Fiduciary Commentary

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By: Brant Griffin - May 11, 2016

DOL Releases Final Fiduciary Rule

The retirement plan landscape and the needs of investors and plan sponsors have changed meaningfully in the forty plus years since the original fiduciary standard was enacted. Participant directed defined contribution plans and IRAs have emerged as America's preeminent retirement funding vehicles and advisory services have developed with them. Today, the governing standards of conduct for ERISA advisory services are antiquated, allowing divergent regulatory standards to apply depending on the organization providing the services.

It's been a long road, but after several false starts and intense debate, in April the DOL has issued final regulations to update the 40-year old fiduciary standard that will raise the minimum standards for investment advice to retirement accounts. The intent of the controversial DOL measure is to broaden the definition of a fiduciary under ERISA by seeking a more expansive standard that seeks to put investors' best interest first. The regulations are effective April 10, 2017, with a phase-in period that ends December 31. 2017.

Background

A fiduciary relationship is viewed as the highest standard of advice available under the law. It requires an advisor acting as a fiduciary to put clients' interests first when making investment recommendations. Registered Investment Advisors (RIAs) have always been held to an elevated fiduciary standard of care by law and maintain a fundamental obligation to act in the best interest of their clients (ahead of all others interests, including their own). Alternatively, a non-fiduciary relationship permits a less demanding, "suitability standard" where investment recommendations simply had to be "suitable" for the client at the time the investment was made. This standard permitted a salesperson to make biased recommendations that were in direct conflict with the best interest of the investor.

> "*Instead of ensuring that trusted advisers give prudent and unbiased advice in accordance with fiduciary norms, the current regulation erects a multi-part series of technical impediments to fiduciary responsibility*"
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> [DOL Notice of Rulemaking, April 2015]

Investment services provided by fiduciaries and non-fiduciaries are virtually indistinguishable to investors, and often to very sophisticated investors as well. Many individuals simply believe that the advice they receive from any financial professional is objective, when it may not be. Slanted sales materials, industry jargon and legalese in advisory agreements often obscure an organization's stance to those that are simply seeking honest advice in managing their financial assets. Due to this obfuscation, investors and plan sponsors often maintain a relationship with organizations without a complete comprehension of their fiduciary standing. These circumstances drove the need for regulations to unify the standards of conduct for financial advice and broaden the set of activities that mandates fiduciary care.

Chronology of the "Fiduciary Rule"

The original fiduciary rule was adopted in 1975, shortly after the passage of ERISA. This standard, along with the *incidental advice rule* of the Investment Advisors Act of 1940 (where advice is incidental to the inherent, transactional

nature of the brokerage business) permit different performance standards depending on the structure of the organization providing services. In fact, Phyllis Borzi, Assistant Secretary of Labor for the Employee Benefits Security Administration, stated there was concern that current regulations may allow plan advisors, "…from whom plans expect impartial advice, to evade fiduciary responsibility."

The New Fiduciary Rule

An investment fiduciary is currently defined in the original 1975 ERISA regulations as a five-part test to determine what activities represent investment advice and ERISA fiduciary status. Under the final regulations, a new standard will replace the 1975 regulation by broadening the activities that would give rise to fiduciary investment advice. The final rule redefines this fiduciary activity as a "recommendation" to a plan, participant or *IRA account* for a fee or other compensation for:

- The advisability of transacting (or holding) of securities or other investment property
- The advisability of investments of securities or other investment property to be invested after a rollover, transfer or distributions from a qualified plan or IRA
- The management of securities or other investment property including, among other things recommendations on investment policies and strategies, portfolio composition, selection of other persons to provide investment advice, or investment management services, selection of investment account arrangements (brokerage vs. advisory), or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA.

There are notably a couple of changes in the final rule that will better protect investors. Two items were removed from the 1975 rule that permitted brokers to avoid fiduciary responsibility:

- Advice will no longer be required to be made on a regular basis
- Advice will no longer be required to serve as the primary basis for the recipient's investment decision.

Non-Fiduciary Activities

The final rule also defines activities that do not give rise to a fiduciary standard. Education and other communications without a "recommendation" to undertake a particular course of action, would not trigger fiduciary status. According to the DOL, "if the communications do not meet the definition of a 'recommendation,' the communications will be considered non-fiduciary." These non-fiduciary communications and other types of activities include:

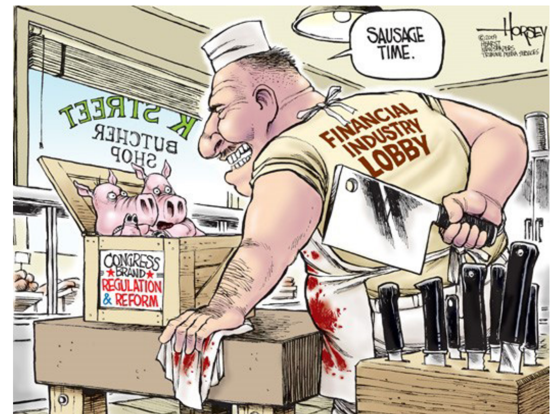
- Providing plan information
- Providing basic financial, investment, retirement, and asset allocation information
- Providing interactive investment materials (e.g. questionnaires, software)
- Communicating investment alternatives
- Platform provider services
- Filling transaction requests

Prohibited Transaction Exemptions

One of the more controversial elements of the regulations is the DOL's "best interest contract exemption" (or BICE) which would potentially exempt an action from ERISA's prohibited transaction rules. BICE permits an exemption from the prohibition from self-dealing for the receipt of brokerage industry's common compensation arrangements.

THE NORTH PIER*spective*

BICE covers investment advice provided to small retirement plans (defined as less than $50 million), individual plan participants and IRA investors and beneficiaries. This exemption permits fiduciary investment advisors to receive certain types of compensation (which may include commission-based and revenue sharing arrangements) that would otherwise be prohibited under the regulations. The exemptions require an agreement contract between the firm and client where the advisor commits to:



- Acknowledge fiduciary status
- Provide advice that is in the client's best interest
- Receive no more than reasonable compensation
- Avoid misleading activities

This prohibited transaction exemption is described by some as a necessary mechanism to provide flexibility to the brokerage community's sales practices. It will certainly accomplish this, but in North Pier's opinion, it will also 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, makes little sense and could very well gut effectiveness of the proposal.

IRAs Now Covered by ERISA

A welcome outcome of the final rules (from my PIERspective at least, but certainly not those of the broker dealers) is the extension of the fiduciary net to encompass the IRA market, including distributions of benefits and rollovers from qualified plans. The effects on qualified plan distribution advice will be far-reaching and represent a massive shift in the way Wall Street does business.

The new rules affecting distribution advice provides important investor protections to the $7.3 trillion IRA market from the rampant practice of self-serving investment recommendations and are long overdue. Commission generating roll-over sales and investments in high-cost IRA accounts subjected retirement savers to unnecessary high investment costs that robbed them of the opportunity for higher income in retirement. With rollover practices and investment product sales to IRA accounts now subject to the fiduciary codes of conduct, thankfully, brokers will be more heavily scrutinized. A likely positive result is that more savings will remain where it was better off all along - employer plans.

Conclusion

Although the rule is will soon be the law of the land, the lobbying effort isn't over. Some believe the lobbying will continue for years. In fact, there have already been attempts in Congress to squash the rule all together, yet again…

North Pier applauds those attempting to protect the interests of plan sponsors & participants and promote the advancement of transparency and accountability in the retirement plan industry. We have always held the simple belief that every organization advising retirement plan sponsors and investors alike, regardless of their organizational structure, should be held to a fiduciary standard.

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