taking action now. With this in mind, consider taking the following initial steps:

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[5] For the definition of "recommendation," please refer to the CCLS flow chart on page 2 of this RMU.
[6] *Id.*

1. Take inventory of all the types of retirement investors your firm deals with (*e.g.*, IRA, SEP, SIMPLE, HSA, 403(b) 401(k) Plans, Profit Sharing, Money Purchase Pension Plan, Defined Benefit Plans, Cash Balance Plans, etc.).

2. Make a list of the different types of "recommendations" being provided to both prospective and current retirement investors (*e.g.*, rollovers to different types of accounts, selling one investment product for another, recommending proprietary investment products or brokerage versus advisory accounts, etc.).

3. Take inventory of all forms of direct and indirect compensation, including but not limited to:
    - commissions;
    - advisory fees;
    - trail commissions (*e.g.*, 12b-1 fees);
    - revenue sharing;
    - finder fees;
    - referral fees;
    - solicitor fees;
    - sponsorship of conferences, seminars and events;
    - soft dollar arrangements;
    - incentive bonuses for selling certain investment or insurance products;
    - free attendance to conferences;
    - receipt of benefits under certain custodial platform arrangements; and
    - marketing assistance and advertising revenue from custodian brokers.

4. Meet with Senior Management and the business units and have a preliminary discussion on the impact of the Rule on current and future business.

5. When necessary, work with legal counsel and/or compliance consultant that are versed in the new DOL rule to assist with analyzing how the rule may affect your firm, what exemptions can be relied on, and the required steps which need to be implemented.

CCLS can help firms maneuver through the complexities of the new Rule and its exemptions. For assistance, please contact us at info@corecls.com, at (619) 278-0020 or visit us at www.corecls.com for more information.

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