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The DOL Fiduciary Rule is Delayed 60 Days: Considerations and Observations

Big Picture

The Department of Labor's fiduciary rule (Rule) will no longer go into effect this coming Monday because it has been formally delayed by 60 days. Beginning on June 9, 2017, the Rule will once again have the power to tag a wide range of retirement industry service providers as investment advice fiduciaries under the Employee Retirement Income Security Act of 1974, as amended (ERISA) (and for purposes of the prohibited transaction rules of ERISA and Section 4975 of the Internal Revenue Code of 1986, as amended), potentially subjecting many of these service providers to what has often been considered the highest standard of care under the law. Also on June 9, the Rule's attendant prohibited transaction exemptions (PTEs) are available to be relied upon for exemptive relief, provided the service provider adheres to the "Impartial Conduct Standards." Unless the Rule and PTEs are not revised whatsoever, compliance with all the conditions of the PTEs begins on Jan. 1, 2018.

Details

- Generally, because the ways in which one can become an ERISA fiduciary by reason of providing investment advice changes on June 9, 2017, exemptive relief for receipt of various forms of resulting compensation is essential. Service providers who are deemed investment advice fiduciaries under the Rule may rely upon the new PTEs (i.e., the Best Interest Contract Exemption and the Principal Transactions Exemption), as well as other relevant PTEs, such as PTEs 84-24 (Certain Transaction Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies and Investment Company Principal Underwriters) and 77-4 (Class Exemption for Certain Transactions Between Investment Companies and Employee Benefit Plans), on June 9, provided they adhere to what are referred to as the "Impartial Conduct Standards."
    - As a reminder, the "Impartial Conduct Standards" can generally be boiled down to:
        - Adherence to ERISA's duties of prudence and loyalty;
        - Compliance with the "reasonable compensation" requirements set forth in Section 408(b)(2) of ERISA; and,
        - Avoidance of making materially misleading statements to the retirement investor on any subject that may be relevant to the investor, including information on the transaction(s), compensation, and material conflicts of interest.
- The Best Interest Contract Exemption goes into effect on June 9, 2017. Until Jan. 1, 2018, however, service providers (including robo advisers) may rely on this

exemption for relief, provided they comply with the Impartial Conduct Standards. The controversial and more compliance-heavy conditions, such as the contract and disclosure requirements, are not required until Jan.1.

- The Principal Transactions Exemption also goes into effect on June 9, 2017. As a reminder, this exemption allows a service provider to engage in particular types of principal transactions involving certain investments, with plans, individual participant and beneficiary accounts and IRAs, subject to various conditions. From June 9, 2017 to Jan. 1, 2018, service providers need only adhere to the Impartial Conduct Standards, including, for purposes of this exemption, a duty to seek best execution. Full compliance kicks in on January 1.

- From June 9 until Jan. 1, 2018, insurance agents, insurance brokers, pension consultants and insurance companies will be able to continue to rely on PTE 84-24, as previously written, for the recommendation and sale of fixed indexed, variable and other annuity contracts to plans and IRAs, subject to the addition of the Impartial Conduct Standards. On Jan. 1, the exemption would no longer apply to transactions involving fixed indexed annuity contracts or variable annuity contracts, and all of the conditions of the exemption would otherwise apply.

Future Status of the Rule/PTEs

- The DOL appears determined to avoid inordinate delays of the Rule and PTEs and seems comfortable with completing its revised legal and economic analyses, as directed by President Donald J. Trump, in his Feb. 3 Memorandum (https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule), by Jan. 1, 2018. We now think it is less likely that a *series of* significant delays will be proposed by the DOL on top of this newly-finalized 60-day delay. The DOL carefully pointed out that it was not prejudging the outcome of the examination ordered by the President and that it reserves the right to ultimately revise or repeal any aspect of the Rule and PTEs, including those provisions that will go into effect on June 9, 2017. It remains uncertain how Alex Acosta, nominee to be DOL Secretary, will affect the Rule's outcome once confirmed. As we noted (http://www.stradley.com/insights/publications/2017/03/im-briefing-march-23-2017), Acosta appears skeptical of the Rule's breadth. He awaits a full Senate vote on his nomination, which has yet to be scheduled.

- A significant delay of the Jan. 1, 2018 full compliance date of the Rule and PTEs is most likely to occur if the DOL concludes that it must make substantial changes to the Rule and PTEs to address the President's concerns. Alternatively, the DOL indicated it could issue "more streamlined PTEs, as it finalizes its review and decides whether to make more general changes to the Rule or PTEs."

- We think the DOL may have foreshadowed how the Rule and PTEs will be revised in light of the President's directive. In short, the Rule's scope and the Impartial Conduct Standards in the PTEs appear relatively safe from significant change, though the scope of the Rule's "exceptions" may be in play. The DOL, however, acknowledged the controversy of various other requirements of the PTEs, such as the contract and disclosure requirements, and we think these are more likely to be watered-down (at least relative to the likelihood of the Impartial Conduct Standards being revised or removed). Two passages from the Final Rule-Delay's Preamble are noteworthy:

Compare:

- *"As compared to the contract, disclosure, and warranty requirements of the BIC Exemption and Principal Transactions Exemption, the Fiduciary Rule and the Impartial Conduct Standards are among the least controversial aspects of the rulemaking project (although not free from controversy or unchallenged in litigation). Indeed, even among many of the commenters and petitioners that support a delay of the applicability date, there are varying degrees of support for the Rule and the Impartial Conduct Standards."*

And:

- *"Since there is fairly widespread, although not universal, agreement about the basic Impartial Conduct Standards, which require advisers to make recommendations that are in the customer's best interest (i.e., advice that is prudent and loyal), avoid misleading statements, and charge no more than reasonable compensation for services (which is already an obligation under ERISA and the Code, irrespective of this rulemaking), this approach provides retirement investors with the protection of basic fiduciary norms and standards of fair dealing, while at the same time honoring the President's directive to take a hard look at any potential undue burdens. After the passage of a year since the Rule and PTEs were published, and based on public comment, the Department finds little basis for concluding that advisers need more time to give advice that is in the retirement investor's best interest and free from misrepresentations in exchange*

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for reasonable compensation. Indeed, financial institutions and advisers routinely hold themselves out as providing just such advice.

With:

- *"Because the provisions requiring written representations and commitments about fiduciary compliance, execution of a contract, warranties about policies and procedures, and the prohibition on imposing arbitration requirements on class claims, would not go into effect during this period, this approach eliminates or minimizes the risk of litigation, including class-action litigation, in the IRA marketplace, one of the chief concerns expressed by the financial services industry in connection with the Fiduciary Rule and PTEs."*

Considerations

- Service providers should be mindful that compliance with the Impartial Conduct Standards is exacting. We think, for example, that the Impartial Conduct Standards require that the service provider document why a particular transaction is in an investor's best interest (i.e., in accordance with the duties of prudence and loyalty under ERISA), though that documentation could be retained internally and need not be shared with the investor until full compliance begins on Jan. 1, 2018. Moreover, service providers should ensure that any material conflicts of interest do not prevent them from satisfying the conditions of the Impartial Conduct Standards, including the manner by which financial advisers are compensated. See, for example:

  - *"Also note that even though the applicability date of the exemption conditions have been delayed during the transition period, it is nevertheless anticipated that firms that are fiduciaries will implement procedures to ensure that they are meeting their fiduciary obligations, such as changing their compensation structures and monitoring the sales practices of their advisers to ensure that conflicts in interest do not cause violations of the Impartial Conduct Standards, and maintaining sufficient records to corroborate that they are adhering to Impartial Conduct Standards…[h]owever, these firms have considerably more flexibility to choose precisely how they will comply during the transition period."*

- In this light, the DOL expects service providers to leverage their compliance efforts to date to comply with the Impartial Conduct Standards. We think service providers should continue to identify and mitigate material conflicts of interest, particularly on and after June 9, 2017. Per the DOL:

  - *"Comments received by the Department and media reports also indicate that many financial institutions already had completed or largely completed work to establish policies and procedures necessary to make the business structure and practice shifts required by the Impartial Conduct Standards earlier this year (e.g., drafting and implementing training for staff, drafting client correspondence and explanations of revised product and service offerings, negotiating changes to agreements with product manufacturers as part of their approach to compliance with the PTEs, changing employee and agent compensation structures, and designing conflict-free product offerings), and the Department believes that financial institutions may use this compliance infrastructure to ensure that they meet the Impartial Conduct Standards after taking the additional sixty days for an orderly transition between June 9, 2017, and January 1, 2018."*

- Because the various disclosure requirements under the PTEs are stayed until Jan. 1, 2018, there is a question as to how the third condition of the Impartial Conduct Standards, namely, the duty to avoid making materially misleading statements regarding the transaction and related compensation and material conflicts of interest, remains relevant. With that said, service providers should exercise caution in all of their communications with retirement investors starting on June 9, even if such communications (e.g., disclosures) are not required under the applicable PTE until Jan. 1.

- The DOL reiterated its "compliance-first" approach to enforcing the Rule and PTEs, which should allay some concerns about compliance over the coming months. As provided in the Final Rule-Delay Preamble: *"Although ERISA provides a cause of action for violations by fiduciary advisers to ERISA-covered plans and plan participants, including violations with respect to rollovers and distributions of plan assets, the Department's focus will be on compliance assistance, both in the period before January 1, 2018, and for some time after."* See also Conflicts of Interest Rule and Exemptions FAQs Part 1, Q. 34 (DOL's general approach "*will be marked by an emphasis on assisting (rather than citing violations and imposing penalties on) plans, plan fiduciaries, financial institutions and others who are working diligently and in good faith to understand and come into compliance with the new rule and exemptions.*").

Other Observations

The DOL continues to believe that a 45-day notice period

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in respect of comments to the legal and economic analysis of the Rule and PTEs remains appropriate, though it indicated it could always re-open the comment period. Speaking of this extended comment period, the DOL *urged* stakeholders to submit comment letters by April 17 that contain *new* data and arguments that address the President's Feb. 3 Memorandum (https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule) and related questions posed by the DOL in its notice of proposed delay of the Rule. *We think submitting comment letters with new data and analysis is critical, especially for those opposed to the Rule and/or its PTEs.*

- No good deed goes unpunished. The DOL deftly pointed to industry trends to comply with the Rule by the now-moot April 10 deadline as a way to encourage compliance with conditions now not otherwise required until Jan. 1. As stated in the Final Rule-Delay Preamble: *"In addition, even though advisers would not be specifically required by the terms of these PTEs to notify retirement investors of the Impartial Conduct Standards and to acknowledge their fiduciary status before January 1, 2018, many investors are likely to know they are entitled to advice that adheres to a fiduciary standard because this final rule will receive publicity from the Department and media, and many advisers will likely notify consumers voluntarily about the imposition of the standard and their adherence to that standard as a best practice.*"

- The DOL defended the short 15-day time period to submit comment letters in respect of this delay. In footnote 6 to the Final Rule-Delay Preamble, the DOL said *"[t]he 15-day comment period was chosen in light of the public reaction and media reports following the Presidential Memorandum expressing concerns about investor confusion and other marketplace disruption based on uncertainty about whether a delay could be accomplished before April 10. The Department concluded that prompt action was needed to protect against this investor confusion and uncertainty, and to ensure that the Rule and PTEs did not become temporarily applicable."*

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