“Bullet Proofing” Insurance Company Sales of Qualified Plan Services & Products

An Evaluation and Review of the
DOL Fiduciary Rule and
Current Wave of Fee Litigation

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The DOL Fiduciary Rule
Critical Issue – Impartial Conduct

Best Interest
No Misleading Statements
Reasonable Compensation

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Update on DOL Rule

• General status
  – Applicable to ERISA plans, self-employed plans, and IRAs
  – What is fully in effect (since June 9):
    • The rule itself: expanded scope for what is considered fiduciary advice
      – Most anything that was fiduciary before is still fiduciary; much more added
    • Impartial conduct standards under new and revised prohibited transaction exemptions (PTEs)
  – What is scheduled to go into effect January 1, 2018: remaining elements of new and revised PTEs
    • Exclusion of variable and fixed index annuities from PTE 84-24
    • A host of requirements and limitations in Best Interest Contract Exemption (BICE)
    • DOL proposal would delay these elements for 18 additional months: final guidance expected within weeks
Update on DOL Rule

• Breaking it down
  – The rule
    • Expanded scope covers recommendations – “calls to action”, one-time or ongoing
      – to buy, sell, hold;
      – to take and/or rollover a distribution; and/or,
      – of an unaffiliated third party fiduciary
    • Excluded from definition, and thus from fiduciary status: but only if related requirements are met
      – Education: to plan sponsor, plan participant, IRA investor
      – Offering of platform to plan fiduciary: with no recommendation
      – Recommendations to independent fiduciary with financial expertise
      – “Hire me” conversations for self or affiliate as fiduciary adviser
Update on DOL Rule

• Impartial Conduct Standards
  – Three Requirements:
    • Adviser must act in best interest of Plan or IRA at time of transaction;
    • Adviser makes no materially misleading statements;
    • Reasonable compensation is paid to the Adviser.
  – Breaking it down:
    • Best Interest: suitable, prudent, with regard only to interests of client.
    • No Misleading Statements: straightforward; or more than meets the eye?
    • Reasonable compensation: evaluation shifted from buyer to seller – combined total of all fees and compensation does not exceed standards under 408(b)(2) and 4975(d)2.
Proposed Uniform Standard of Care
**UNIFORM STANDARD OF CARE**

*Goal: Approved by Industry, Regulators, and Consumer Groups*

### “ABOVE THE LINE” UNIFORMITY

- Uniform (Plain English) Definitions
  - Best Interest
  - Conflicts of Interest

- Uniform Disclosure Requirement
- Compensation Neutral
- Transaction Based

### Common Uniform Definitions:

A recommendation is in the “Best Interest” of the consumer when the [advisor/rep/broker/insurance producer]:

- puts the consumer’s interest first before the financial interest of the [advisor/rep/broker/insurance producer];
- acts with reasonable care, skill, prudence and diligence in gathering and evaluating the Consumer’s Profile information used to make the recommendation;
- makes no misleading statements;
- provides full disclosure of the recommended [investment/insurance product]’s features, fees, and charges;
- fairly discloses how and by whom the [advisor/rep/broker/insurance producer] will be compensated, and
- avoids, discloses or reasonably manages Material Conflicts of Interest.

“Material Conflict of Interest” means a financial interest of an [advisor/rep/broker/insurance producer] that makes a recommendation that a reasonable person would expect to affect the impartiality of such recommendation.

### Common Disclosure Requirement:

Material Conflicts of Interest must be disclosed at or prior to the point of sale or at the time the recommendation is made (no requirement for more frequent or annual disclosures). This disclosure must include:

- the types and scope of services provided;
- the types of compensation received by the person making the recommendation (or related party) or that the customer may pay as a result of the recommendation.

### Common Guiding Elements:

**Neutrality** – The uniform standard of care is neutral to business model, product type, and compensation approach such as commissions, fees, hourly rates, or sales charges, or other fees or variable compensation.

- The fact that an advisor or firm only offers or recommends proprietary or a limited range of products or product types or receives commissions or other variable compensation shall not be inconsistent with this uniform standard of care.
- The uniform standard of care does not require a recommendation of the least expensive or “best” product available.

**Transaction Based** – Unless otherwise agreed to in writing by the advisor and consumer, the uniform standard of care is a transaction-based standard that is applied when a recommendation is made, and there is no further or ongoing obligation under the standard.
Goal: Approved by Industry, Regulators, and Consumer Groups

“ABOVE THE LINE” UNIFORMITY

Uniform (Plain English) Definitions
• Best Interest
• Conflicts of Interest
Uniform Disclosure Requirement
Compensation Neutral
Transaction Based

STATES
SEC
DOL

FINRA (BD)

Rulemaking

Rulemaking

Rulemaking
Common Uniform Definitions

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Litigation Discussion

• Potential Litigation During the Transition

• The Current Wave of Fee Litigation
Insurer Exposure to Qualified Plan Litigation

• **Issues:**
  – Areas of Attack/Concern
    • Fiduciary Conduct Exposure
    • Co-Fiduciary Conduct/Exposure
    • Non-Fiduciary Conduct
  – Conduct Creating Status
    • Investment Advice
    • Discretion Over Plan
      – Investments
      – Management
      – Administration
  – Categories of Exposure Allegations
    • Excessive Fees
    • Improper Investments
    • Improper/Inadequate Disclosure
    • Co-fiduciary liability
Issues During the Transition Period

• Potential for “Fiduciary” litigation
  – ERISA Standards
    • Only for Qualified Plans
  – State Law Standards (IRA Advice & Sales)
    • Recent Precedents
    • Recommendations

• Potential for Class Action
  – State Law Standards
  – Recommendations
The Current Wave of “Excessive Fee” Litigation

• Beginning in 2011, a number of excessive fee cases were filed.

• The Investment Company Act cases largely feature two themes involving subadvisory services:
  1. The fee is allegedly excessive because the manager-defendant delegates advisory services to a subadviser, but keeps a disproportionate amount of the fee; and/or
  2. The fee is allegedly excessive because the manager-defendant provides similar advisory services to other funds as a subadviser at a lower fee.

• The ERISA cases require additional allegations regarding alleged breaches of fiduciary duty or prohibited transaction allegations
Adviser/Sub-Adviser
Investment Company Act

• **Section 36(b):** “[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser.”

• **The Gartenberg Standard:** Courts consider all relevant factors, including:
  – The nature and quality of the services provided;
  – The profitability of the fund to the adviser-manager;
  – Fall-out benefits;
  – Economies of scale;
  – Comparative fee structures; and
  – **The independence and conscientiousness of the trustees.**
Sivolella v. AXA Equitable Life Ins. Co.  
(D.N.J. filed 2011)

- Plaintiffs’ Theory: The primary adviser allegedly delegated services to subadvisers, but kept a disproportionate amount of the fee.
- Defendants prevailed after a 25-day bench trial.
- The court credited the board’s process and decision-making:
  - The board’s fee-approval process was directed by an independent lead director;
  - The board had sufficient diversity of expertise, even though most individuals had backgrounds in financial services;
– New board members were identified by an executive search firm and benefited from a comprehensive training regimen;
– The board received information about the funds and the adviser’s fee from multiple sources other than the adviser; and
– The evidence demonstrated that the board was active and participated in preparing and requesting materials regarding the adviser’s fee.
Adviser/Sub-Adviser - ERISA

• **ERISA Fiduciary Duty:**
  – Allegations
    • General allegation – record-keepers offer advisory services to plan participants through contracts with Financial Engines or other comparable adviser.
    • Fees are paid (shared) by Financial Engines to record-keepers
    • Alleged “pay to play” by Financial Engines
  – Violation
    • Recordkeeper becomes fiduciary by appointing FE or other adviser.
    • Recordkeeper breaches fiduciary duty by receiving fees for no services
    • Recordkeeper engages in PT by receiving excessive compensation
Adviser/Sub-Adviser - ERISA

- **Fleming v. Fidelity Management**
  - Allegations
    - Record Keeper (Fidelity) “hired Financial Engines” & is fiduciary
    - FE gave up 45 basis pts to get on platform to render advisery service – “pay to play” – fiduciary breach
    - Caused price of advisery services to be inflated by selecting higher priced shares (revenue sharing) in Brokerage Link
  - Motion to Dismiss Granted – No fiduciary; No PT
    - “Product Design” chosen by plan sponsor, not Fidelity
      - Fidelity not fiduciary in negotiating own comp
      - Fidelity not fiduciary in designing product before offering Brokerage Link to plan sponsor
  - No Prohibited Transaction
    - Agreements on revenue sharing made prior to engagement of services by Plan
Adviser/Sub-Adviser - ERISA

• **Patrico v. Voya:**
  – Allegations
    • Participant advice platform – VRA Adviser; FE platform subadviser
    • Allegation - FE provides all services
    • Allegation - Portion of fee paid to VRA/ Adviser – excessive because provides no services
    • Allegation - Breach of fiduciary duty and prohibited transaction
  – Motion to Dismiss Granted: No Fiduciary Breach; No PT
    • No claim Voya “controlled” compensation decision – Plan sponsor controlled
    • No claim any “fiduciary” caused the plan to pay “excessive” compensation
    • Status: Motion to Amend Pending
Revenue Sharing/ Record Keeper Cases

• **Rosen v. Prudential:**
  – Allegations:
    • Prudential – Service provider for Platform of funds: Prudential Trust offered “Goal Maker” select group of investment options; Prudential group annuity contract (part of platform option)
    • Allegation – platform concentrated on actively managed funds that provided revenue sharing
    • Prudential – self-dealing through the revenue sharing
    • Goal Maker – only high-cost options – breach of duty
  – Issues: MTD
    • Prudential a fiduciary due to ability to choose funds?
    • Is revenue sharing a violation of ERISA?
    • Separate Account expenses and Goal Maker high cost funds – fiduciary breach?
Revenue Sharing/ Record Keeper Cases

- Status Court granted MTD
  - Prudential not a fiduciary:
    - Getting revenue sharing – does not make one a fiduciary
    - Pegram – “only a fiduciary if have discretion” – no authority to make decision on funds – required notice and approval from plan sponsor
    - No excessive fees – not a fiduciary because cannot set its own compensation
  - Separate Account & Goal Maker Allegations – No breach
    - Service provider who adheres to agreed upon terms not required to deviate even if plan participants would be better off if had done so.
    - Revenue sharing to affiliate is not, standing alone, a violation of ERISA
Conclusion