Dechert LLP

The New DOL Fiduciary Rule: Impact on Mutual Fund Distribution

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The U.S. Department of Labor (DOL) has issued the final version of its "investment advice" regulation (Final Rule), which is widely expected to impact significantly the financial services industry, including registered investment companies (funds) and their sponsors and intermediaries. The implications of the Final Rule have been emerging since its release, as the fund industry has studied its terms and considered its application to current distribution structures. The Final Rule expands the definition of "fiduciary" under the Employee Retirement Income Security Act of 1974 (ERISA).

For a comprehensive overview of the Final Rule, please refer to Dechert's May *OnPoint*, which provides an in-depth discussion of: (i) the basic structure of the Final Rule and "Best Interest Contract" Exemption (BIC Exemption); (ii) the definition of "recommendation" under the Final Rule; (iii) the activities excluded from this definition; (iv) the widespread impact of the Final Rule; and (v) the effective date of the Final Rule and certain grandfathering relief.

This *OnPoint* addresses the potential impact of the Final Rule on the most common fund distribution channels, including: (i) direct sales; (ii) unaffiliated broker-dealers; (iii) affiliated broker-dealers; and (iv) 401(k) plans and other defined contribution retirement plans. Significantly, the Final Rule expressly applies to advice regarding the rollover of 401(k) distributions from 401(k) plans and individual retirement accounts (IRAs) and extends to fiduciary conduct regarding IRAs themselves. This analysis is not intended to provide a complete summary of the Final Rule and, therefore, should be read in conjunction with Dechert's comprehensive *OnPoint*. Also, today, Dechert is contemporaneously publishing an *OnPoint* on the Final Rules from the perspective of broker-dealers and their registered representatives that provide investment advisory services.

It is anticipated that the DOL will provide guidance in the form of FAQs this summer, and that such guidance will shed further light on the anticipated trends discussed herein.

Exemptions

BIC Exemption

One aspect of the Final Rule that is of major significance for the purposes of fund distribution is the BIC Exemption, which is a key aspect of the DOL's effort to overhaul ERISA's fiduciary rules. The BIC Exemption is a prohibited-transaction class exemption that generally permits "investment advice" fiduciaries to receive certain types of compensation that would otherwise be prohibited (*i.e.*, commissions, sales loads, 12b-1 fees and revenue sharing payments – collectively, "distribution-related compensation"), provided that certain conditions are met. It is anticipated that the BIC Exemption will be a primary means through which many fund intermediaries will comply with the Final Rule – thus, it will significantly impact the shape and structure of fund distribution arrangements.[1]

The conditions of the BIC Exemption include, among other requirements, adherence to "Impartial Conduct Standards," warranties, disclosure requirements (including website disclosure), and adoption of policies and procedures relating to conflicts.

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1 *See also* the discussion of the "Best Interest Contract Exemption" in Dechert's broker-dealer *OnPoint*.

The Impartial Conduct Standards require that an "adviser" provide advice that is in the "best interest" of the investor – that is, "based upon the investment objectives, risk tolerance, financial circumstances and the needs of the retirement investor" and "without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity or other party."[2]

The Impartial Conduct Standards also require that, in connection with a "recommended" transaction:

- The adviser, the financial institution or any of their affiliates or related entities may not receive direct or indirect compensation that is in excess of reasonable compensation; and

- The fiduciary may not make any materially misleading statements regarding the applicable fees, material conflicts of interest or any other matters relevant to the retirement investor's investment decision.

Entities relying on the BIC Exemption also must warrant to investors that the financial institution requires that neither the financial institution nor any affiliates (or other related parties) use or rely upon compensation practices, quotas, appraisals or performance or personnel actions, or other actions or incentives that would reasonably be expected to cause advisers to make recommendations that are not in the best interest of the retirement investor.

Advice relating to rollovers from retirement plans to IRAs is considered by the DOL to be advice in the context of a plan and therefore covered by ERISA's statutory remedies; however, advice relating to investments in an IRA or a non-ERISA plan generally is not covered.[3] To address this difference, the BIC Exemption contains a written contract requirement that is designed to provide certain quasi-ERISA remedies to investors who are not covered by ERISA and therefore would not benefit from the protections afforded by the statute. By requiring a contract for investment recommendations made with respect to non-ERISA IRAs and other non-ERISA plans, the BIC Exemption allows investors to bring contract-based (rather than statute-based) actions in state court.[4]

The BIC Exemption also prohibits an adviser from limiting an investor's rights to enforce the contract in certain ways. For example, the contract may not: (i) contain an exculpatory provision that disclaims or otherwise limits liability for breach of the terms of the contract; (ii) cause the investor to waive or otherwise limit its right to participate in a class action; (iii) cause the investor to agree to limit damages that may be sought in an individual or class action claim to liquidated damages; or (iv) require arbitration or mediation of individual claims in locations that are distant or

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2 *See* Definition of the Term "Fiduciary," 81 Fed. Reg. 68 at 21026-21029 (Apr. 8, 2016) (Final Rule Release). In this context, an "adviser" means an employee or other representative of a financial institution that provides investment advice, but not a fund adviser acting in that capacity.

3 *See, e.g.*, 81 Fed. Reg. 21,002, 21,012 ("[B]ecause the most common scenario in which Level Fee Fiduciaries need an exemption is when they make a recommendation to rollover assets from an ERISA plan to an IRA, the final exemption does not require Level Fee Fiduciaries to enter into a contract. Instead, such Retirement Investors would be able to rely on their statutory rights under ERISA in the event the applicable standards are not met."). Note, however, that a small number of IRAs are subject to ERISA.

4 An actual federal claim would generally seem to be unavailable to a non-ERISA IRA or another non-ERISA retirement plan, as ERISA would not apply. While it is theoretically conceivable that an aggrieved non-ERISA IRA or such a retirement plan might contact the Internal Revenue Service (IRS) in an attempt to have the IRS pursue the provider for excise taxes (which, if payable, would be payable only to the government), it is unclear to what extent the IRS would, as a general matter, actually seek to pursue such a course. Accordingly, this possibility is not likely to surface as the mainstream mechanism for enforcing the BIC Exemption.

otherwise unreasonably limit the ability of investors to assert the claims safeguarded by these provisions.[5] Regarding the inability to limit the possibility of class actions, note that many potential claims might be especially dependent on particular facts and circumstances surrounding any given dispute, raising some doubt as to whether the risk of class action lawsuits generally presents a practical concern.

It is widely expected that the Impartial Conduct Standards and the required warranties will make it difficult for intermediaries to receive, and for intermediaries at the firm-level to pay the financial advisers they employ, compensation that differs depending on the investment product recommended to clients (differential compensation).[6] Notably, receipt of differential compensation could significantly increase the potential liability of an intermediary at the individual and firm-level, given the possible availability of class action and individual lawsuits under the BIC Exemption.

Streamlined BIC – "BIC Lite"

A fiduciary also may seek relief under the "BIC Lite" prong of the BIC Exemption, which provides more streamlined compliance requirements that are available to: (i) a "level-fee fiduciary" (a fiduciary that receives a fee that is either based upon a fixed percentage of the assets held by the retirement investor or that otherwise does not vary with the particular investment recommended, and that similarly pays only such level fees to any financial adviser involved with the applicable advisory services); or (ii) a "bank networking arrangement" (an arrangement for the referral of retail, non-deposit investment products under which bank employees refer bank customers to an unaffiliated investment adviser, broker-dealer or insurance company). As further detailed below, BIC Lite imposes fewer requirements than otherwise imposed under the BIC Exemption and, in particular, does ***not*** require that the fiduciary enter into a written contract with the investor. The fiduciary also would not be required to meet the specific disclosure or recordkeeping requirements of the BIC Exemption. BIC Lite is designed to incentivize fiduciaries to receive and pay out level fees and to eschew differential compensation.

Direct Distribution of Fund Shares

Many mutual funds distribute their shares directly to investors. Through this channel, investors interact directly with funds and their service providers by mail, by phone through customer service call centers and through web pages maintained by funds and their sponsors.[7] Much of the information that is provided to these investors is not investment advice and is not intended to be a recommendation to take (or not to take) a particular course of action. Nonetheless,

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5 However, the BIC Exemption does permit financial institutions and advisers to mandate arbitration of individual claims, according to the DOL, so that claims which do not involve systemic abuse or entire classes of participants can be resolved outside of court.

6 Differential compensation refers to the receipt of compensation that varies by type or amount. *See* Final Rule Release, at 21033. Differential compensation could be based on a particular product, group of products or arrangement with other intermediaries, wholesalers or product manufacturers. This term refers to the payment systems currently in place (*i.e.*, commission-based fees, 12b-1 plans, revenue sharing) and is at the opposite end of the spectrum from fee-based accounts or advisers receiving compensation by the hour.

7 While the majority of funds are not purchased through direct channels, it appears that 12% of households owning mutual funds outside of workplace retirement plans purchased them directly from fund companies, fund supermarkets, or discount brokers. *See* A Review of Trends and Activities in the U.S. Investment Company Industry, 2014 Investment Company Fact Book, ICI, available here.

as discussed below, there are risks that some of these communications could be deemed recommendations, thereby implicating fiduciary status.

Potential Impact on Fund Service Providers

The Final Rule generally does not directly regulate registered funds or their primary service providers. Funds, their boards of directors/trustees and investment advisers are not, and will not be, deemed to be fiduciaries under ERISA by virtue of their fund management activities. Funds' principal underwriters, acting as such, also generally will not be deemed to be ERISA fiduciaries, unless they are providing fiduciary advice in connection with their sales/marketing activities.

Nonetheless, the distribution channels that involve fund sponsors and distributors directly communicating with investors (whether investor accounts are held at the fund transfer agent or through a supermarket or other intermediary) may well be affected by the Final Rule. To the extent that a fund service provider's materials and communications with customers rise to the level of a recommendation, the service provider could be deemed a fiduciary. For example, if an intermediary or fund representative (*i.e.*, call center) merely discusses with a plan participant whether the participant should (or should not) roll over an IRA account, the communication could rise to the level of a recommendation, potentially triggering fiduciary status. Accordingly, fund service providers that communicate directly with investors may need either to take steps to minimize the risk of being deemed an ERISA fiduciary, or to accept that role and bear the consequences.

- <u>Service/Call Centers</u>: Fund distributors and transfer agents who operate service or call centers could be deemed to be ERISA fiduciaries if their employees provide recommendations to shareholders tied to retirement accounts (*e.g.*, IRAs). To the extent that these employees communicate to investors more than simply information about funds – *e.g.*, discuss the merits of the funds – those communications could be considered "recommendations" and thus risk fiduciary status. While many call centers are intended to serve only as sources of non-investment information, some direct-selling fund managers have service center personnel whose responsibilities include discussing the merits of certain investments. Depending on the type of call center(s), the fund complex may need to closely scrutinize whether call center communications trigger the Final Rule.

- <u>Websites</u>: Statements on fund websites could be interpreted as rising to the level of a recommendation, and therefore as crossing the fiduciary line.

In light of the compliance burdens imposed by the Final Rule, funds and their sponsors will need to decide whether some portion of the information provided to customers through these means is intended to constitute a recommendation and will need to engineer processes and train employees either to comply with the relevant policies and procedures or to avoid statements that could be deemed recommendations covered by the Final Rule. Fund websites may need to be comprehensively reviewed, and additional information posted to the website will need to comply with the fund sponsor's policies on fiduciary status.

Funds and their sponsors may be able to rely upon certain exceptions from the Final Rule for general communications, investment education and asset allocation models. However, the restrictions that apply to parties seeking to qualify for these exceptions may limit their usefulness, since the exceptions are designed to prohibit communications that could constitute recommendations of specific investments. Funds and their service providers also may rely upon the counterparty transactions exception for fund wholesalers that are dealing with investment professionals (such as a registered representative of a broker-dealer or a registered investment adviser).[8]

Distribution through Unaffiliated Broker-Dealers

Unaffiliated, full-service broker-dealers constitute one of the most important distribution channels for the fund industry. Through a wide variety of types of services and programs, these intermediaries often provide advice and recommendations to individuals regarding their IRAs, including advice relating to rollovers from employer-sponsored retirement plans to IRAs. These broker-dealers, depending on the program and the client, may be paid with commission-based compensation (in the form of sales loads and 12b-1 fees) or asset-based fee compensation paid from the client's account. Many such broker-dealers also compensate the professionals who advise clients (financial advisers) using a schedule (often called a payout grid) that sets the amount or rate of compensation paid to the financial adviser for each investment product sold. Payout grids are frequently tied to the amounts of compensation that the broker-dealer receives from the sales load and other charges, which can result in differential compensation paid to the financial adviser. Under the Final Rule, these practices face a number of challenges, which are widely expected to lead broker-dealer intermediaries to consider restructuring payout grids and other compensation in ways that have not yet been determined. As discussed below, these changes could have a powerful impact on fund distribution practices.

Direct Impact on Intermediaries

Under the Final Rule, many of these broker-dealer intermediaries would be deemed ERISA fiduciaries with respect to advice and recommendations relating to rollovers from retirement plans to IRAs and to advice and recommendation to plan participants and beneficiaries as to how they should invest the distribution of their benefits. As ERISA fiduciaries, these intermediaries would be subject to duties of prudence and loyalty and, absent an exemption, would be prohibited from receiving (or limited in their ability to receive) distributed-related compensation and sub-transfer agency fees with respect to the investment products they recommend. An intermediary providing fiduciary advice to non-ERISA IRAs would be subject to the prohibited transaction provisions of the U.S Internal Revenue Code, which generally correspond to ERISA. However, as described below, the BIC Exemption may offer broker-dealer intermediaries a path to continue to receive such payments.

Reliance on the BIC Exemption or BIC Lite

The BIC Exemption will allow fiduciary intermediaries to continue to receive distribution-related compensation from funds and fund sponsors whose products they recommend, provided that the conditions of the BIC Exemption are met. In particular, the broker-dealer intermediary would have to comply with the Impartial Conduct Standards, and thus would have to provide advice that is in the best interest of the investor "without regard to the financial or other interests" of the broker-dealer. This latter requirement has raised concerns that broker-dealers that receive different levels of compensation from funds and their sponsors, or that incorporate differential compensation into their adviser payout grids, could be challenged for not acting in the best interest of investors, even though such compensation may be permitted under the BIC Exemption. This concern is amplified by the availability of private class action lawsuits, as

[8] For further information regarding these exceptions (including, among others, the counterparty transactions exception), please refer to Dechert's comprehensive *OnPoint* and to Dechert's broker-dealer *OnPoint*.

it is not hard to imagine the plaintiffs' bar launching suits against any broker-dealer that receives or pays out differential compensation in any meaningful amount.[9]

As noted above, the Final Rule provides less onerous requirements under BIC Lite, which is available only to advisers who agree to limit their compensation for selling investment products to a level fee. However, under BIC Lite, a broker-dealer cannot offer proprietary funds or unaffiliated funds pursuant to which the broker-dealer receives 12b-1/distribution fees or revenue sharing payments. A broker-dealer relying on BIC Lite also would be subject to the Impartial Conduct Standards. Because reliance on BIC Lite would require an even more serious departure from traditional broker-dealer fund distribution models, it remains to be seen how widely BIC Lite actually will be relied upon by intermediaries.

Potential Compensation Arrangements

The DOL attempted to provide some clarity to intermediaries regarding the potential for liability created by the intersection of the best interest standard with fund and fund sponsor payments. The adopting release for the BIC Exemption describes examples of several compensation arrangements, analyzed below, for intermediaries' personnel that generally would not violate the Impartial Conduct Standards. While some broker-dealers may enter into these arrangements, most of them represent a significant departure from existing compensation models, and thus it is not clear how widely any of these arrangements will be adopted.

Algorithm-Based Advice

A fiduciary broker-dealer may receive any amount or form of compensation related to advice provided in accordance with an unbiased computer model created by an independent third party, where the advice is conveyed by an individual person. The basis for this example appears to be the DOL's position that automated (or "robo") advice will help avoid conflicts and lower the cost of advice. The advice would have to be conveyed by a "live" adviser in a hybrid arrangement, since the BIC Exemption is not available for pure robo advice.[10] Most broker-dealers' traditional offerings, particularly for clients with larger accounts, are centered on personal advice from a financial adviser. Relying on third-party automated advice may undermine the broker-dealer's value proposition for these offerings. Nonetheless, some broker-dealers may find these arrangements to be an appealing way to service smaller accounts that would not be economical in fee-based arrangements, or to avoid the orphaned accounts (discussed below under Anticipated Trends).

Financial Adviser Asset-Based Compensation

Under the BIC Exemption, a fiduciary broker-dealer may receive differential compensation, provided that its financial advisers are paid only compensation based upon the dollar amount of assets held by the retirement investor, regardless of how the retirement investor's assets are allocated among different investments. Of the DOL's examples, this arrangement represents the least amount of change from the existing compensation models of broker-dealer intermediaries, since these intermediaries would be able to receive the same types of compensation from funds and fund sponsors. However, payout grids will need to be revised to make sure that no advisory personnel are provided with differential compensation. In addition, doing so may make it less attractive for fund sponsors to make

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9 This is not to say that such lawsuits would necessarily be successful. However, most intermediaries can be anticipated to take steps in an effort to avoid such actions and the negative publicity that they could engender. Also see discussion in summary of BIC Exemption, above.

10 *See* "Best Interest Contract Exemption," 81 Fed. Reg. 68 at 21058 (April 8, 2016).

revenue sharing and related payments (*e.g.*, for preferred status) to broker-dealers, since the latter would not be able to incentivize financial advisers to recommend the sponsor's funds. Reliance on this arrangement also could be disruptive to financial advisers, since the net effect of a level payout grid could be to lower advisers' compensation, with possible negative effects on a firm's ability to recruit and retain financial advisers.

Fee Schedules with Rebates

A fiduciary broker-dealer may receive transaction-based compensation, such as sales loads, commissions and 12b-1 fees, under a fee schedule for the broker-dealer and its financial advisers, under which the broker-dealer: (i) may charge fees to the retirement investor in the case that payments from third-party providers do not satisfy the scheduled fees; and (ii) must rebate fees to the retirement investor in the case that fees received from third-party providers exceed the financial institution's scheduled fees. This arrangement appears to be designed to allow intermediaries to recommend funds that make higher 12b-1/distribution payments than other funds that the intermediary recommends. However, the administrative burdens of correctly identifying and paying rebates may well make this arrangement a less attractive option for broker-dealer intermediaries, and those institutions will likely pressure funds with higher fees to standardize their fee levels to align with those of the majority of other funds sold on the broker-dealer's platform.

Compensation Based on Time and Expertise

A fiduciary broker-dealer may pay its financial advisers differential compensation based solely upon the time and expertise necessary to provide prudent advice with respect to the product, or other factors that would be neutral with respect to recommendations made to the retirement investor, but only if the broker-dealer also adopts a stringent supervisory structure to ensure that recommendations satisfy the Impartial Conduct Standards. According to the DOL, the arrangement would not be permitted to provide an incentive to recommend one fund over another or one type of product over another. This compensation model would represent a significant departure for many broker-dealer intermediaries and would likely require the reshaping of a firm's operations, supervisory structure and culture, at a significant expense and with little immediate benefit. Thus, it is arguably unlikely to be adopted by many broker-dealers.

Decisions Faced by Broker-Dealer Intermediaries Advising IRAs

Broker-dealer intermediaries advising IRAs will face many challenges, including product changes and determining which exemptions offer the most promising path. How these intermediaries choose to meet these challenges will have a significant impact on fund distribution arrangements, which is analyzed below.

Deciding Between the BIC Exemption and BIC Lite

Broker-dealer intermediaries offering services to IRAs are faced with first deciding whether to limit their services in order to avoid giving "investment advice," and thereby avoid compliance with the BIC Exemption. If the broker-dealer decides not to so limit its services, it must then decide either: (i) to accept the general conditions of the BIC Exemption (particularly the liability exposure) in order to accept 12b-1 /distribution and revenue sharing payments; or (ii) to rely upon BIC Lite. Even if the broker-dealer decides to rely upon the BIC Exemption, the liability provisions may create pressure to limit or eliminate the receipt of 12b-1/distribution and revenue sharing payments for non-IRA accounts.

While broker-dealer intermediaries that rely on BIC Lite will not be able to receive revenue sharing payments, those relying on the BIC Exemption may do so, but would have to disclose those payments and face potential class action liability. For this reason, some have speculated that broker-dealer requests for revenue sharing payments will abate. However, it is not clear how broker-dealers will replace this revenue. Requests for increased payments for sub-transfer agency services likely would run into increased Securities and Exchange Commission (SEC) and fund board scrutiny based on the concern that such payments may constitute "distribution in guise."[11] Over time, broker-dealers may come to build this revenue into account-level fees. Their ability to do so will clearly vary with the fee tolerance of their clients and clients' perception of the value of the broker-dealer's service offerings.

Potential "Bleed-Over" Effect

There also is the possibility that there will be a bleed-over effect from broker-dealers' IRA accounts to non-IRA accounts. Given that broker-dealers will have IRA fee and compensation models as well as policies and procedures designed to comply with the Impartial Conduct Standards, and will make disclosures about the potential conflicts these present, these broker-dealers may decide also to apply the same measures to their non-IRA accounts. Otherwise, they may be vulnerable to investor confusion and pressure, as well as to potential class action liability on non-IRA accounts. The greater the bleed-over effect, the more significant the impact of any related changes on fund distribution arrangements.[12]

Potential Demand for New Share Classes

Commenters have speculated that broker-dealer intermediaries could insist on using fund share classes that have no distribution charges or 12b-1 fees, or at least are the lowest fee share class, out of concern that the plaintiffs' bar could launch class action lawsuits alleging that the use of higher expense share classes was not in the best interest of investors and was therefore a breach of fiduciary duty.[13] Fund sponsors that do not have comparable share classes could be asked to create them. However, it is not clear that such share classes would be different from those currently offered by many fund sponsors.

The Impartial Conduct Standards are designed to incentivize and pressure fiduciary intermediaries not to pay differential compensation to financial advisers, and not to receive differential compensation from funds and fund sponsors. Thus, broker-dealers will face greater challenges if the various distribution, revenue sharing and other payments they receive with respect to the various fund share classes they recommend differ from fund to fund and/or from sponsor to sponsor. Broker-dealer intermediaries therefore have good reason to encourage funds and their sponsors to standardize their payments, either overall or for certain common types of share classes (*e.g.*, retail and institutional). Commenters have speculated that the larger broker-dealer intermediaries may request such standardized payments, and that mutual funds and their sponsors will have to accommodate them.[14] If this dynamic

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11 *See* Mutual Fund Distribution and Sub-Accounting Fees, Investment Management Guidance Update No. 2016-01 (Jan. 6, 2016), available here.

12 However, as noted in Dechert's comprehensive *OnPoint*, open questions include whether (i) if a broker-dealer re-crafts its disclosure and training for retirement investors, those changes will be implemented across the board for other (non-retirement) customers; (ii) a broker-dealer will be willing to give a customer one level of disclosure for the customer's retirement accounts and another (presumably lesser) level of disclosure for the customer's non-retirement accounts; and (iii) if broker-dealers do standardize their disclosure and training practices and extend them to nonretirement customers and accounts, how this will affect the regulatory efforts of the SEC.

13 Ignites Exchange: How B-Ds, Fund Shops are Prepping for DOL's Fiduciary Rule, Webcast (June 28, 2016).

14 Figuring out Fiduciary, Investment News, Liz Skinner (May 9, 2016).

plays out, it is not clear whether the industry will coalesce around one or a few standard share classes, or broker-dealers each will set their own payment schedules, leading to a proliferation of share classes.

In response to some of these tough decisions, it is possible that the broker-dealer community may seek SEC exemptive relief from Section 22(d) of the Investment Company Act of 1940 to allow imposition of sales loads at the broker-dealer, rather than the fund, level.[15] If they could do so, they could receive differential compensation (from their clients) and still rely on BIC Lite. While in the past the SEC staff has been sympathetic to limiting the effect of Section 22(d) to allow competition among broker-dealers to set sales loads,[16] it is unclear whether the SEC would take this action without conducting a detailed examination of the history and policy objectives of the Final Rule.

Fund Supermarkets

Many funds are made available to investors through fund supermarkets, which are financial institutions (generally broker-dealers) that offer a large menu of funds. Fund supermarkets typically allow investors to establish and maintain accounts through which they may hold a variety of funds from different managers. Supermarket sponsors provide funds and their shareholders a range of services, including: custody of fund shares; consolidated account statements and tax reporting; transaction processing and confirmations; payment of fund distributions; and provision of fund prospectuses and other fund documents and filings. Supermarkets also may offer distribution services (*e.g.*, website advertising). Fund supermarket sponsors are typically compensated for these services through one of two means: (i) the investor pays the sponsor a transaction fee; or (ii) the underlying funds, their managers and/or their distributors or other affiliates, alone or in combination, pay the sponsor a percentage of the fund's assets held at the supermarket. Fund payments may either be pursuant to Rule 12b-1 plans (where the fund's board deems all or some portion of these payments to be primarily intended to result in fund distribution) or under shareholder service plans or contracts that are not subject to a Rule 12b-1 plan (where the board determines that the supermarket's services are for administrative services or otherwise are not primarily intended to result in fund distribution).

Fund supermarkets typically do not solicit investors to purchase shares of any particular funds; however, they often communicate with investors through the supermarket's websites, call centers and financial consultants. While many of these communications address administrative matters, they sometimes relate to the merits of individual funds. For example, some supermarkets' websites provide algorithms that allow an investor to select or rank funds using certain characteristics and asset allocation models that suggest portfolios of funds given an investor's stated goals and risk preferences. Some supermarket sponsors offer IRAs, and their websites and personnel may offer assistance with rollovers.

Supermarket sponsors face similar choices with respect to these communications as do mutual fund sponsors for their own service/call centers and websites (discussed above under Direct Distribution of Fund Shares). Supermarket sponsors will need either to take steps to minimize the risk of being deemed an ERISA fiduciary, or to accept that role and its risks and consequences. Supermarket sponsors that aim to avoid fiduciary status may be able to rely upon the exceptions from the Final Rule for general communications, investment education and asset allocation models noted above; these exceptions may be more useful for supermarket sponsors than for fund managers, since many supermarket communications do not aim to recommend specific investments.

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15 *Id.*; Assessing the New DOL Fiduciary Rule: Policy and Practical Challenges, ICI Conference (May 10, 2016).

16 Proposed Rule: Mutual Fund Distribution Fees; Confirmations, SEC Release Nos. 33-9128 and IC-29367, at Sec. III.I.1 (July 21, 2010).

Even where a supermarket's sponsor chooses to provide services as an ERISA fiduciary, the effect may not be as significant as for full-service broker-dealers, since supermarkets often rely less on differential compensation. Both transaction fees and non-transaction fee supermarket payments tend to be more standardized, and supermarket sponsors' compensation to their financial consultants and other personnel often does not vary with the funds that they recommend or sell. Thus, supermarket sponsors may find it easier to comply with the conditions of the BIC Exemption or BIC Lite, and the fiduciary rule may have a smaller impact on fund supermarkets than on full-service broker-dealers. Nonetheless, the risk of liability or the desire to receive only level fees may incentivize some supermarket sponsors to standardize their non-transaction fee schedules even further, and funds and their managers may find it even more difficult to negotiate exceptions to these schedules.

Anticipated Trends

Analysts have pointed out that the pressures described above will likely lead broker-dealer intermediaries to shift many client accounts to programs with asset-based fees, amplifying a long-existing trend. However, lower-balance accounts are less profitable or even unviable for many broker-dealer intermediaries' fee-based programs, which could lead intermediaries to "fire" certain clients,[17] resulting in orphaned accounts. The DOL has long understood this dynamic, and seems to believe that robo-advisers and other low-cost advisers not relying upon the BIC Exemption could absorb these accounts. Whether the DOL is correct remains to be seen.

There could be product-level impacts as well. Fiduciary intermediaries may be less willing to recommend alternative or other specialty funds because those funds may be viewed as more expensive, less liquid or more risky than other options and thus vulnerable to class action lawsuits. Fiduciary intermediaries may exhibit a preference for single share class funds since, where a fund has multiple share classes, intermediaries may need to substantiate any advice to purchase one share class (particularly a more expensive one) over another.

Commentators have pointed out that, all other things being equal, larger broker-dealers will be better able than smaller broker-dealers to afford the additional compliance expense and liability exposure created by the BIC Exemption, as well as the recordkeeping and tracking burdens imposed by the Final Rule.[18] A possible effect would be to incentivize more consolidation in the broker-dealer industry.

To a certain degree, the incentives and changes created by the Final Rule likely will reinforce the pre-existing trends toward fee-based accounts and consolidation in the broker-dealer intermediary business.[19] However, it is too early to determine which, if any, of these anticipated trends will take effect: for example, the larger firms in a consolidated broker-dealer industry with even more negotiating power could insist on custom share classes. It seems certain, however, that this distribution channel faces a period of uncertainty and flux in the near- to medium-term, and that when these effects have surfaced, many accounts will have moved, accompanied by many redemptions and purchases of fund shares.

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17 *See, e.g.*, The Economics of Change: How the DOL Fiduciary Rule Will Set Money in Motion and Alter Business Models Across the Advice Industry, Investment News Research and Legg Mason Joint Study (May 6, 2016).

18 *See, e.g.*, Assessing the New DOL Fiduciary Rule, *supra* note 10.

19 Final Department of Labor Rule's Effects Are Substantial, Morningstar Equity Research (May 17, 2016).

Affiliated Broker-Dealers

Some fund complexes are distributed partially or primarily through an affiliated broker-dealer. A primary advantage of this distribution model is that the fund complex can rely upon a network of financial advisers who understand and are well trained in the features of the funds. While, for a variety of reasons, the affiliated broker-dealer distribution model is less prevalent than it once was, a number of significant fund complexes rely on this model. For these fund complexes, the challenges discussed above, under Distribution through Unaffiliated Broker Dealers, may be more accentuated.

Affiliated broker-dealers that comply with the BIC Exemption may continue to recommend proprietary funds; however, the conditions to the BIC Exemption are designed to render the affiliated broker-dealer "impartial" and appear to be designed to create heavier burdens for affiliated broker-dealers.[20] Notably, while compliance with the BIC Exemption means that the broker-dealer's receipt of compensation is not automatically prohibited, it may still be questioned. Broker-dealers that restrict their recommendations, in whole or in part (*e.g.*, regarding a specific type of product), to proprietary products must disclose these restrictions and the related material conflicts of interest, among other requirements. In order to qualify for the BIC Exemption, broker-dealers offering proprietary products still must reasonably conclude that: (i) the limitations will not cause the receipt of compensation in excess of reasonable compensation; and (ii) the policies, procedures and incentive practices will not result in imprudent investment recommendations or the failure to act impartially when making investment recommendations.[21]

Thus, the burden remains on the broker-dealer to demonstrate that recommending a proprietary fund is in the best interests of the client. This burden may be harder to meet in light of possible class action litigation: irrespective of the relative merits of the affiliated broker-dealer model, the plaintiffs' bar is more likely to accuse a broker-dealer of bias when recommending a proprietary fund. Because of this greater potential exposure, the affiliated broker-dealer model could face additional compliance burdens to demonstrate and document that recommending a proprietary fund is in the client's best interest.

In sum, the Final Rule may create incentives and pressures for broker-dealers recommending proprietary funds: (i) to eliminate differential compensation; (ii) to open their architecture to include more non-proprietary funds; and (iii) to document even more thoroughly that the basis for recommending a proprietary fund is in the client's best interest.

401(k) Plans

Recommendations of funds to 401(k) plan sponsors and participants are at the core of the Final Rule. Since mutual funds are among the most widely-used 401(k) plan investment options, the Final Rule will significantly impact how mutual funds are sold to 401(k) plan sponsors, as well as the communications between funds and plans. Communications with 401(k) plan sponsors regarding funds as plan options implicate the Final Rule in at least two common ways.

First, many plan sponsors, particularly for larger plans, rely upon a third-party administrator (TPA) to make available to the plan sponsor and fiduciary an array of funds; these funds are often narrowed by third-party investment consultants into a menu of fund options for plan participants. The plan fiduciary is then expected to select and monitor

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20 *See also* the discussion of "Proprietary Products" in Dechert's broker-dealer *OnPoint*.

21 As noted above, BIC Lite is not available for recommendations to invest in proprietary funds.

investments that are offered on the platform. The TPA and the consultant can be paid out of plan assets, by the sponsor, or by funds selected through 12b-1 or service fees.

Second, many plan sponsors, often for smaller plans, rely upon broker-dealer intermediaries to help them design their plans, including investment options. These intermediaries are frequently compensated in part using distribution-related compensation.

As discussed below, these two pathways lead to several different permutations of how TPAs and broker-dealer intermediaries can continue to receive compensation for advising retirement investors.

Platform Provider Exception

TPAs may be able to rely on the platform provider exception to the definition of "advice." This exception allows a service provider such as a TPA to provide an "off the rack" selection of investment options to an independent fiduciary of an ERISA plan without being deemed to be a fiduciary under the Final Rule. To comply with the conditions to the exemption, the platform provider must disclose in writing to the fiduciary that the provider is not undertaking to provide impartial advice and is not acting as a fiduciary. It should be noted, however, that this exception is not available for IRAs and non-ERISA plans.

Activities that fall within the exception include: (i) identifying investment alternatives that meet objective criteria specified by the plan fiduciary (such as expense ratios, fund size and type of asset or credit quality); (ii) responding to RFPs, requests for information or similar solicitations with a sample line-up of investments based only on the size of the employer or plan or the current investment alternatives under the plan; and (iii) providing objective financial data regarding investment alternatives.

A platform provider that identifies a line-up of investment alternatives must disclose any financial interest in any of the alternatives, as well as the precise nature of any such interest. Many TPAs offer affiliated funds in their line-ups. However, as plan service providers, TPAs already are required to provide extensive disclosures on Form 5500 to plan sponsors regarding the TPA's compensation. Thus it is not clear whether the disclosure requirements will lead plan sponsors to put any meaningful pressure on TPAs not to include affiliated funds.

"Investment Education" Exception

Certain investment-related information and materials are considered general investment education and are excluded from the scope of communications that are treated as a recommendation under the Final Rule. Such investment education materials may be categorized generally as: (i) plan information; (ii) general financial, investment and retirement information; (iii) asset allocation models; and (iv) interactive investment materials.

Fund sponsors and TPAs may rely extensively on the Investment Education exception to communicate in particular with plan sponsors and participants. However, this exception is designed to prevent tailored advice and recommendations of specific investment options, and thus may not provide enough leeway for those seeking to persuade plan sponsors and participants to use particular funds.

Counterparty Transactions Exception

The Final Rule includes an exception for counterparty transactions, which covers any advice given to certain fiduciaries of a plan that are capable and independent of the adviser with respect to an arm's length transaction – the so-called "seller's carveout." To rely on the exception, among other conditions, a fund sponsor or adviser must inform the fiduciary that the sponsor or adviser is not impartial and cannot receive compensation from the plan or the fiduciary. Generally, this exception will not be available for communications directed to retail investors (including small retail 401(k) plans), because such investors are not typically represented by an independent fiduciary.

401(k) Plans Relying on Broker-Dealers Compensated Through 12b-1 Plans

Many 401(k) plans, including many smaller plans, that receive advice from broker-dealers that are compensated with 12b-1 and/or sales charges will have to navigate a more challenging environment going forward. These broker-dealers will have to rely on the BIC Exemption or BIC Lite to make recommendations to plan sponsors and participants, and thus will be subject to pressures similar to those applicable to unaffiliated broker-dealers, described above. In particular, some have speculated that such broker-dealers will experience pressure to use fund share classes that have no distribution charges or 12b-1 fees, or at least are the lowest fee share class. However, doing so would be inconsistent with their current compensation model, and the broker-dealers would have to charge the plan or its sponsor directly for their services. In fact, the reason that many plan sponsors, particularly those of smaller plans, rely on such broker-dealers is that the sponsor and the plan do not have the resources to pay directly for the broker-dealer's advice.

Despite potential disadvantages, broker-dealers offering 401(k) plans may restructure their offerings and their internal compensation systems to comply with the BIC Exemption so that they can accept 12b-1 fees and other differential compensation, due to the absence of alternative compensation models.

Conclusion

Of the distribution channels discussed above, while the direct distribution model may face meaningful compliance and training burdens, it likely will undergo relatively limited changes in response to the Final Rule.[22] Instead, the primary focus for funds will be on how the Final Rule impacts provider platforms and distributors of fund shares. As detailed above, each of the novel compensation structures proposed by the DOL in the Final Rule Release presents distinct challenges given the current compensation structure of the financial services industry. Although affiliated and unaffiliated broker-dealers alike will experience significant challenges in marrying compliance with a viable business model, affiliated broker-dealers face particular challenges. It remains to be seen how broker-dealer intermediaries will respond to the Final Rule, whether they will restructure their 401(k) offerings and, in particular, whether they will choose to rely on the BIC Exemption. Further, the sale of mutual funds to 401(k) plans and participants will also require compliance with the Final Rule, especially when TPAs and broker-dealer intermediaries are involved.

With the Final Rule coming into force in April 2017, and full compliance with the BIC Exemption required no later than January 2018, industry participants are busy weighing their compliance options and digesting the business impact of the Final Rule.

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[22] While funds will likely include certain disclaimers on their websites and marketing information, and will probably train outward-facing personnel to appropriately respond to retirement investor inquiries under the new fiduciary standard, the direct-distribution channel will not experience the overhaul that the broker-dealer/intermediary channel will experience.

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