

**Risk Management Update**  
**June 2016**

**THE DOL CONFLICTS OF INTEREST RULE AND HOW IT MAY AFFECT YOU (PART 2)**

**Who is an ERISA Fiduciary?**

In the April 2016, Core Compliance & Legal Services, Inc. (“CCLS”) published a Risk Management Update (“RMU”) titled, “The DOL Conflicts of Interest Rule and How it May Affect You (Part 1).”<sup>1</sup> That RMU provides guidance on determining fiduciary status under the new Department of Labor Conflicts of Interest rule (the “Rule”).<sup>2</sup>

Due to the breadth of the new definition of fiduciary, most Retirement Advisors<sup>3</sup> who deal with Retirement Investors<sup>4</sup> will fall within the new definition and need to rely on one or more prohibited transaction exemptions (“PTE”) issued by the Department of Labor (“DOL”) to conduct business with Retirement Investors.

There are numerous PTEs that have been granted by the DOL under the Employee Retirement Income Security Act of 1974 (“ERISA”), including those granted and amended as part of the release of the Rule. For example, the new Principal Transaction Class Exemption gives Retirement Advisors the ability to perform principal transactions<sup>5</sup> under certain circumstances, and amended PTE 84-24 provides relief for receipt of compensation when recommending fixed rate annuity contracts<sup>6</sup> to Retirement Investors, so long as required conditions are met. However, the PTE that will most likely be relevant to a majority of Retirement Advisors is the new Best Interest Contract Exemption (the “BIC Exemption”), which is the focus of this RMU.

**Best Interest Contract Exemption**

The Rule is designed to protect the best interest of Retirement Investors by addressing conflicts of interest that surround recommendations made by Retirement Advisors. The BIC Exemption allows Retirement Advisors to continue to receive fees, such as commissions, 12b-1 fees, sales loads and fees under revenue sharing arrangements, so long as they adhere to the exemption’s requirements.

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<sup>1</sup> See <http://www.corecls.com/wp-content/uploads/2016/04/CCLS-RMU-April-2016-The-DOL-Conflicts-of-Interest-Rule-and-How-it-May-Affect-You-Part-1.pdf>.

<sup>2</sup> See <https://www.dol.gov/ebsa/regs/conflictsofinterest.html>.

<sup>3</sup> See CCLS RMU Part 1 for definition at <http://www.corecls.com/wp-content/uploads/2016/04/CCLS-RMU-April-2016-The-DOL-Conflicts-of-Interest-Rule-and-How-it-May-Affect-You-Part-1.pdf>.

<sup>4</sup> *Id.*

<sup>5</sup> Generally defined under ERISA as a fiduciary purchasing and selling investments to Retirement Investors when the fiduciaries are acting on behalf of their own accounts.

<sup>6</sup> This does not include variable annuities or indexed annuities.

The BIC Exemption has five main requirements:

1. Acknowledge fiduciary status;
2. Adhere to Impartial Conduct Standards (as outlined in the Rule);
3. Implement policies and procedures;
4. Refrain from giving or using certain types of incentives; and
5. Disclose fees, compensation and material conflicts of interest.

Below is a summary covering each requirement.

1. *Acknowledge Fiduciary Status*. To qualify for the BIC Exemption, a Retirement Advisor is required to acknowledge fiduciary status in writing in a contract.
2. *Adhere to Impartial Conduct Standards*. Retirement Advisors will be required to adhere to Impartial Conduct Standards (as defined in the Rule) and agree to do so in a contract. This includes:
  - *Give advice that is in the Retirement Investor's best interest*. Retirement Advisors must give advice that is in the Retirement Investor's best interest, attest to this in writing and document the rationale for each recommendation. One way to comply is to develop a Best Interest Worksheet. The worksheet should contain a series of questions regarding the existing investment, the recommended investment and rationale as to why the new investment recommendation is in the best interest of the Retirement Investor.
  - *Charge no more than reasonable compensation*. "Reasonable" is a subjective term, so one common way to determine whether compensation is reasonable is to benchmark fees versus a peer group. Importantly, the compensation must be evaluated in relation to the services provided. Retirement Advisors need to consider both direct and indirect compensation. Forms of indirect compensation include, but are not limited to, 12b-1 fees, revenue sharing, shelf-space arrangements, finder's fees, marketing assistance and sponsorship of firm conferences and client appreciation events. Retirement Advisors will be required to retain documentation of compliance with the standard of charging no more than reasonable compensation, which can be incorporated into a Best Interest Worksheet as mentioned above.
  - *Make no misleading statements about investment transactions, compensation, and conflicts of interest*. This is fairly self-explanatory, but again, the Retirement Advisor must attest to complying with this standard in writing.
3. *Implement Policies and Procedures Geared to Prevent Violations of the Impartial Conduct Standards*. This can be done through training, documentation and communications with investors.

- Firms that fall under the definition of Retirement Advisor are required to ensure that their representatives are provided with information and training pertaining to the investment products being sold, and that clients are fully advised of the risks surrounding the investment products.
  - Retirement Advisors should document the basis for their recommendation and for their conclusions that their recommendations satisfy the Impartial Conduct Standards.
  - Retirement Advisors should take special care when recommending investments that entail unusual complexity and risk.
4. *Refrain from Giving or Using Incentives.* As outlined in the Rule, “firms are prohibited from having 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.”

In addition to those obvious “sales contests,” more subtle issues could arise with payouts tied to investment products, production requirements, attendance at company conferences, and indirect compensation to affiliates and related parties (such as revenue sharing with an investment adviser’s affiliated broker-dealer).

5. *Disclose Fees, Compensation and Material Conflicts of Interest.*

Retirement Advisors must provide Retirement Investors with disclosures that outline conflicts of interest, compensation/charges paid by the Retirement Investor and include information on payments to be received from third parties that are tied to recommended investments. Consider the following:

- Retirement Investors must be allowed to obtain specific disclosures upon request.
- Retirement Advisors must have and keep current a website, which includes details on the firm’s business practices and material conflicts of interest. In addition, the website must include a description of the firm’s written policies and procedures that address conflicts of interest and disclosure of compensation and incentive arrangements, among other information.

**Level Fee Fiduciary (“LFF”)**

The BIC Exemption also includes a streamlined exemption for LFFs. To qualify as an LFF the Retirement Advisor (and its affiliates if involved with the advisory services provided) must receive only a level fee and no other variable direct or indirect compensation.<sup>7</sup>

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<sup>7</sup> As outlined in the BIC Exemption, 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.”

Retirement Advisors that qualify as an LFF need only comply with the fiduciary acknowledgement and Impartial Conduct provisions of the BIC Exemption and must document why the recommendations are in the best interest of the Retirement Investor.

### **Implementation Dates for the BIC Exemption**

The implementation of the BIC Exemption is phased in from April 10, 2017 to January 1, 2018. The first two requirements of the BIC Exemption, acknowledgement of fiduciary status and adherence to the Impartial Conduct Standards will be effective April 10, 2017. The other elements of the BIC Exemption, including the website disclosures referenced in #5 above, will go into effect on January 1, 2018.

The DOL also provides “grandfathering” relief for certain investments made prior to April 10, 2017, and allows Retirement Advisors to modify current agreements to comply with the BIC Exemption via negative consent, under certain conditions. Please see the Release for more information.<sup>8</sup>

### **Conclusion**

In order to rely on the BIC Exemption, Retirement Advisors that falls under the new definition of fiduciary should consider the following action steps:

- ✓ Acknowledge fiduciary status in writing
- ✓ Follow standards to ensure advice is impartial and in the best interest of Retirement Investors
- ✓ Maintain written policies and procedures to address conflicts and help ensure advice remains in the best interest of Retirement Investors
- ✓ Train representatives on investment products being sold by the firm
- ✓ Provide written disclosures to Retirement Investors on, fees, risks, and conflicts
- ✓ Discontinue any incentive based compensation to representatives that would cause recommendations that are not in the best interests of a Retirement Investors

The DOL has forestalled the effective date of both the Rule and the BIC Exemption to allow Retirement Advisors time to prepare. Due to the complexity of both, Chief Compliance Officers should begin working with senior management to determine whether the firm meets the new definition of fiduciary (see Part 1 of this RMU series for practical steps to take), and if so, determine what steps the firm must take to comply and outline an implementation plan.

For assistance, please contact us at [info@corecls.com](mailto:info@corecls.com), at (619) 278-0020 or visit us at [www.corecls.com](http://www.corecls.com) for more information.

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<sup>8</sup> See <https://www.dol.gov/ebsa/regs/conflictsofinterest.html>.

**(“CCLS”). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on regulatory compliance issues.**

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