

Chapman Client Alert

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Current Issues Relevant to Our Clients

FAQs—UITs and the New DOL Fiduciary Rule

The U.S. Department of Labor (the “DOL”) recently released its highly anticipated final rule to define the term “fiduciary” and address conflicts of interest in providing investment advice to retirement accounts. The final rule requires those who provide investment advice to employee benefit plans and individual retirement accounts (“IRAs”) to abide by a fiduciary standard. Absent an exception, a fiduciary is prohibited from collecting variable compensation or engaging in principal transactions with investors in employee benefit plans and IRAs. The DOL also released related new and amended prohibited transaction exemptions to address certain issues arising for fiduciaries under the Employee Retirement Income Security Act of 1974 (“ERISA”). The two key exemptions include the Best Interest Contract Exemption (the “BIC”) and the Principal Transactions Exemption. Both the BIC and the Principal Transactions Exemption offer persons engaged in the sale of unit investment trusts (“UITs”) ways to continue their existing business practices in a substantially similar way. This Client Alert addresses several frequently asked questions related to sales of UITs registered under the Investment Company Act of 1940 by those persons deemed fiduciaries under the new rule. If you have any additional questions, feel free to contact any member of our Investment Management Group. For additional information about the new rule and related exemptions, please see our Client Alert available [here](#).

What is the BIC Exemption?

Compliance with the BIC exemption allows a fiduciary, such as a broker-dealer, to receive variable compensation that would otherwise be a prohibited transaction. This permitted compensation may include commissions, sales loads, 12b-1 fees, revenue sharing payments and similar payments. One of the key conditions to the exemption is that a firm must enter into a written contract with a retirement client that provides, among other things, that the firm and its advisers will provide investment advice that is, at the time of a recommendation, in the “best interest” of the investor. This generally means that any advice provided must reflect 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 investor, without regard to the financial or other interests of the firm, its advisers or any affiliates.

Does the final BIC exemption cover UITs?

Yes. The previously-proposed BIC exemption covered UITs as eligible assets and the final exemption covers investment advice provided with respect to all investment products, including UITs.

Does the BIC exemption allow a broker-dealer to receive current customary UIT sales charges/concessions, including volume concessions, and typical revenue sharing payments?

Yes.

Does the BIC exemption allow for broker-dealers to conduct riskless principal trades in UIT units?

Yes. For this purpose, a “riskless principal” transaction is defined as a transaction in which a financial institution, after having received an order from a retirement investor to buy or sell an investment product, purchases or sells the same investment product for the financial institution’s own account to offset the contemporaneous transaction with the retirement investor. Other principal transactions cannot be conducted in reliance on the BIC exception but can be conducted in reliance on the Principal Transactions Exemption.

What is the Principal Transactions Exemption?

The Principal Transactions Exemption allows certain fiduciaries to engage in the purchase and sale of certain securities in principal transactions with investors in employee benefit plans or IRAs. Similar to the BIC exemption, one of the key conditions to the exemption is that a firm must enter into a written contract with a retirement client that provides, among

other things, that the firm and its advisers will provide investment advice that is, at the time of a recommendation, in the “best interest” of the investor.

Does the new Principal Transactions Exemption apply to UITs?

Yes. The exemption applies to both riskless and at-risk principal transactions in UIT units between a broker-dealer and its retirement investor customer.

Do broker-dealers need to repaper agreements for existing IRA brokerage accounts to comply with the BIC and Principal Transactions exemptions?

No. While the exemptions have certain new contract requirements, the final exemptions allow for existing clients to consent to the new contract provisions through a negative consent process for existing contracts. The negative consent contract amendment may also be delivered electronically. An “existing contract” includes an investment advisory agreement, investment program agreement, account opening agreement, insurance contract, annuity contract, or similar agreement or contract that was executed before April 10, 2017, and remains in effect. Under the negative consent procedure, a firm must deliver a proposed contract amendment along with certain disclosures to the investor prior to January 1, 2018, and if the investor does not terminate the amended contract within 30 days, the amended contract is effective.

For new contracts, at what point does the customer contract required under the BIC and Principal Transactions exemptions need to be signed?

The contract must be entered into before or at the same time the first recommended transaction is executed. Accordingly, conversations with an investor or potential new client can occur prior to signing a contract, but advice given before signing the contract must be covered by the contract.

Are individual financial advisors required to sign the customer contract required under the new BIC and Principal Transactions exemptions?

No. The contract may be between the broker-dealer firm and the client only. A new contract is also not required for each interaction with different employees of the same firm.

When do the new rule and exemptions become effective?

While the new rule is “effective” 60 days after publication in the Federal Register (June 2016), compliance with the new requirements will not be required until April 10, 2017. The BIC and Principal Transaction exemptions will become available on April 10, 2017. Both exemptions provide for a transition period from April 10, 2017 to January 1, 2018 where firms will qualify for the exemptions while complying with a limited number of the conditions. Full compliance with the BIC and Principal Transactions exemptions will be required on January 1, 2018 to qualify for the exemptions.

Will a UIT sponsor or its wholesalers or other representatives be deemed “fiduciaries” if they engage in typical marketing efforts with financial advisors of a broker-dealer that is itself an “investment advice fiduciary” to IRAs? For example, these efforts might include daily discussions with financial intermediaries, educational seminars, and other communications about investment products that are designed to educate broker-dealer representatives and other investment professionals about product terms and features, suitability assessments and investment solutions, among other things.

No, if prior to making such communications the UIT sponsor satisfies the following:

- the investment professional to whom such communications are addressed is a fiduciary of the plan or IRA that is independent of the UIT sponsor;
- the sponsor knows or reasonably believes that the independent fiduciary is a registered investment adviser or broker-dealer (among certain other financial institutions);
- the sponsor knows or reasonably believes that the independent fiduciary is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies;
- the sponsor fairly informs the independent fiduciary that the sponsor is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, and fairly informs the independent fiduciary of the existence and nature of the sponsor’s financial interests with respect to the UITs;

- the sponsor knows or reasonably believes that the independent fiduciary is a fiduciary under ERISA or the Internal Revenue Code, or both, with respect to any UIT transactions and is responsible for exercising independent judgment in evaluating the transactions; and
- the sponsor does not receive a fee or other compensation directly from the plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner for the provision of investment advice (as opposed to other services) in connection with any UIT transaction.

Note that this exclusion will likely not apply in a situation where persons other than financial professionals are in attendance. For example, this might be the case if a UIT wholesaler assists in a seminar presented by a third-party broker-dealer where

clients of the broker-dealer are in attendance (including clients with IRAs).

Conclusion

The final DOL rulemaking significantly expanded the scope and feasibility of the previously-proposed BIC and Principal Transactions exemptions. The final rules make it clear that UIT transactions can be conducted under both exemptions. As a result, both exemptions may provide workable solutions for many broker-dealers to continue to conduct UIT unit purchases and sales as they have in the past.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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