Review of the Department of Labor's (DOL) Final Definition of Fiduciary

Key Points IBDs, RIAs and Advisors Need to Know

Contents

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By now most retail advisors and firms have heard about the DOL's final regulation that redefines the term fiduciary for the Employee Retirement Income Security Act of 1974, (ERISA) and the Internal Revenue Code of 1986 (the Code).

Accompanying the publication were final versions of two new prohibited transaction exemptions and final amendments to a number of existing exemptions. The scope and breadth of the final rule, when considered in combination with the DOL's new prohibited transaction exemption conditions, could profoundly change the financial advisor firm business model, compensation arrangements and supervisory structures.

The following article summarizes the key items introducing broker dealers (IBDs), registered investment advisers (RIAs) and advisors need to know to be prepared for the final rule's April 10, 2017 applicability date. It's best to begin planning for the changes ahead as early as possible.

Three Key Points

1 **The final rule has a major impact on all retail service models, including RIA models.**

2 **Most will need to use the DOL's Best Interest Contract (BIC) exemption to avoid engaging in prohibited transactions.**

3 **The final BIC exemption is easier to implement and will be significantly less expensive than the original 2015 proposal.**

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Three Key Points

1 The final rule has a major impact on all retail service models, including RIA models.

Most members of the retail advisor community had been anticipating a final rule that would implicate transaction-based, but not fee-based business models. Many were surprised by the final rule, as it clearly states that IRA rollover recommendations are classified as fiduciary advice in virtually all instances, regardless of whether they involve a brokerage or advisory account recommendation.

2 Most will need to use the DOL's BIC exemption to avoid engaging in prohibited transactions.

Under the DOL's final regulatory package, the BIC exemption is, in most instances, the only source of prohibited transaction exemption relief to cover rollover recommendations, including:

- their amount and form,
- the destination vehicle for rollover distributions,
- the selection of investment account arrangements (e.g., brokerage vs. advisory), investment policy or strategy, and
- the securities or other property in which accounts should be invested.

3 The final BIC exemption is easier to implement and will be significantly less expensive than the original 2015 proposal.

With that said, it retains many of the original proposal's core elements, including adherence to DOL's best interest standard of conduct and use of litigation risk exposure as an enforcement mechanism.

When compared to the 2015 proposal, the final BIC exemption is much easier to implement. The up-front contracting requirement has been replaced with a rule requiring that documentation be in place by the time that an investment recommendation is implemented. The contract is now a two-party arrangement between the financial institution and the client. A negative consent process is available for extending BIC contracts to existing clients, thereby avoiding the need to solicit manual signatures. The final BIC exemption's disclosure requirements remain substantial. It conditions the availability of exemptive relief on either;

- the establishment of an enforceable written contract (for most rollover recommendations); or
- a set of written acknowledgments for advice provided to ERISA plans and participants.

Such contracts and written acknowledgments are intended to provide clients with a basis for enforcing their rights to receive advice that is consistent with DOL's best interest standard of conduct.

The Basic Framework of the Final Rule

Under the final rule, virtually all retail selling and advisory activity involving participants in 401(k) plans, other employer-sponsored retirement plans subject to ERISA, and IRAs, will give rise to fiduciary status, for purposes of ERISA and the Code, on the part of the individual advisor and, in many cases, his or her firm. The final rule generally assigns fiduciary status according to whether an individualized investment recommendation has been made to an ERISA plan, plan participant or IRA holder or whether a recommendation has been directed to a specific ERISA plan, participant or IRA holder. Fiduciary advice recommendations are defined to include:

- securities recommendations,
- investment management recommendations on investment policies and strategies,
- portfolio composition,
- selection of third parties for the provision of investment advisory or management services, and
- the selection of investment account arrangements.

Recommendations for rollovers, transfers or distributions from a plan or IRA, including recommendations as to the destination of rollover distribution proceeds are also covered.

ERISA fiduciaries are required to strictly avoid conflicts of interest, including receiving compensation from third parties in connection with transactions involving a client's funds—which is prohibited. Code section 4975 contains a set of parallel prohibited transaction provisions that are applicable to transactions involving ERISA plans as well as IRAs, which are generally not subject to ERISA.

In its final rulemaking package, the DOL identifies a number of common compensation arrangements and sales practices that would create prohibited conflicts of interest on the part of fiduciary advisors and firms after the final rule becomes applicable on April 10, 2017, including:

- the receipt of sales loads, commissions, 12b–1 fees, revenue sharing and other payments from third parties that provide investment products;
- proprietary product recommendations;
- recommendations that plan participants rollover their 401(k) or other retirement plans assets to an IRA (either brokerage or advisory) that will generate fees to the advisor and the advisor's firm;
- steering customers to products that generate higher fees for the advisor and the firm where identical, lower-fee products are available;
- recommendations to switch from brokerage accounts to fee-based accounts that generate additional compensation to the advisor and the firm.

DOL indicates that its intention in re-defining fiduciary status is not necessarily to outlaw common compensation and fee practices in the retail advisor space. The intention is to condition the availability of prohibited transaction exemption relief for such practices on compliance with a best interest standard of conduct enforceable against advisors and their firms by ERISA plans, plan participants and IRA holders.

An **individualized investment recommendation** is a recommendation based on the particular needs of the recipient or directed to a specific recipient with respect to specific decision.

DOL's Final BIC Exemption

To cover the receipt of compensation by fiduciary advisors resulting from non-discretionary advice recommendations made, the DOL has provided prohibited transaction exemption relief under the conditions of its new BIC exemption. The conditions of the BIC exemption are designed to assure that fiduciary advisors will recommend only those transactions that are in the best interest of client. Under the DOL's formulation, best interest means advice that is provided with –

> *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 retirement investor, without regard to the financial or other interests of the advisor, financial institution, or any affiliate, related party, or other party.*

Unlike ERISA, Code section 4975 contains no private right of action that would provide a basis for IRA holders to enforce violations of the Code's prohibited transaction rules.

DOL officials have repeatedly identified as their chief rulemaking objective that plans, participants and IRA clients who transact on the basis of fiduciary recommendations, be assured of their ability to enforce the best interest standard of conduct against advisors and firms. The emphasis is on creating an **enforceable standard.** In this regard, most IRAs are subject to prohibited transaction restrictions not under ERISA, but under Code section 4975. Unlike ERISA, Code section 4975 contains no private right of action that would provide a basis for IRA holders to enforce violations of the Code's prohibited transaction rules. Up to now, the sole source of prohibited transaction enforcement powers with respect to IRAs and the Internal Revenue Service (IRS) has been the IRS' authority to seek excise taxes for prohibited transactions. The IRS has only rarely brought such enforcement actions.

To remedy this perceived deficiency, the DOL has designed the BIC exemption prohibited transaction relief conditions in a way that will ensure the availability of private, contract-based enforcement rights by IRA holders. By requiring the delivery of a written fiduciary acknowledgment, the BIC exemption also assures the availability of ERISA-based enforcement rights to plans and plan participants.

For the delivery of fiduciary advice to IRA holders, the BIC exemption requires that the IBD or RIA firm (i.e., a financial institution) represented by an advisor provide the following, in an enforceable written contract with the IRA holder.

1. **A Fiduciary Acknowledgement.**
   The financial institution is required to state in writing that both it and its advisors act as fiduciaries under ERISA or the Code or both with respect to their advice recommendations.

2. **Agreement to Comply with Impartial Conduct Standards.**
   The financial institution must agree to provide advice that is in the client's best interest (i.e., advice that is not just prudent, but is also delivered without regard to competing financial interests) and to not receive compensation in excess of what is reasonable. In addition, they must refrain from making materially misleading statements concerning the transaction, its compensation or material conflicts.

3 Provision of Warranties.

The financial institution must warrant that it has adopted and will comply with written policies and procedures reasonably designed to assure that:

- its advisors comply with the best interest standard of conduct,
- it has identified and documented its material conflict of interest in rendering advice,
- it has identified a person or persons (i.e., a BIC compliance officer) responsible for addressing material conflicts, and
- it adheres to the Impartial Conducts Standards by advisors.

Also, the financial institution must warrant that it will not rely upon any quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other actions or incentives that would reasonably be expected to cause advisors to make non-best interest recommendations. In this regard, the DOL notes that any differential payments to advisers across the categories of investments available for recommendation need to reflect neutral factors, such as time and effort. They may not be based on what is more lucrative to the financial institution. For example, categories based on the differential compensation available to the financial institution from different mutual fund complexes, or in the amounts paid to the firm for different annuities or riders would be impermissable. Presumably, differential compensation attributable to the time and effort involved in explaining difference product types (e.g., mutual funds vs. annuities) would be allowed.

4 Disclosures.

Disclosures must be provided, either as part of the BIC contract itself or as part of a separate written document, at or prior to the execution of a recommended transaction. They must prominently describe how the advisor and the firm will be compensated, as well as describe material conflicts of interest. The client must be informed that he or she has the right to obtain written copies of the financial institution's policies and procedures, and to receive specific details on the costs, fees and compensation associated with recommended transactions free of charge. These disclosures must be re-delivered to cover subsequent recommendations if more than a year has passed from the delivery of the original or if a different type of product is being recommended.

5 Website Link.

A link to the financial institution's website must be provided. On the website, the financial institution is obligated to provide various additional disclosure items, including:

- a discussion of its business model and the material conflicts of interest associated with that model,
- a schedule of typical account fees and charges,
- information about the stringency of its policies and procedures relating to conflict mitigation,
- lists of all product manufacturers that make third party payments,
- a discussion of the extent to which those arrangements affect advisor compensation, and
- a description of any cash or non-cash incentive arrangements for advisors to recommend particular products, investments or product categories, including compensation grids.

The website must also make available an electronic copy of the client's best interest contract that is accessible by the client.

6. **Product Limitations.**
Disclosures of any limitations on an advisor's ability to recommend products based on proprietary product or third party payment considerations.

7. **Monitoring Disclosure.**
A description of whether the financial institution and the advisor will monitor the client's investment holdings and alert the client to any recommended changes.

8. **Exculpatory Provisions Disallowed.**
The contract may not contain disclaimers or limitations of advisor liability or require a waiver or qualification of a client's right to participate in a class action. Punitive damages waivers and waivers of rescission rights are allowed to the extent permissible under applicable state or federal law.

Where advice is being provided to an ERISA plan or plan participant (as opposed to an IRA holder), the BIC exemption requires delivery of the same materials that an IRA holder would receive, except that the materials do not need to be embedded in a written contract. The reason for this difference is that where ERISA enforcement rights are available, the unilateral delivery of the fiduciary acknowledgement and related information is sufficient to secure the plan's and participant's right to bring a claim under the ERISA statute (i.e., a bi-lateral contract is not needed to secure enforcement rights).

Streamlined BIC Relief for Level Fee Fiduciaries

A **level fee fiduciary** is defined to mean an advisory and related financial institution who receive only a level fee, disclosed in advance, in connection with the advisory and management services being provided.

As noted, virtually all IBDs and RIAs providing retail advice recommendations to ERISA plans, participants and IRA holders will need to look to the BIC exemption for prohibited transaction exemption relief. However, a special streamlined version of the exemption is available for level fee fiduciaries. A level fee fiduciary is defined to mean an advisory and related financial institution who receive only a level fee, disclosed in advance, in connection with the advisory and management services being provided. A level fee is one that is based on a fixed percentage of the value of the assets, or a set fee that does not vary with any particular recommended investment, as opposed to a commission or other transaction-based fee.

Level fee fiduciaries need to comply with the fiduciary acknowledgement and Impartial Conduct Standards conditions described above in items 1 and 2, but need not meet the remaining requirements. Also, level fee fiduciaries may satisfy their streamlined exemptive relief obligations through a unilateral delivery of materials to the client; a bi-lateral contract is not required when the recipient of said advice is an IRA holder. However, level fee fiduciaries utilizing the streamlined version of the exemption are required to satisfy a special condition requiring the documentation of why a rollover recommendation or a switch from a brokerage to a level fee arrangement serves the client's best interest.

In Conclusion

In conclusion, change is coming. The final rule is going to impact the way your business is conducted, particularly with respect to compensation arrangements, supervisory structure and service models. The final rule, which will go into effect in 2017, establishes a standard of care to which plans, participants, and IRA clients can hold their advisors and firms accountable when advising them on their retirement assets. Going forward, firms will need to use the BIC exemption or else run the risk of engaging in prohibited transactions. While there is time before changes need to be made, it best serves members of the industry to begin preparing today, so as to be ready for tomorrow.

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Updates and further information on this topic are available at www.groom.com.

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