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The Fiduciary Rule

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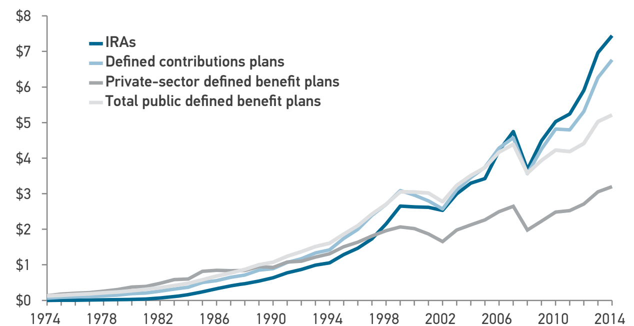

The Department of Labor (DOL) released its Conflicts of Interest Proposed Rule on April 14, 2015, which requires all financial advisers of retirement accounts to act as fiduciaries. The department withdrew a similar proposed 2010 rule after it received opposition from the industry. This time around, the Administration appears set on getting the rule finalized as it is one of President Obama's priorities as part of his "middle class economics" agenda. Once the current public comment period closes July 21, a public hearing will be held, followed by a second public comment period. Therefore, the final rule will likely not be released until late September or October. Dodd-Frank gave the SEC the authority to establish a fiduciary rule for brokers that is no less stringent than the standard applicable to investment advisors when providing personalized investment advice about securities to retail customers. The SEC has not done so, but the DOL is moving forward, arguing that the rule is needed to update retirement standards last set in 1975 and to protect retail investors' retirement savings.

The Rule Expands the Definition of a Fiduciary

The proposed rule broadens the definition of who is a fiduciary to include those providing investment advice to an employee benefit plan, a plan participant, a plan fiduciary, an IRA, or an IRA owner if they make investment recommendations (including rollovers and other distributions), investment management recommendations, appraisals, and recommendations of other people to provide investment advice for a fee or to manage plan assets. It amends the current five-part test, which deems a person a fiduciary if he or she renders advice:

1. As to the value of securities or other property or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property;
2. On a regular basis;
3. Pursuant to a mutual agreement, arrangement, or understanding, with the plan or a plan fiduciary;
4. That will serve as a primary basis for investment decisions with respect to plan assets; and
5. That will be individualized based on the particular needs of the plan or IRA.

Under the DOL's proposed rule, the five-part test will be revised to remove the requirement that the advice must be mutual, ongoing, or serve as the primary basis for the investment decision.

Exemptions to the Definition of Fiduciary

The proposed rule then provides a number of carve-outs for certain types of advice that would not be treated as investment advice for individuals who do not represent themselves as acting as fiduciaries:

1. Seller's Carve-Out: The seller's carve-out applies to advice provided in connection with an arm's length sale, purchase, loan, or bilateral contract between an expert or sophisticated plan investor and an adviser. The advice must be provided to a plan fiduciary who exercises authority or control regarding the management or

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disposition of the plan's assets and who is independent of the adviser. The carveout is limited to retirement plans and does not apply to plan participants or IRAs. To qualify, the adviser must obtain written representation from the plan fiduciary that he or she is the fiduciary with responsibility over the benefit plan's assets and that the employee benefit plan has 100 or more participants or the adviser must know or reasonably believe that the plan fiduciary has responsibility for managing at least $100mn in employee benefit plan assets. The adviser must inform the fiduciary that he or she is not working to provide impartial investment advice and he or she may not receive any compensation directly from the plan.

2. Swap And Security-Based Swap Transactions: The carve-out for swap and security-based swap transactions allows swap dealers, security-based swap dealers, major swap participants, and security-based major swap participants who make recommendations to plans to avoid being fiduciaries when acting as counterparties to a swap or security-based swap transaction provided they obtain a written representation from the plan fiduciary that the fiduciary will not rely on his or her recommendations. This exemption also applies only to retirement plans and not to IRAs or individual plan participants.

3. Plan Sponsor Employees: Employees of a plan sponsor are exempted from the fiduciary definition if they provide advice to fiduciaries as long as the employees receive no compensation for the advice beyond their normal compensation.

4. Identification of Investment Options: A carve-out is designed for service providers, such as record-keepers and third-party administrators, who offer a platform of investment options to participant-directed individual account plans subject to ERISA. The plans' fiduciaries then choose the investment options that will be offered in the plans.

5. Marketing Materials Exemption: The marketing materials carve-out exempts advisers who market or make available a platform of investment options, without regard to the individualized needs of the plan or its participants, provided the advisers disclose in writing that they are not undertaking to provide impartial investment advice. Under this exemption, advisers can identify investment options that meet objective criteria or can provide objective financial data regarding the investment options.

6. Appraisals, Fairness Opinions, Statements Of Value Exemption: An exemption exists for appraisals, fairness opinions, or statements of value that are provided to satisfy reporting and disclosure rules and for persons conducting valuations or appraisals for employee stock ownership plans (ESOPs).

7. Investment Education Exemption: The investment education carve-out is amended to no longer allow recommendations related to specific investment products, specific investment managers, or the value of particular securities or other property. For instance, an adviser under this exemption could advise that a large-cap stock fund be included in an investment portfolio, but could not provide an example of a large-cap fund.

The Best Interest Contract Exemption

Fiduciaries of IRAs and other plans not covered by ERISA are subject to the prohibited transaction rule, but, currently, IRA owners do not have a statutory right to bring suit against fiduciaries under ERISA for violation of the prohibited transaction rule and fiduciaries are not personally liable to IRA owners for losses caused by their misconduct. Under the prohibited transactions rule, a fiduciary cannot receive directly or indirectly from any party any fees that vary based on the investment option selected by a plan participant or IRA investor. This includes commissions paid by the plan, plan participant, or IRA or commissions, trailing commissions, sales loads, 12b-1 fees, revenue sharing, and other payments paid by the investment providers or other third parties to advisers and financial institutions. The proposed DOL rule will expand the definition of fiduciaries and allow IRA investors to bring suit against fiduciaries. This proposed change will require advisers under commission-based fee arrangements to

either fit under a prohibited transaction exemption or fit within one of the specific carve-outs mentioned above.

The seller's exemption applies only to investment advice provided to retirement plans with 100 or more participants or with $100mn in employee plan assets. Therefore, for advisers to small plans and IRA investors, the DOL has proposed a new prohibited transaction exemption, the Best Interest Contract (BIC) exemption, to attempt to preserve commission-based compensation, but ensure that investment advice is provided with the best interest of retail investors in mind. The BIC exemption is available to advisers who provide investment advice with respect to only certain assets, which are as follows:

- Bank deposits and certificates of deposit
- Share or interests in registered investment companies
- Bank collective funds
- Insurance company separate accounts
- Exchange-traded REITs
- Exchange-traded funds
- Corporate bonds offered pursuant to a registration statement under the Securities Act of 1933
- Agency debt securities as defined in FINRA Rule 6710(l) or its successor
- US Treasury securities as defined in FINRA Rule 6710(p) or its successor
- Insurance and annuity contracts
- Guaranteed investment contracts
- Exchange-traded equity securities

Futures contracts, puts, calls, straddles, and any other "option or privilege of buying an equity security from or selling an equity security to another without being bound to do so" are specifically excluded from the definition of assets.

The BIC exemption requires advisers and their firms to enter into a written contract with the plan or IRA investor which states that the adviser and the firm are fiduciaries to the extent that they make investment recommendations; that they will act in the best interest of the plan or IRA investor; that their advice will reflect the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the plan or IRA investor without regard to the financial or other interests of the adviser, firm, or any affiliate; that they will charge no more than reasonable compensation and not make misleading statements; that the adviser's firm has put in place policies and procedures to mitigate material conflicts of interest and to ensure compliance with the impartial conduct standards; that identifies any material conflicts of interest; that allows for a private right of action against the firm for violations of the contract; that the investor can obtain complete information about all fees; and that will notify the plan or IRA investor if the adviser does not recommend a sufficiently broad range of assets to meet the plan's or IRA investor's needs.

Non-traded REITs are not included among the list of products permitted under the BIC exemption because these products have high front-end fees due to their illiquidity. These products could not be used in retirement accounts, but still could be used in non-retirement accounts. Therefore, brokers could lose commissions on selling these products, or could try to make up the losses by offering clients other investment products.

Impact On Industry

Impact On Insurance Agents: Insurance agents may be considered fiduciaries under the proposed rule. Insurance agents would be subject to the same disclosure and compliance policy requirements that registered investment advisors are subject to. An advisor affiliated with a plan service provider, such as an insurance company, would not be allowed to sell a variable annuity, only fixed-rate annuities, from that provider.

The BIC exemption includes a supplemental exemption that gives more leeway to advisers when structuring a plan's or IRA's purchase of an insurance or annuity product. The

DOL assumes that the fiduciary that coordinates a plan's or IRA's purchase of an insurance or annuity product is not the insurance agent or his or her employer/insurance company. The fiduciary would be the plan sponsor or IRA owner acting on the agent's advice. To take advantage of the exemption, the transaction must be effected by the insurance company in the ordinary course of its business, the combined total of all fees and compensation received must not be in excess of reasonable compensation under the circumstances, purchase must be for cash only, and the terms must be at least as favorable to the plan as the terms generally available in an arm's length transaction with an unrelated party.

Impact On Broker-Dealers: Brokers may be considered fiduciaries under the proposed rule. An exemption is made for broker-dealers who are engaged in simple order-taking.

Disclosure Requirements: The proposed rule will increase compliance costs within the industry. Small and mid-sized plans that are subject to ERISA will likely be at a disadvantage because of the costs and compliance burdens as compared to large firms. The BIC exemption requires the following disclosures and requires the adviser to notify the DOL that it will utilize the BIC exemption:

- A point-of-sale disclosure to the customer that includes the all-in and ongoing costs of the recommended investment;
- Annual compensation disclosures that also list the investment transactions, fees, and expenses, and the adviser's direct and indirect compensation for each client;
- Online disclosures of all direct and indirect compensations for each of its products; and
- Notice and other related disclosures if the advisor is unable to recommend a sufficiently broad range of investment due to platform-related or other limitations.

While some in the industry support the theory behind the rule, they point out that customers will likely lose choice and access to advice and guidance given the new restrictions. They also argue that the rule will create confusion among consumers since the rule only applies to investment advice for retirement accounts, and not for other savings accounts.

SIFMA Alternative

SIFMA argues that DOL's proposal to create a fiduciary duty that would only apply to retirement accounts and not all retail brokerage accounts would create confusion for investors and regulatory duplication. SIFMA has proposed an alternative: a uniform best interests of the customer legal standard for broker-dealers, applicable to all retail brokerage accounts. The best interests of the customer legal standard would be consistent with the any fiduciary standard that the SEC ultimately proposes under Dodd-Frank. It would allow brokers to charge reasonable investment-related fees and would require brokers to avoid and/or manage material conflicts of interest and to provide disclosures about material conflicts and investment-related fees to increase transparency. This alternative would still allow for the sale of only proprietary or other limited range of products by a broker to a retail investor.

Timeline of the Rulemaking

There are still a few more steps before the DOL's rule becomes finalized:

- Public comments on the proposed rule are due July 21, 2015.
- The Employee Benefits Security Administration will hold a public hearing on August 10, 11, and 12 (and 13 if necessary), 2015
- A second public comment period will remain open for 14 days after the official hearing transcript is posted, likely 30-45 days total. Therefore, the second public comment period could end between September 11 and September 26, 2015.
- The final rule would be issued thereafter.

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