FEATURE

The Fiduciary Path — What Lies Ahead?

The final fiduciary regulation seems "better" than the proposal, but many questions remain.

BY NEVIN E. ADAMS, JD

After a 5-month comment period, 4 days of public hearings, more than 3,000 comment letters, some 300,000 petitions, and more than 100 meetings with stakeholders, and nearly a year to the day that the Labor Department unveiled its "conflict of interest" proposed rule, we have a final fiduciary regulation.

In the intervening weeks it seems that nearly every legal and consulting firm in the United States has weighed in with an analysis of what the regulation — or at least our current understanding of the regulation — could mean. It is, by some accounts, the end of affordable investment advice. By other accounts, it marks the beginning of a new era of innovation, stripped of the inherent conflicts of interest that have long plagued the variable compensation model. Either way, it certainly moves the needle sharply when it comes to advice offered to the largest pool of retirement savings in America today — the $7 trillion IRA market. It is, depending upon whom you choose to believe, the best of times — the worst of times — or, more likely, something in-between.

So, what's in the final regulation?

The 'New' Fiduciary

First off, any individual receiving compensation for making investment recommendations that are individualized or specifically directed to a particular plan sponsor running a retirement plan, plan participant, or IRA owner for consideration in making a retirement investment decision, is now a fiduciary; more specifically, if you provide recommendations regarding retirement accounts, you will be a fiduciary under ERISA. Being a fiduciary under the final regulation means that an advisor must provide impartial advice in the client's best interest and cannot accept any payments creating conflicts of interest — this would be compensation that varies based on the recommendation — unless the advisor qualifies for an exemption to what would otherwise be considered a prohibited transaction.

This exemption — designed to ensure that the customer's interests are protected — comes in the form of a modified version of the Best Interest Contract unveiled in the proposed regulation — the "BIC."

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The BIC

For advisors who are interested in preserving (or establishing) a variable compensation model, the Labor Department has preserved a path, though one fraught with a number of complicated and potentially expensive disclosures. That said, the final fiduciary rule includes some improvements in the BIC exemption presented in the 2015 proposal. Variable compensation is, as it was in the original proposal, allowed under a BIC exemption. The BIC is subject — as it was in the previous proposal — to a commitment by the firm and the advisor to:

- provide advice in the client's best interest;
- charge only reasonable compensation;
- avoid misleading statements about fees and conflicts of interest;
- adopt policies and procedures designed to ensure that advisors provide best interest advice; and
- prohibit financial incentives for advisors to act contrary to the client's best interest.

The Labor Department says it has taken a number of steps to streamline the BIC exemption to lower compliance costs for firms implementing it and to ensure that firms can continue offering commission-based advice to clients for whom it is the best option. Advisors recommending any asset — not just those on the asset list included in the proposed regulation — can take advantage of the BIC exemption, including proprietary products (and things like listed options and non-traded REITs).

As was the case in the proposed regulation, the advisor firm must direct customers to a web page disclosing the firm's compensation arrangements and make customers aware of their right to complete information on the fees charged. However, the final regulation revises existing exemptions, including limiting the so-called "insurance exemption" to recommendations of "fixed rate annuity contracts."

Transaction Disclosures

Under the final regulation's exemption, the transaction disclosure has been simplified, and the requirement of 1-, 5-, and 10-year projections has been eliminated, as has the requirement of an annual disclosure. Instead, the Labor Department says that clients can request more detailed disclosures on costs and fees; that way, they can get the information they need at less cost to firms.

In response to concerns that firms would be required to retain detailed data on inflows, outflows, holdings, and returns for retirement investors, the regulation says that firms have to retain only the records that show they complied with the law (in this case, the BIC exemption), as they would in other situations.

The BIC exemption contains special provisions clarifying how it can be used for recommendation of proprietary products, including a requirement that firms determine that the limitations are not so severe that the advisor will generally be unable to satisfy the exemption's best interest standard and other requirements.

BIC and BIC 'Lite'

The advantage for firms embracing the BIC approach is that they can continue, at least in large part, to do business the way they did prior to the new regulation. Relying on the BIC means the potential for greater liability — perhaps the real cost here — as well as additional costs in compliance, but also more flexibility in how you do business. That said, many will likely be willing to trade off some of that flexibility for the lower costs and liability associated with an approach that has been termed BIC "Lite."

Under BIC Lite, you don't need a contract, nor must you provide warranties,

LEVEL BEST

Final regulation incorporates NAPA's "level-to-level" comp recommendation

In a big win for NAPA advocacy efforts and the ability for plan advisors to help participants with rollover decisions, the DOL's final fiduciary regulation provides a streamlined exemption for "level-to-level" advisor compensation.

The level-to-level compensation provision enables advisors and firms that receive only a "level fee" in connection with the advice they provide to rely on the exemption without entering into a contract so long as special attention is paid and documentation is kept to show that certain specific recommendations are in the customer's best interest — including a recommendation to roll over assets from an employer plan to an IRA. Level fee fiduciaries receive the same compensation regardless of the particular investments the client makes, whether based on a fixed percentage of assets under management or a fixed dollar fee.

Original Proposal

Under the proposed fiduciary rule, unless compensation did not increase at all when a rollover from an employer-sponsored plan to an IRA occurs (which is, of course, uncommon due to the customized services typically provided within the IRA), advisors would have only been able to help participants on the rollover if they first complied with the complex and cost-prohibitive Best Interest Contract (BIC) exemption. In fact, under the original proposal, advisors with any investment discretion wouldn't even have been allowed to use the BIC, and thus would have been legally prohibited from working with a participant on the rollover transaction if there were any differential compensation.

That would have effectively penalized the advisor for engaging in the rollover transaction — and would put retirement plan advisers at a competitive disadvantage vis-à-vis advisors who had no previous relationship with the participant in the plan. This issue was raised in testimony during the DOL's public hearings by Marcy Supovitz, NAPA's Founding President and then-President-Elect of the American Retirement Association, and subsequently embraced during the comment period on the proposed regulation by a number of Democratic senators.

— *NEA*

disclosures, or the web information described above, nor are you required to provide disclosures to the Labor Department.

In order to use BIC Lite, you need to be a level fee fiduciary (see sidebar at left). That means *no* remuneration beyond the fee received by the adviser, financial institution and any affiliate in connection with advice to the plan or IRA. That level fee is disclosed in advance to the investor, and is compensation based on a fixed percentage of assets or a set fee that does not vary with the investments that are recommended.

Investment Education

The final regulation clarifies what does and does not constitute fiduciary advice, and includes examples of communications that would not rise to the level of a recommendation and thus would not be considered advice. One significant modification in the final regulation: It specifies that education is not included in the definition of retirement investment advice so advisors and plan sponsors can continue to provide general education on retirement saving without triggering fiduciary duties.

It also expressly provides that communications that a reasonable person would not view as an investment recommendation are, in fact, not considered a recommendation under the final regulation, including general circulation newsletters, television, radio, and public media talk show commentary, remarks in widely attended speeches and conferences, research reports prepared for general circulation, general marketing materials, and general market data.

Significantly, a side-by-side comparison of the original proposal and the final regulation explains that education to plan participants including naming specific funds would be permitted "if certain conditions are met." The original proposal would have restricted plan advisors from being able to mention specific funds in the plan menu in asset allocation education materials.

However, in the context of IRAs, the Labor Department notes that there is no independent fiduciary to review and select investment options, and so references to specific investment alternatives will be considered advice, not education.

Seller's Exception

Under the final rule, recommendations to plan sponsors managing more than $50 million in assets (vs. $100 million in the proposed rule) will not be considered investment advice if certain conditions are met and hence will not require an exemption.

Litigation

The rule and exemptions ensure that advisors are held accountable to their clients if they provide advice that is not in their clients' best interest. If advisors and firms do not adhere to the standards established in the exemption, retirement investors will be able to hold them accountable — either through a breach of contract claim (for IRAs and other non-ERISA plans) or under the provisions of ERISA (for ERISA plans and participants).

Transition Timing

There will be more time to implement — but not a lot more. In April 2017 (one year after the rule's publication), the broader definition of fiduciary will take effect, but to take advantage of the BIC exemption, firms will be required to comply only with a subset of conditions, including:

- acknowledging their fiduciary status;
- adhering to the best interest standard; and
- making basic disclosures of conflicts of interest.

The other requirements of the exemption will go into full effect on Jan. 1, 2018.

The DOL has said it intends to focus during that time on providing compliance assistance to help plan fiduciaries and fiduciary investment advisors make the transition to the new rule, exemptions, and consumer protections for investment advice.

No Contract Requirements for ERISA Plans

The new rule eliminates the contract requirement for ERISA plans and their participants and beneficiaries that had been included in the proposed regulation. Firms must acknowledge in writing that they, and their advisors, are acting as fiduciaries when providing investment advice to the plan, participant, or beneficiary, but no contract is required.

The final exemption simplifies the contract requirement so that it is only between the firm and the client, and notes that there does not have to be a new contract for each interaction with a different employee of the same firm, such as call centers.

TPAs OK?

Third-party administrators mostly untouched by the final regulation

Third-party administrators got some good news, and some much-need clarity, in the final fiduciary regulation. While "producing" TPAs that act as a plan's investment advisor would, of course, need to keep in mind the provisions of the new regulations that focus on the advisor role, the new fiduciary regulation made clear that a TPA's recommendation of a record keeper would not constitute a "recommendation," and thus would not result in fiduciary status for the TPA, even if there was a differential in compensation as a result.

Additionally, the platform exception was simplified and broadened in the final regulation, addressing ambiguity that had caused concern in the 2015 proposal. Specifically, the final regulation made clear that there are:

- no restrictions on proprietary investments on the fund platform; and
- no requirement or limit as to the number of investments.

It was also spelled out that so-called "segmented" platforms were permitted. This would include differentials in, say, the menu of funds offered to plans in a certain size segment. As long as the segmentation isn't to a specific plan, these segmented platforms are allowed under the final regulation.

Of course, that doesn't mean that there are no considerations for TPAs. Activities such as helping plan sponsors choose investments, making a recommendation as to the selection of an advisor (and receiving compensation for that advice) would constitute recommendations, and establish fiduciary responsibility. Similarly, if a TPA were to make a recommendation regarding a rollover transaction and receive a referral fee for that service, it would likely be considered advice.

One item that wasn't included in the final regulation (though it was acknowledged) is a platform exception for IRAs. As stated in the regulation, the lack of an intervening, independent fiduciary in reviewing the funds (as there is in ERISA plans) concerned the Labor Department. While the regulation acknowledges that in the presence of such an entity could provide the desired shield, the particulars of that situation are not yet clear, and would require additional research.

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IRA Advice Contracts

As for advice to IRA holders, the final BIC exemption makes clear that the contract can be signed at the same time as other account opening documents. However, any advice given before the contract was signed must be covered by the contract and also meet a best interest standard. The exemption also permits existing clients to agree to the new contractual protections by "negative consent."

Grandfathering

The BIC exemption includes a grandfathering provision that allows for additional compensation from previously acquired assets. The grandfather provision includes recommendations to hold, as well as systematic purchase agreements, but requires that additional advice satisfy basic best interest and reasonable compensation requirements.

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EXPERT OPINIONS

Though we've had the final regulations to study for some time now, advisors, consultants, home office staff and the legal community are still scrutinizing the text to evaluate its impact on business practices, compliance requirements, and revenue structures. And will likely be doing so for some time to come.

For some perspective on the regulation, we reached out to four of the nation's leading ERISA legal experts — former Assistant Secretary of Labor Brad Campbell (now with Drinker Biddle & Reath), Groom Law's David Levine, Marcia Wagner of the Wagner Law Group, and Fred Reish of Drinker Biddle & Reath — to get their take on the final fiduciary regulation, and how they think we'll look back on its impact(s).

What were you *most* pleased to find in the final regulation?

Campbell: While "pleased" is not the word I would use to describe my reaction to the final rule, the most useful addition is the level fee option in the Best Interest Contract (BIC) exemption, despite the limits on its application.

Wagner: The inclusion of the negative-consent BIC, the ability to grandfather old accounts, and the elimination of the most onerous disclosure rules.

Levine: The inclusion of the level fee "BIC Lite" exemption like the ARA's level-to-level proposed exemption and the simplification of the BIC disclosures. These changes make the BIC a more workable (although not without challenges) solution.

Reish: The most important change, and the one that I felt was most needed, was the simplification of the requirements for the BIC exemption. As drafted, the exemption would not have been workable, which would not have been in anyone's best interest.

What were you most disappointed *not* to find there?

Wagner: Additional time. April 10, 2017 and Jan. 1, 2018 will not be enough time for the largest entities to respond.

Levine: More clarity and flexibility in the platform exception (formerly carve-out) to the definition of fiduciary. As advisors have taken on more roles and the lines between advisors, investment managers, and other service providers continue to blur, the concept of what is a "platform" becomes more important than ever.

Reish: I believe that the usefulness of the disclosures have been diminished by the fact that the financial disclosures are not required to be made in dollar amounts…for costs and compensation. At this time, though, it may not be possible. For example, the systems changes would have been very expensive and would have taken longer than the applicability dates allow. But, in due course, I hope that dollar amount disclosures are required for costs and compensation. That is because, while percentage disclosures may be effective for plan sponsors, I think that there are a fairly large number of individual IRA investors who will not take the time to read all the materials that are given to them, to visit the website, to request additional disclosures, and then to do the calculations necessary to understand the impact.

Campbell: I was most disappointed by the absence of a broad exclusion for sales activity. Much of the difficulty posed by the rule is that it runs counter to securities and insurance regulation — rather than simply establishing a standard of care to govern proper sales conduct, the rule generally prohibits the sale of many affiliated products unless one complies with the onerous conditions and accepts the frivolous litigation risks presented by the BIC exemption.

What is the aspect of the fiduciary regulation that you find/think that advisors haven't focused on yet — that you think they should be?

Campbell: First, I think too many advisors believe that if they are already charging a level fee then they have nothing to worry about under the rule. That is simply not the case — almost all advice regarding rollovers, for example, results in a prohibited transaction under the rule, whether you charge a level fee or not. Second, I think too many advisors don't fully appreciate the scope of the rule with respect to distribution advice. Many recommendations that financial professionals would not think of as retirement savings advice could be subject to the rule. For example, recommending that a distribution from an IRA be used to purchase life insurance for estate planning purposes, or to purchase a long-term care policy, would be fiduciary advice.

Levine: The need to truly "unpack" their activities. From theories that saying "hire me" covers a broad range of activities — including specific recommendations — to the complexities of managed account solutions where an advisor plays a role, a deeper dive will be necessary.

Reish: I believe that the long-term impact of the fiduciary regulation is not yet commonly understood. For example, in order to make a prudent recommendation of an insurance product (*e.g.*, a traditional fixed rate annuity or an individual variable annuity), an adviser needs to consider the financial stability of the insurance company and its anticipated ability to make payments 20, 30, 40 or more years in the future. That requires a degree of sophistication and a fair amount of work. Also, I am concerned that some advisers have not yet focused on the fact that BIC exemption refers to IRA investors as "retirement investors." I believe that terminology reflects the Department of Labor's belief that IRA money is held for retirement and should not be treated simply as a personal investment sandbox. In other words, the investment and insurance recommendation should be consistent with providing benefit adequacy and retirement income after the IRA owner has retired.

Wagner: How the grandfathering rule will apply to a previous book of business that an advisor does not want to transition. For example, the rule requires the compensation to be reasonable before the grandfathering rule can take effect.

Five years from now, what do you think we'll think of the fiduciary regulation?

Levine: The fiduciary regulation imposed new process and compliance requirements that were burdensome but have been heavily systematized. It will likely be viewed as reshaping who plays what role in the retirement services industry. However, depending on the DOL's additional interpretations, we may also be looking at a more complex enforcement and litigation landscape 5 years out from the regulation.

Campbell: I think we will look back and shake our heads that we spent so much time and treasure on comprehensive change that provided no real benefit in relation to its costs. The winners will have been the lawyers, and the losers will have been the small plan participants and small-account-balance IRA owners.

Wagner: I believe these regulations are a watershed moment for the industry and will have a much bigger lasting impact than any other major regulation since PPA 2006. We will have seen them reshape the entire industry in a more dramatic fashion than 408(b)(2) or 404a-5.

Reish: I believe that the fiduciary regulation will be viewed favorably 5 years from now. However, in saying that, I am separating the regulation from the exemptions. With regard to the exemptions, I believe that BIC exemption will need to be modified in the future, as the Department of Labor learns about unforeseen difficulties and consequences, as well as deficiencies that should be improved.

Any words of counsel or caution for those trying to comply with the fiduciary regulation?

Reish: For small advisory firms, I believe they should consider pure level fee advice to IRAs. The cost and difficulty of satisfying the BIC exemption conditions will probably be too burdensome for small firms. Generally, for advisers, I believe that the greatest potential for unknowing violations lies in capturing rollovers and in recommending the transfers of IRAs. In both of those cases, advisers should work with knowledgeable attorneys to develop their systems, policies and documentation. There is risk in recommending rollovers and IRA transfers.

Wagner: Get help. Do not go it alone. Either from your home office or from competent ERISA counsel. The new rule is filled with landmines.

Levine: If it looks too good to be true, it probably is. While there will be commonalities among many compliance strategies, because each advisor or service provider is structured differently, careful attention needs to be paid to each organization's operational structures at a granular level.

Campbell: For advisors: Be patient, be flexible, and don't panic. As frustrating as it is to wait, the financial institutions with which you are affiliated have to make major business decisions based on a very complex set of rules where there is no one-size-fits-all compliance solution. This takes a little time. When a decision is made, it will almost certainly result in significant changes to the process and documentation related to your investment recommendations, and it may materially change your compensation arrangements. Change is coming, and we are going to have to adapt. However, don't panic — we will get through this and you will be able to help your clients.

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MODEL CITIZENS

At the 2016 NAPA 401(k) SUMMIT, three prominent industry execs weighed in on the potential impact of the fiduciary regulation on different business models

"This is a big win" for the RIA model, said J. Fielding Miller, CEO of CAPTRUST Financial Advisors. William R. Chetney, CEO of GRP Advisor Alliance said he considers it "interesting to see how broker-dealers react" and that it is a little challenging for them from some perspectives, but that it also creates some clarity. Edward O'Connor, Managing Director for Retirement Strategy at Morgan Stanley, noted that the biggest challenge is that now "we have to think of the best way to document the best interest consideration for investors and to demonstrate it when challenged."

All three were relieved that the point-of-sale provisions that were in the rule in its proposed form were removed from the final rule.

The disruption is "tremendous" for advisors, in Chetney's view. O'Connor agreed, saying that "there are going to be a lot of smaller firms that will be struggling to comply with the rule." Miller was the most blunt of all, saying, "This is going to thin out the herd," and calling it "prime hunting season for our industry."

For good measure, O'Connor reminded attendees that the other shoe has yet to drop. "And let's not forget, the SEC is coming. This is going to continue," he said.

Will the rule result in a trend of encouraging participants to keep their assets and accounts where they are, and to forgo the common practice of transferring them at times such as changing jobs? Miller said he thinks so, responding that he thinks there will be less movement out of plans and that one of the results will be that there will be a lot more money in plans and left in plans. Chetney agreed, and said that because of the rule, plan sponsors and participants won't leave as much of a trail as they had in the past as a result of changing jobs.

Does the rule put advisors in jeopardy? Not necessarily; "I don't think we've dis-invented the advisor," said Chetney. O'Connor was even more confident, remarking, "Clearly there's a huge need for Americans to be helped" in building retirement income. "Individual responsibility is not going away. Individuals have to take care of their own lives."

What about the future? "We see this as a really, really good opportunity to grow," said Miller. Plan sponsors, he said, are "inundated with lots of information," and his firm hopes that results in requests for proposals. "There is opportunity" in the disruption the rule creates, he said.

But Miller added that there is a risk — the rule it could result in a disclosure that nobody reads.

O'Connor said that the rule emphasizes that "you need to be a specialist in this business" and that as a result of the rule's promulgation, "rollovers will be less important in anyone's business model" and that the multiple employer plan model will be embraced and accepted to a greater degree than it is now.

There is a "real opportunity for people to consider what they can do for customers that they don't do now," said Chetney, adding that the rule provides "a real opportunity to re-envision what we do for plan sponsors and participants."

— John Iekel

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Insurance Sales

Under the final regulation, firms can use the BIC exemption to sell other insurance products like variable and indexed annuities. Additionally, the new regulation contains new preamble language emphasizing that fees are not the only factor in making investment decisions, while giving firms more flexibility on how to comply with disclosure provisions. The DOL says this should make it easier for insurance firms to recommend their products.

So, will this be the best — or worst — of times? As is often the case, the answer will depend on where you stand now, and how you plan to structure your practice in the future — and the answers to the questions that are only just now beginning to be asked.