April 10, 2017

DOL Postpones Fiduciary Rule

Regulations Defining Fiduciaries Are Delayed Until June 9, 2017 and the Best Interest Contract and Principal Transaction Exemptions Are Significantly Simplified Until January 1, 2018

SUMMARY

On April 4, 2017, the Department of Labor (the "DOL") announced that the effective date of 2016 regulations (the "2016 Regulations") defining "fiduciary" for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA") and Section 4975 of the Internal Revenue Code (the "Fiduciary Rule") will be deferred from April 10, 2017 until June 9, 2017. In addition, the DOL announcement (the "Announcement") temporarily modifies the "Best Interest Contract Exemption" (the "BIC Exemption") and the "Principal Transaction Exemption" from the prohibited transaction rules (together with the BIC Exemption, the "PTEs") so that the requirements of these exemptions will be satisfied prior to January 1, 2018 as long as the fiduciary satisfies the "impartial conduct standards" described below. Accordingly, fiduciaries may qualify for these PTEs prior to January 1, 2018 even if they do not satisfy the disclosure, representation and warranty requirements of the PTEs.

The Announcement was issued by the DOL in response to a memorandum from President Trump directing the DOL to review the Fiduciary Rule. The Announcement is somewhat surprising insofar as it partially implements the Fiduciary Rule on June 9 notwithstanding that the DOL acknowledged that it is unlikely to complete a review of the Fiduciary Rule before such date. While the Announcement defers the effective date of the Fiduciary Rule and temporarily relaxes the requirements of the PTEs, many market participants had expected that the effective date of the 2016 Regulations would be deferred until the review was complete.

BACKGROUND

In April 2016, the DOL promulgated final regulations that would treat many common types of investment "recommendations" to retirement plans and IRAs (collectively, "Retirement Investors") as fiduciary investment advice, making many financial service providers subject to ERISA fiduciary standards of care and/or the prohibited transaction rules. Once the 2016 Regulations are in effect, compensation arrangements that are widely used in the financial services industry—such as sales commissions, revenue-sharing arrangements and other types of indirect compensation—would be prohibited to these fiduciaries under ERISA and the Code unless the fiduciary satisfies the requirements of the BIC Exemption, the Principal Transaction Exemption, or qualify for certain other exceptions.[1] The 2016 Regulations and the PTEs were scheduled to go into effect on April 10, 2017.

The BIC Exemption permits financial institutions and their associated investment advisers to receive otherwise impermissible forms of compensation for providing investment advice to Retirement Investors, so long as the financial institution and investment advisers comply with the conditions of the exemption. In general, "Principal Transactions" are not eligible for the BIC Exemption, but are instead eligible for the Principal Transaction Exemption. A "Principal Transaction" generally involves the purchase or sale of an investment product that is held or issued by an investment adviser or financial institution to a Retirement Investor.

In order to qualify for the BIC Exemption, the financial institution must: (1) acknowledge fiduciary status in writing; (2) acknowledge in writing that the financial institution and its investment advisers will adhere to the "Impartial Conduct Standards" (defined below); (3) warrant that the financial institution and its investment advisers will comply with policies and procedures designed to prevent a violation of such impartial conduct standards; and (4) make detailed disclosures to the investor. Additionally, after January 1, 2018, a financial institution is required to enter into a written and enforceable contract with Retirement Investors under which it contractually agrees to comply with the requirements of the BIC Exemption.

Under the BIC Exemption, the Impartial Conduct Standards require that:

- The investment adviser must act in the "Best Interest" of the Retirement Investor, defined as:
  - acting with 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
  - acting without regard to the financial or other interests of the investment adviser, financial institution or any affiliate, related entity, or other party;
- The compensation received by the investment adviser or the financial institution (or its affiliates or related entities) with respect to the recommended transaction may not exceed reasonable compensation; and

- The financial institution and its investment advisers may not make any materially misleading statements to the Retirement Investor about the recommended transaction, fees and compensation, conflicts of interest, and any other matters relevant to the Retirement Investor's investment decisions.

While there are certain additional restrictions, the terms and conditions of the Principal Transaction Exemption are generally similar to the BIC Exemption. The Principal Transaction Exemption generally defines Impartial Conduct Standards in the same manner as the BIC Exemption, except that it requires the fiduciary to seek the best execution reasonably available under the circumstances, rather than to receive no more than "reasonable compensation."

THE ANNOUNCEMENT

As noted above, the Announcement was issued in response to a memorandum from President Trump directing the Labor Secretary to examine the Fiduciary Rule against specific standards and to update the DOL's economic and legal analysis accordingly. Depending on the outcome of the examination, the memorandum directed the Labor Secretary to propose, as appropriate, revisions to the Fiduciary Rule or to rescind it altogether. In response, the DOL published a notice soliciting comments on a proposed extension of the effective date of the Fiduciary Rule and the PTEs.

In response to what it described as a "very high volume of comment and petition letters," the DOL announced that it would defer the effective date of the 2016 Regulations by 60 days to June 9, 2017.[2]

The Announcement provides that the BIC Exemption and the Principal Transaction Exemption will be available on June 9, 2017 in a modified and relaxed form. More specifically, as noted above, the 2016 Regulations included the Impartial Conduct Standards, and representations, disclosure and warranty requirements, in addition to the contract requirement that was scheduled to go into effect on January 1, 2018. The Announcement suspended all the requirements for these exemptions other than the Impartial Conduct Standard during the period between June 9, 2017 and January 1, 2018. Thus, until January 1, 2018, fiduciaries can satisfy the PTEs as long as they satisfy the Impartial Conduct Standard. The remaining requirements in the PTEs (including the representation, disclosure, warranties and written contract requirements) will go into effect on January 1, 2018.

The DOL acknowledged in the Announcement that the full review mandated by the President's memorandum would likely take longer than the 60-day delay provided for in the Announcement, and noted that many firms reasonably assumed that the DOL would delay implementation. However, the DOL concluded that the uncertainty surrounding the effective date of these rules was best resolved by delaying the effective date of the 2016 Regulations for 60 days, while allowing fiduciaries to comply with the PTEs in 2017 if they comply with the Impartial Conduct Standard even if they do not comply with the remaining requirements of the PTEs.

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ENDNOTES

[1] For additional background on the new fiduciary rules and the Best Interest Contract and Principal Transaction exemptions, please see the Sullivan & Cromwell LLP publication entitled "DOL Releases Final 'Investment Advice' Regulation" (April 20, 2016).

[2] The Announcement also delays the applicable dates of amendments to previously granted exemptions. Each of the amendments generally requires the fiduciaries relying on such PTEs to adhere to the same impartial conduct standards required in the BIC Exemption. The amended PTEs are: PTE 86-128 (which allows a fiduciary to cause the advice recipient to pay the fiduciary or its affiliate a fee for effecting or executing securities transactions as agent); PTE 75-1 (which provides an exemption for broker-dealers and banks engaging in securities transactions with plans and IRAs); PTE 77-4 (which provides relief for the purchase or sale by a plan or IRA of open-end investment company shares where the investment adviser for the open-end investment company is also a fiduciary to the plan or IRA); PTE 80-83 (which provides relief for a fiduciary that causes a plan or IRA to purchase a security when the proceeds of the securities issuance may be used by the issuer to retire or reduce indebtedness to the fiduciary or its affiliate); and PTE 83-1 (which covers the sale by the sponsor of a mortgage pool to a plan or IRA of certificates in an initial issuance of certificates, where the sponsor, trustee or insurer of the mortgage pool is a fiduciary with respect to the plan or IRA assets invested in such certificates).

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