Fiduciary Commentary

Spring 2015

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By: Brant Griffin - May 19, 2015

DOL Proposes Revised Fiduciary Rule

Currently, the law governing standards of conduct for those performing ERISA advisory services is nothing short of chaotic. Opposing regulations apply different performance standards depending on the stance of the organization providing services. This results in some retirement plan service providers assuming a fiduciary role under the law, while others do not.

A fiduciary relationship is viewed as the highest standard of advice available under the law and requires the fiduciary to put the clients' interests first when making investment recommendations. Retirement plan sponsors and advisors, for example, have long maintained this fiduciary role while others including recordkeeping organizations and broker-dealers have not. A non-fiduciary position subjects them to a different, less demanding, "suitability standard" where their investment recommendations must simply be "suitable" for the client at the time the investment is made. This standard does not legally obligate individuals or firms to put the interests of their clients ahead of their own. In fact, it permits them to do the opposite. As a result, many who avoid this fiduciary role are able to make investment recommendations that are in direct conflict with the best interest of the plan.

Alternatively, Registered Investment Advisors (RIAs) are subject to an elevated standard of care as mandated by their legal framework under ERISA. RIAs, by definition, are fiduciaries and maintain a fundamental obligation to act in the best interest of their clients, and ahead of all others, including their own.

Unfortunately, investment services provided by broker-dealers and RIAs are indistinguishable to many plan sponsors and participants. Many investors believe that the advice they receive from financial professionals is objective, when in reality it is often biased in favor of investments that produce the greatest revenue or a tangential benefit. Due to this obscurity in standards, investors and plan sponsors often engage organizations without a complete understanding of their fiduciary standing and conflicts. As a result, the DOL is proposing a revision to the fiduciary rules to broaden the set of activates that mandates fiduciary conduct.

Background

The current defining fiduciary standard was developed by the DOL in 1975, shortly after the passage of ERISA. The regulation defines a fiduciary through a five-part test defining the activities that trigger fiduciary status. Currently, a person who does not have discretionary authority or control with respect to the plan gives fiduciary investment advice if they:

- Render advice to the plan as to the value or the advisability of transacting in securities or other property for a fee
- Provided on a regular basis
- Pursuant to a mutual agreement with the plan
- The service will serve as a primary basis for investment decisions and
- The advice is individualized to suit the needs of the plan.

After several false starts and years of work and intense debate, the agency has re-proposed rules to update the 40-year old fiduciary standard. The intent of the rule is straightforward; to expand the definition of a fiduciary under

ERISA by seeking a more expansive, principle-based standard that puts investors' best interests first, and requires disclosures when conflicts might arise. The proposal is currently in a comment period that concludes on July 6. It is anticipated that there will be a substantial remarks from stakeholders, that may yet alter the outcome of the law.

The Proposal

This long awaited regulation replaces the original five-part test with a four-part test that would substantially broaden the circumstances in which advice would be subject to ERISA and meet the definition of a fiduciary. The proposal identifies the following activities that give rise to fiduciary status, including:

- Renders investment advice to a plan (including recommendations regarding distributions and rollovers of IRAs) for a fee
- Provides services pursuant to an agreement, arrangement, or understanding
- The advice is given for consideration in making investment or management decisions regarding plan or IRA assets.
- The advice is individualized to the recipient

A welcome outcome of the regulations (from my PIER*spective*, at least) is the extension of the fiduciary net to cover advice to the entire $7 trillion IRA market. The industry was expecting the regulations to include the plan rollover process, but surprisingly the DOL integrated rules that cover services to all IRA accounts. The broadening of the definition is aimed at protecting employees from the rampant practice of self-serving investment recommendations committed during the rollover process. Often, former or retired employees are targeted by the investment community and encouraged to rollover their retirement plan savings into retail IRA accounts, which more often than not feature higher fees and sometimes commissions.

The proposal maintains a broad approach in its definition of advisor compensation. The proposal sites both "direct and indirect" compensation and "fee or other compensation" in order to cast a wide net around the numerous types of soft dollar compensation arrangements available in the qualified plan environment. Furthermore, the current requirement of advice being provided on a "regular basis" would no longer be required. One time advice is enough to trigger fiduciary status.

Best Interest Contract Exemption

One of the more controversial elements of the regulations is the DOL's "best interest contract" exemption from ERISA's prohibited transaction rules. The rule permits an exemption from the prohibition on self-dealing for the receipt of brokerage industry's common compensation arrangements that create conflicts and violate ERISA's prohibited transaction rules. This exemption would require advisers and firms to acknowledge their fiduciary status, in writing and adhere to "basic standards of impartial" conduct. Curiously enough, one of the requirements of basic standards of impartial conduct is to receive no more than reasonable compensation, but what is reasonable?

This prohibited transaction exemption is described by some as a necessary mechanism to provide flexibility to the brokerage community. In my opinion, it will simply make the proposed rule less effective by granting a legal loophole for firms to maintain practices that are in direct opposition to the fiduciary commitment they are required to make. Permitting “fiduciaries” to act in a non-fiduciary manner by accepting payments from vendors that are otherwise in violation of the rules, makes little sense and will gut effectiveness of the proposal.

Conclusion

The 2015 proposal is a bold attempt to broaden the circumstances that define an investment fiduciary, to not just ERISA plans but to the vast IRA market as well. The DOL withdrew its initial fiduciary revision in 2011, bowing to fierce resistance from Wall St., which claimed that the regulation would significantly increase regulatory costs forcing them to abandon clients with small accounts. The firms that successfully fended off the DOL's first attempt at a unified fiduciary standard are again preparing for battle.

Many experts believe that all investment and financial advice should be held to a fiduciary standard, but remain concerned that there's simply too much money being made to affect the real change that is needed and once again, investors' interests will be subordinated to the profits of Wall Street. According to the White House's Council of Economic Advisors, the cost of tainted investment advice is approximately $17 billion annually. Clearly, Wall Street has a strong financial incentive to maintain the status quo.

The watering down of the proposed regulations through exemption loopholes does not bode well for sponsors and investors alike. Any regulations that eventually are passed will undoubtedly be met with staunch opposition by the Wall Street firms who stand to benefit from such unsavory practices. The sad truth is that being a fiduciary in name does not make one a fiduciary in spirit. Sponsors and investors alike will need to remain vigilant and take renewed steps to clearly understand the fiduciary standing of the organization advising them.

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