



Executive Compensation and Benefits Alert

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Department of Labor Issues Guidance on Conflicts of Interest Rule

The Department of Labor (DOL) recently issued guidance on the Conflicts of Interest Rule it released earlier this year. The guidance, issued on October 27, 2016, is in the form of answers to frequently asked questions, which the DOL stated are based on questions it has received since the rule's publication (the FAQs). The FAQs are expected to be the first of at least three rounds of DOL guidance.

Background

On April 6, 2016, the DOL released its long-awaited Conflicts of Interest Rule, including some new prohibited transaction class exemptions and revisions to certain existing prohibited transaction class exemptions (the Rule). The Rule is generally to be effective on April 10, 2017. The Rule significantly increases the scope of communications with retirement investors, including individual retirement accounts, or IRAs (retirement investors) that would be considered to be fiduciary advice under the Employee Retirement Income Security Act of 1974, as amended (ERISA) and Section 4975 of the Internal Revenue Code (the Code). Under ERISA and the Code, fiduciaries to a plan, including an IRA, cannot engage in self-dealing with regard to the plan, which, among other things, effectively can prevent the use of commissions and other variable compensation in dealing with retirement investors, unless the transaction is covered by an applicable exemption.

The Rule includes two new exemptions: the Best Interest Contract Exemption (BICE) and the Principal Transactions Exemption (Principal Exemption). The BICE, Principal Exemption and revisions to other existing exemptions include requirements that advisers (including broker-dealers and other financial intermediaries, and the individual advisers who work for such parties) act in accordance with certain "Impartial Conduct Standards" (sometimes pursuant to written contracts) that, in general, include that the adviser act in the retirement investor's "best interests," make various disclosures and avoid unreasonable compensation.

The Guidance

Although the FAQs do not reverse or override anything in the Rule or set forth particular revisions, the FAQs do reinforce and clarify the DOL's position on various issues, primarily regarding the BICE and Principal Exemption. For a more detailed overview of the Rule, see our April 25, 2016, client alert "[Labor Department Redefines 'Fiduciary' for ERISA and Internal Revenue Code Purposes.](#)"

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Among the issues discussed in the FAQs are:

- The DOL noted that the BICE is intended to be the primary exemption for investment advice to retirement investors and is generally available to advisers even if other exemptions also may be available, but it is not available with respect to an adviser's exercise of discretion.
 - The DOL noted broadly that satisfaction of any exemption requires careful monitoring of arrangements with retirement investors to ensure compliance with the anti-conflicts of interest requirements. The DOL emphasized that although charging a level fee for providing investment advice would not typically result in such fees causing prohibited transactions — and therefore do not necessarily require satisfying the BICE — the adviser is still a fiduciary to the retirement investor, and it is possible for an adviser's other practices to result in prohibited conflicts.
 - A recommendation to roll over an IRA or move a retirement investor from a commission-based to fee-based account is advice that requires an exemption and detailed documentation as to why the recommendation was made (including consideration of fees and expenses of moving the assets vs. leaving them in an existing plan), even if the account into which funds are transferred is fee-based (level fee). The FAQs discuss various factors that should be taken into account in giving such advice.
 - Financial institutions may pay their individual financial advisers incentive compensation. However, such arrangements need to be carefully designed and monitored to avoid creating incentives that may not be in the best interest of a retirement investor. For example, compensation based on the profitability of a particular product to the financial institution, as compared to similar products, would not generally be viewed as satisfying the requirement. The DOL emphasized that incentives should be based upon “neutral” factors, such as complexity of advice and the time it takes to provide the advice. The DOL noted that incentive pay grids are not prohibited but could, depending upon design, encourage imprudent behavior, particularly where, for example, there are large jumps in payouts at specified hurdles or where reaching a particular hurdle has the effect of retroactively increasing payouts on investments made prior to reaching that plateau. Financial institutions should pay particular attention to monitoring adviser recommendations when the adviser nears thresholds, to ensure advice aligns with the investor's best interests.
 - Financial institutions may pay recruitment bonuses in connection with bringing on a new individual adviser and still satisfy the BICE, but such bonuses should not be based on reaching sales or other targets based on business production.
- “Back-end” bonus arrangements (based on achievement of sales or asset targets) that don't necessarily meet the impartial conduct standards to which a financial institution is contractually bound prior to the date of the FAQs may be effectively “grandfathered” for a reasonable period, subject to meeting certain requirements, including establishing policies addressing conflicts arising from the arrangements and strict monitoring for any such conflicts.
 - A fiduciary does not receive only a level fee with respect to an account if the fiduciary receives any transaction-based payments (such as 12b-1 fees or revenue sharing) from third parties or is limited to recommending investing in proprietary products, and receipt of such fees would make the “BICE-lite” level fee exemption unavailable.
 - The DOL provided some clarifications as to how the BICE and the revised prohibited transaction class exemptions 82-24 apply to fees paid on sales of annuities. Insurance companies may act as the financial institution with respect to independent agents under the BICE but are only responsible for their own products. Although independent marketing organizations (IMOs) do not ordinarily qualify as financial institutions under the BICE (which would allow them to sign best interest contracts, for example), the exemption provides a process for an IMO to apply to the DOL to be treated as a financial institution under an individual exemption. (The DOL is currently considering several such requests.)
 - Financial institutions are not per se precluded under the BICE from giving discounts to customers but would have to monitor the use of discounts to ensure that conflicts of interest do not arise.
 - With respect to disclosures required under the BICE, a financial institution may make available a model contract, as opposed to the actual contract executed by a retirement investor (and model amendments where negative consent is permitted), if the model contains all relevant contractual terms. However, the DOL noted that it considers best practice to be posting actual contracts. In addition, specific disclosures about a transaction is required only for purchases and not for recommendations to hold or sell, and information provided to a retirement investor must be accurate as of the date advice is provided.
 - The categories of assets to which the BICE may apply is not limited. However, the new Principal Exemption only applies to limited types of assets. The DOL reiterated that application can be made for individual exemptions that would apply the same rules under the Principal Exemption to other categories of assets, which, to the extent granted, would effectively expand the scope of assets available under the exemption.

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Significantly, the DOL stated that although it has broad authority to investigate and audit compliance with ERISA, including with the Rule in general, it currently will emphasize assisting parties that in good faith are trying to comply with the Rule, rather than citing violations and imposing penalties.

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Although the FAQs do not make any significant changes to application of the Rule, they do provide some insights as to issues that affected parties are concerned about, as well as the DOL's

view on certain matters. As noted above, there are any number of questions that remain, and the FAQs are expected to be the first of several pieces of DOL guidance to come. We will keep you apprised as developments arise with respect to the Rule.

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

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