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Correspondence Memorandum

Date: May 27, 2016

To: Deferred Compensation Board

From: Tarna Gahan-Hunter, Legislative Liaison

Subject: Legislative Update

This memo is for informational purposes only. No Board action is required.

This memorandum provides information on pertinent legislative issues to the Wisconsin Deferred Compensation Board (Board).

The Department of Labor (DOL) released the final rule on April 6, 2016 that defines who is a “fiduciary” of an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA) as a result of giving investment advice to a plan or its participants or beneficiaries. The final rule also applies to the definition of “fiduciary” for purposes of Individual Retirement Accounts (IRAs) under the Internal Revenue Code of 1986. The final rule expands the definition of “fiduciary” to encompass a wider range of persons providing investment advice or recommendations to plans or IRAs for a fee. In conjunction with the final rule, the DOL has released two new prohibited transaction exemptions (PTE) and amended existing ones. The primary new PTE defines a best interest contract exemption (BIC). The principle of these rules is to help protect participants in retirement plans and IRA investors by making financial advisers accountable for acting in their client’s best interest.

Even though governmental 457 plans are not directly covered by this regulation, it is considered best practice to adhere to ERISA standards. In addition, it is important to note that when participants are advised to roll over their Section 457 plan assets into an IRA, they need to know that their adviser is working in their best interests, and that the proposed rule would improve the reliability of the advice that they receive.

The rule will be applicable to financial institutions and the financial advisers employed by them on April 10, 2017, which is one year after its effective date. However, in response to implementation and feasibility concerns raised by the financial services industry, the DOL has delayed full compliance with certain provisions of the “best interest contract” and “principal transaction” exemptions until January 2018.

Reviewed and approved by Pam Henning, Assistant Deputy Secretary
Pamela L Henning
Electronically Signed 5/27/16

Board	Mtg Date	Item #
DC	6.14.16	10

Please find attached the April 8, 2016 Instant Insights (an Empower Retirement publication) which describes the main provisions of the rule, as well as the key terms of the new and amended PTEs promulgated by the DOL.

Attachment: Instant Insights

Attachment

Instant Insights

April 15, 2016

By: Empower Retirement legislative and regulatory affairs

The Department of Labor publishes final rule

The DOL publishes final rule on investment advice fiduciaries

On April 6, the Department of Labor (DOL) released its final regulation defining who qualifies as a fiduciary under ERISA by reason of providing investment advice for a fee. In conjunction with the new rule, the DOL has released two new prohibited transaction exemptions (PTE) and amended existing ones. The primary new PTE defines a *best interest contract exemption* (BIC).

Background

Under current law, a person is deemed an "investment advice for a fee" fiduciary if he or she meets all the conditions of a five-part test that the DOL created in 1975. In 2010, the DOL proposed a rule to replace the existing five-part test. In response to industry concerns, the DOL withdrew the proposal in 2011. The rule, which the DOL reproposed in 2015, received more than 3,000 comments and became the subject of four days of public hearings.

The final rule

The final rule covers three broad sections:

1. What constitutes investment advice?
2. When advice is provided
3. Examples and exceptions (referred to as *carve-outs* in the 2015 proposal) to the general rules regarding what qualifies as investment advice

Under the final rule, someone will become an ERISA fiduciary if he or she provides information that is categorized as investment advice under item one above; meets the conditions for when the advice is provided under item two above; or offers information that does not fall under one of the exceptions in item three above.

The rule's intent is to expand the universe of parties subject to ERISA's fiduciary rules. It will likely have a particular impact on people either who assist with IRA rollovers and IRA investing or who work with small plan sponsors in a nonfiduciary capacity in reliance on the five-part test. ERISA fiduciaries must comply with fiduciary standards of conduct, including the duty to use a prudent process in making fiduciary decisions and to act in the best interest of the advice recipient. There are also special rules for fiduciaries under ERISA's prohibited transaction rules and related exemptions regarding how the fiduciary can be paid.

What constitutes investment advice?

The final rule defines advice as:

1. A recommendation to purchase, hold, sell or exchange investments, or how assets are invested after a transfer, rollover or distribution from a plan or an IRA.
2. A recommendation to take a distribution or roll over a distribution.
3. A recommendation regarding the management of investments, including investments that are part of a rollover or distribution. While this could also include the recommendation of an investment advisor or investment management services, the preamble to the rule indicates that vendors would still be able to market services as long as they do not rise to the level of an investment recommendation.

Note that item 2 above is a reversal of the DOL's position in prior guidance (DOL Advisory Opinion 2005-23A), which held that it is not fiduciary advice to make a recommendation of distribution options even if accompanied by an investment recommendation. The DOL has replaced the advisory opinion with the final rule.

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The proposal defines a *recommendation* as a "communication that, based on its content, context and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action." The final rule notes that the more individually tailored a communication is to a specific recipient, the more likely it will be considered a recommendation.

In order to be considered fiduciary, the advice must be offered for a fee. Fees include direct and indirect compensation received by the advisor or an affiliate. This is a very broad definition.

A change from prior law is that the rule will now apply to advice provided to plans, plan fiduciaries, plan participants and beneficiaries, as well as IRAs and IRA owners. This extension of ERISA's fiduciary standards of care to advice provided to IRAs and IRA owners is a significant change from prior law.

When advice is provided

A person will be viewed as having provided the advice outlined above if any of the following applies:

1. The person has acknowledged fiduciary status under ERISA with respect to the advice provided.
2. The advice is given in accordance with a written or verbal agreement or understanding and based on the particular investment needs of the recipient.
3. The advice is specifically directed to the recipient regarding the advisability of making investment or management decisions in a plan or an IRA.

Some key differences between the final rule and the current five-part test include that the advice would no longer need to be provided on a regular basis and that it does not need to serve as the primary basis for the fiduciary decision in order to be considered fiduciary advice. For example, a recommendation provided solely in the context of making a sale to a plan could be considered fiduciary advice if it meets the conditions above without being subject to an exception.

The final rule clarifies that order-taking, or mere execution of a securities transaction at the direction of another, remains nonfiduciary activity.

Exceptions

The final rule provides a number of examples of what is not considered a fiduciary communication or advice and exceptions from what is considered advice.

1. Platform providers: This covers providers who make a menu of investments available for selection by a plan fiduciary without regard to the individualized needs of the plan and who disclose that they are not providing investment advice. The platform provider carve-out does not apply to those providing services to IRA holders.
2. Selection and monitoring assistance: Platform providers can also offer some selection and monitoring assistance, such as identifying investment alternatives that meet objective criteria defined by the plan fiduciary or providing objective financial data and comparisons with independent benchmarks. This exception covers sample investment lineups included in a response to a request for proposal. A platform provider generally has to disclose its financial interest in the identified investments.
3. General communications: This covers providing information that reasonably cannot be considered a recommendation, such as newsletters, broadcasts, and widely attended speeches and conferences.
4. Investment education: The proposal preserves the distinction between nonfiduciary education and fiduciary advice but makes some changes to the definition of what qualifies as education. It clarifies that the exception for education applies regardless of whom the education is provided to (plan, participant, beneficiary or IRA owner). Consistent with current law, education includes information about the plan, general financial education, asset allocation models and interactive investment materials. The definition of education has been expanded to include information on retirement income planning. Plans may refer to a designated investment options under the plan in asset allocation models or interactive materials as long as all designated investment options with similar risk and return characteristics are identified and a statement providing where further information may be obtained is included.[1] Asset allocation models for IRAs may not include references to specific investments.

1 The DOL's prior guidance defining *education* in Interpretive Bulletin 96-1 will be superseded.

5. Independent plan fiduciary or financial expert (seller's carve-out):
   a. This provides an exception for the provision of advice to an independent plan fiduciary, including banks, insurance carriers, registered investment advisers and broker-dealers.
   b. This provides an exception for advice provided to a large plan as part of an arm's length transaction. The advice must be provided to a plan in which the plan fiduciary has under management or controls at least $50 million in plan assets. Disclosure and other requirements also apply.
6. SWAPS: A recommendation to enter into a SWAP regulated by the SEC or CFTC is not considered fiduciary advice.
7. Employees: This covers employees of the plan sponsor providing advice to a plan fiduciary or employees who receive no other compensation beyond their normal work compensation.

Exemptions

In addition to providing exceptions for certain activities, the rule creates two new prohibited transaction exemptions and amends current ones.

The BIC is a new prohibited transaction exemption intended to allow fiduciaries to continue to receive commissions, transaction fees, and other types of compensation that would otherwise not be allowed due to potential conflicts of interest. Unlike the proposed rule, the final rule is available for compensation received in connection with any type of asset and is not restricted to specific asset categories. It is available when providing advice to IRA owners, plan fiduciaries that don't fit within the financial expertise exclusion, and plan participants.

Basic requirements of the BIC:

1. Acknowledge fiduciary status in writing.
2. Adhere to impartial conduct standards (advice is in the best interest of the customer and is subject to ERISA's prudence standard; compensation is reasonable; and there are no misleading statements).
3. Implement policies and procedures designed to prevent conflicts of interest.
4. Refrain from using incentives for acting contrary to a customer's best interest.
5. Disclose information about fees, compensation and conflicts of interest.
6. Retain records demonstrating compliance with the exemption.

The disclosure requirements include a point-of-sale disclosure that must be provided on or before the execution of the first transaction subject to the exemption. The disclosure must contain specific details regarding fees, potential conflicts, the standard of care due, investment monitoring frequency, a link to additional website information, and the availability of additional information due upon request. Additional disclosures are required if proprietary products are used. In a change from the proposed rule, the disclosure does not need to include future projections of fees. Disclosure of fees, conflict of interest policies, model notices, third-party payments and other information must also be provided on a public website. The final rule eliminated the requirement to provide an annual disclosure if no new advice is provided during the year. More detailed disclosures must be made available upon request. The final rule also contains a mechanism to correct good faith disclosure errors without losing the protection of the exemption.

When relying on the exemption for providing advice to IRA owners, the firm providing advice (not the individual advisor) and the advice recipient must enter into a contract. The contract must be in place before execution of the first transaction subject to the exemption so it can be incorporated into other account-opening documents. It can be executed by electronic consent without requiring a "wet" signature. It must cover advice provided prior to execution of the contract. The final rule retains the requirements from the proposed rule prohibiting the use of disclaimers or a waiver of right to participate in a class action, but it does allow for a waiver of punitive damages or use of arbitration in some circumstances. No written contract is required to rely on the exemption when providing advice to plans or participants, but the same conditions prohibiting use of disclaimers, etc., apply. Some of the data retention requirements that were contained in the proposed rule have been eliminated. The only data that must be maintained is documentation that demonstrates compliance with the exemption.

The grandfathering rules allow otherwise prohibited compensation to be received on existing accounts without the need for the BIC to the extent that it is received based on a recommendation to hold an asset (or pursuant to a systematic purchase agreement). If a BIC contract is required for an existing customer, one can use a negative consent process, which does not require a client signature.

The final rule contains a more streamlined exemption for level fee arrangements. It can be used when providing advice in the context of an IRA rollover in which the advisor's fees for servicing the IRA account are level but may be higher than what the participant is paying in their plan account. Under this special rule fiduciary, status must be acknowledged, and the advisor must comply with the impartial conduct standards. However, no contract is required, and the other BIC disclosure and warranty requirements do not apply. There is a special disclosure rule for the level-fee exemption when used in the context of a plan-to-IRA rollover requiring documentation of the alternatives that were discussed and reasons why the rollover is in the best interest of the investor.

Other exemptions

In addition to reworking the BIC, the DOL has finalized a new exemption for principal transactions and amended other prohibited transaction exemptions in order to add an impartial conduct standard of care as an additional requirement.

Of note, the DOL has significantly revised PTE 84-24 in the final rule package. PTE 84-24 historically allowed the receipt of a commission by an appropriately credentialed firm in connection with the sale to a plan or an IRA of an insurance contract (such as a fixed or variable annuity contract) or a mutual fund. PTE 84-24 also exempted the prohibited transaction that occurred if a plan or an IRA bought an insurance contract or a mutual fund from an entity that was a party in interest to the plan.

The final rule package greatly limits the exemption as available for insurance contracts. PTE 84-24 will now be available only regarding plan or IRA purchases of a fixed annuity contract that qualifies as a fixed rate annuity contract, a term that requires consideration of state insurance nonforfeiture law.

Thus, PTE 84-24 will not be available for purchases of variable annuity contracts nor fixed indexed annuity contracts. The exemption for sales to plans and IRAs of both variable annuity contracts and fixed indexed annuities has been moved to a new section of the BIC. This reflects a preference by the DOL that only comparatively straightforward fixed annuities should benefit from the easy-to-satisfy exemptive relief available under PTE 84-24.

Lastly, PTE 84-24 in the final rule package retains the proposed rule's treatment of sales involving mutual funds. This means that commissions can continue to be paid (and purchases effected) in connection with a plan's acquisition of mutual funds but not in connection with an IRA's acquisition of mutual funds.

Timeline

The final rule, which is effective on June 7, 2016, becomes applicable April 10, 2017. The difference between the effective date and the applicability date means that there is a time lag after the final rule becomes effective and when parties must comply. The interim definition of investment advice appears to largely reflect the investment advice definition in place prior to the final rule release.

There are two applicability dates relevant to the BIC exemption. By the general effective date (April 10, 2017), anyone intending to rely on the exemption must provide a notice acknowledging fiduciary status, adhere to the impartial conduct standards, provide a general disclosure notice and designate someone to be responsible for monitoring compliance with the impartial conduct standards and for addressing material conflicts of interest. The effective date for the detailed disclosure requirements, the creation of anti-conflict policies, as well as the contract required with IRA advice recipients, is January 1, 2018.

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