FINANCIAL SERVICES FLASH REPORT

U.S. Department of Labor Releases Final Fiduciary Rule

June 9, 2016

The United States Department of Labor (DOL) has released its final Conflict of Interest Rule–Retirement Investment Advice (also known as the fiduciary rule), which amends the Employee Retirement Income Security Act of 1974 (ERISA).[1]

The new fiduciary rule replaces the current ERISA definition of "fiduciary", introduces new non-fiduciary exceptions and expands the scope of the rule to regulate investment retirement accounts (IRAs) and 401(k) plans. It also establishes exemptions, including the Best Interest Contract (BIC) Exemption.

Implementation of the new rule will follow a phased approach, with certain "Phase I" requirements taking effect on April 10, 2017, and full compliance with the remaining "Phase II" rules required by January 1, 2018.

For the first time, advisers' conduct is subject to the new ERISA definition of "fiduciary", which will require broker-dealers and retirement investment advisers to adapt their business practices and client relationships to comply with the new standards.

The term "adviser" describes "an individual or entity who is, among other things, a representative of a registered investment adviser, a bank or similar financial institution, an insurance company, or a broker-dealer."[2] A financial institution is described as an entity that employs or retains advisers as independent contractors, agents or registered representatives.

Prior to the release of the fiduciary rule, the relationship between adviser and client was subject to suitability standards issued by the Financial Industry Regulatory Authority (FINRA) when the adviser is a broker-dealer or is otherwise subject to FINRA regulations. Previously, it was sufficient for advisers to provide recommendations to clients if they had a "reasonable basis"[3] to believe the recommended products suited the client's investment profile. Through the fiduciary rule, current FINRA suitability standards are replaced with elevated standards that require advice to serve the best interests of a client's investment objectives.

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[1] Conflict of Interest Rule – Retirement Investment Advice, Federal Register, Vol. 81, No. 68, U.S. Department of Labor, April 8, 2016: http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806.
[2] *Ibid.*
[3] *Ibid.*

In the past, broker-dealers could realize revenues from the client as well as receive third-party compensation through incentives and other payments, thus creating, in the DOL's view, a potential conflict of interest, as earnings were possible from more sources than the client.

Prior to the release of the fiduciary rule, under ERISA and the Internal Revenue Service (IRS) rules, individuals providing fiduciary investment advice to plan sponsors, plan participants and IRA owners were not permitted to receive payments creating conflicts of interest without a prohibited transaction exemption (PTE). In the past, PTEs have tended to be limited to narrow categories of specific transactions under more prescriptive and less flexible conditions. The BIC Exemption will allow firms, previously subject to FINRA regulations, to continue to set their own compensation practices, as long as they commit to putting their client's best interest first and following other practices, discussed later.

Fiduciary Investment Advice

Replacing the definition of "fiduciary" amends how ERISA evaluates fiduciary communications and how nonfiduciary exceptions are assessed in the context of providing retirement investment advice. Under ERISA Section 404(b), fiduciary responsibility with regard to investment duties requires the adviser to give appropriate consideration to investment recommendations and consider the facts and circumstances that the fiduciary knows or should know are relevant to the particular investment or investment course of action involved.

Fiduciary investment advice incorporates both impartial conduct standards and best interest standards as required conduct for advisers having fiduciary responsibly to their clients. Impartial conduct standards describe the obligation to provide investment advice in the client's best interest, avoid misleading statements and not recommend transactions believed to result in more than reasonable compensation. The best interest standard focuses on the obligation of a fiduciary to act solely in the interest of the client with care, skill, prudence and diligence.

A recommendation made by an adviser is considered fiduciary investment advice and is defined as "a communication that, based on its content, context and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action."[4] Distinguishing nonfiduciary and fiduciary communication is contingent on facts and circumstances surrounding the statements made by the adviser. This includes consideration of the relationship and expectations of the client and of whether the communication would reasonably be considered a recommendation.

The more individually tailored a communication is, the more likely it will be considered a recommendation and constitute fiduciary investment advice. In contrast, a general communication is less likely to constitute a recommendation and is therefore nonfiduciary. It seems reasonable that communications will often need to be reviewed on a case by case basis to consider both the specific relationship with the client and the product or service offerings.

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[4] "Department of Labor Finalizes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle-Class Families Billions of Dollars Every Year," U.S. Department of Labor: www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html.

Therefore, determining whether a recommendation was communicated may be more subjective and may require careful comparison with the carve-out exceptions outlined in the rule.

The definition of “fiduciary” set forth under the fiduciary rule identifies specific exceptions where otherwise covered communications would be nonfiduciary. The exceptions appear to support transparency and disclosure to retirement industry consumers and include:

- Information delivered by a plan provider to a plan fiduciary without regard to the individualized needs of the plan
- Information conveyed to a plan fiduciary identifying investment alternatives that meet objective criteria specified by the plan fiduciary
- Information provided in response to a request for proposal or similar solicitation by or on behalf of the plan
- Communications considered general communications, which occur when a reasonable person would not view them as investment recommendations
- Communications related to investment education, which is described in four sections covering a range of communications

The definition also contains three exceptions related to adviser conduct. Each exception appears focused on specific circumstances surrounding communications or which may arise in the course of managing a portfolio of products or investments, as well as handling administrative responsibilities. These nonfiduciary exceptions include:

- Advisers engaging in arms-length transactions with independent fiduciaries of a plan where the independent fiduciary is qualified, has financial expertise and meets the details of requirements set forth under the rule
- Dealer conduct in swap transactions
- Employees of plans, plan sponsors, related organizations, plan fiduciaries and independent contractors that serve a support function and receive no fee or other compensation, direct or indirect, in connection with advice provided

Considering compliance with the fiduciary standards, as well as the above exceptions, a robust compliance program will monitor how these new requirements are applied to client relationships and will assess circumstances intended to fall within these enumerated exceptions. Further discussion about integrating effective compliance practices is below.

Best Interest Contract Exemption (BIC Exemption)

The final rule includes several exemptions from this new definition of fiduciary, and the one that will most frequently be used is the BIC exemption. The BIC exemption is a written contractual agreement where the financial institution and the adviser have agreed to abide by fiduciary standards of conduct. Entering into a contract governed by the BIC exemption, the financial institution and the adviser execute a written agreement with a retirement investor promising to provide clear and accurate information and full disclosure of fees, compensation and material conflicts of interest, as well as to maintain transparency in dealings and to responsibly adhere to the best interest standard. By following these guidelines, a financial institution is allowed to be compensated in a way that would otherwise be prohibited.

Under the contract, the financial institution also agrees to refrain from incentives that may interfere with the adviser's fiduciary responsibility and to provide advice that is in the retirement investor's best interest (i.e., prudent advice based on the investment objectives, risk tolerance, financial circumstances and needs of the retirement investor).

Following implementation, when forming new advisory relationships, financial institutions and advisers across the retirement investment industry will routinely establish contractual relationships through the BIC exemption. The contract will need to be signed before or at the time an adviser-recommended transaction is initiated. For existing advisory relationships, the retirement investor will need to be provided notice of the new rules and implementation of impartial conduct standards, but further action will not be required.

Advisers and financial institutions are not expressly prohibited from any form of compensation under the BIC exemption, but they are responsible for adhering to fundamental standards of fiduciary conduct and fair dealing. DOL commentary makes it clear that the exemption neither bans all conflicted compensation nor permits financial institutions and advisers to act on their conflicts of interest to the detriment of the clients they serve as fiduciaries. This point appears to emphasize the responsibility of financial institutions and advisers to incorporate a disciplined approach regarding management of client relationships, including a commitment to fiduciary responsibilities.

In particular, responsibilities under the BIC exemption include affirming commitment to fiduciary standards; promising to follow impartial conduct standards, including communicating advice in the retirement investor's best interests; charging reasonable fees; disclosing conflicts of interest; and maintaining transparency as well as integrating policies and procedures designed to prevent violations of impartial conduct standards.

BIC Exemption – Assessing Compliance Risks

The impact of the BIC exemption on compliance risks will be both structural and substantive, with associated compliance risks, including an assessment of the required internal policies and procedures, as well as the recognition that a client has the right to litigate a perceived breach of fiduciary duties. Currently, an unsatisfied client is required to agree to arbitrating disputes with financial institutions and advisers.

Policies and Procedures

Financial institutions and advisers are required to comply with the new regulations governing the BIC exemption. Written policies and procedures to mitigate risk posed by conflicted payments arising from sales incentives should be developed, integrated and internally enforced. Successful policies and procedures require:

- Structuring the compliance program to ensure that advisers maintain compliance with impartial conduct standards throughout the client relationship
- Developing a system to effectively monitor and prevent material conflicts of interest from interfering with the adviser adhering to impartial conduct standards
- Designating an individual or creating a committee responsible for resolving material conflicts of interest and monitoring advisers' commitment to impartial conduct standards in managing client relationships
- Devising an effective process for financial institutions to engage in continuous self-assessment, as well as assessment of their affiliates and related entities, to ensure that there are no incentive compensation options, including quotas, appraisals, performance or personal actions, bonuses, contests, special awards, differential compensation or other actions or incentives that would reasonably cause or attempt to cause advisers to make recommendations not in the retirement investor's best interest

Litigation Risk Management

The risk of litigation presents a significant departure from the FINRA arbitration process embodied in current financial institution and advisory agreements. While individual claims may be the subject of a pre-dispute binding arbitration agreement, the BIC exemption indicates that claims for violation of fiduciary responsibility must be allowed to proceed in court. This requires financial institutions to analyze litigation risk through an inventory of business activities and auditing the effectiveness of their implemented policies and procedures, as discussed above.

Litigation risk analysis is conducted to identify aspects of adviser conduct, recommendations and client relationship management that may be susceptible to conflict of interest, misrepresentation or other breach of fiduciary responsibility. Commentary from the DOL provides assurances that investors will not be able to use this enforcement mechanism simply because they did not like how an investment turned out.

Prohibited Transaction Exemption 84-24 (PTE 84-24)

Several exemptions to prohibited transactions under ERISA have been established over the 43 years since ERISA's enactment. Under the fiduciary rule, several existing prohibited transaction exemptions are modified. One notable amendment is PTE 84-24, which is concentrated on fixed-rate annuity contracts. This exemption is particularly relevant to advisers such as insurance agents, insurance brokers, pension consultants and investment company principal underwriters providing retirement investors advice on plans or IRAs.

PTE 84-24 provides an exemption for fixed-rate annuities that is less paperwork-intensive and less structured than requirements under the BIC exemption. In comparison, variable-rate annuities and fixed-indexed annuities are subject to the BIC exemption. The difference in the exemptions means that variable annuities and fixed-index annuities are subject to more complex regulatory standards, which may potentially impact how advisers recommend annuities.

Something to watch is what impact, if any, this disparate treatment of annuities will have on how a financial institution markets or sells these products to clients.

Principal Transaction Exemption

The principal transaction exemption allows activity that would otherwise violate fiduciary responsibilities under impartial conduct standards. Here, the exemption grants authority to an adviser to engage in buying or selling certain investments held in the financial institution's inventory (i.e., to engage in principal transactions) with plans, participant or beneficiary accounts, and IRAs. Such transactions are conditioned on certain enumerated requirements under the exemption that appear consistent with the consumer protection rationale underling the fiduciary rule.

Inventory described under the definition of "principal traded asset" includes debt securities, certificates of deposit and unit investment trusts, as well as future investments permitted to be purchased through exemptions granted by the DOL. Additionally, the definition includes securities and investment property used for purposes of a sale by a plan, a participant or beneficiary account, or an IRA. Under the rule, riskless principal transactions are purchased or sold from the financial institution's account to offset the client's contemporaneous transaction.

To utilize this exemption, a financial institution is required to develop, integrate and maintain detailed policies and procedures to maintain oversight of advisers and self-regulate compliance with the rules governing this exemption. Compliance measures implemented through the policies and procedures should include:

- Establishing oversight of advisers to ensure that conduct is consistent with impartial conduct standards
- Addressing material conflicts of interest associated with principal transactions and riskless principal transactions
- Mitigating material conflicts of interest from causing violations to impartial conduct standards
- Designating individuals responsible for addressing material conflicts of interest and monitoring advisers' management of client relationships
- Prohibiting actions or incentives that would reasonably cause or attempt to cause advisers to make recommendations not in the retirement investor's best interest
- Addressing credit risk and liquidity assessments for debt securities as related to principal transactions and riskless principal transactions

Implementation Timeline

Implementation of the fiduciary rule is set to occur in two phases. The aim of this phased approach is to support the integration process across the entire retirement investment industry.

The first phase follows the release date of April 6, 2016, and the publication date of April 8, 2016, and extends through April 10, 2017. In this twelve-month period, fiduciary standards are required to be implemented. April 10, 2017, is described as the "applicability date" because it is the deadline for financial institutions and advisers providing retirement investment advice to integrate and comply with fiduciary standards.

The second phase immediately follows the applicability date and extends through January 1, 2018. Financial institutions are expected to reach full compliance with the fiduciary rule during this eight-month period. DOL commentary indicates that financial institutions are required to integrate policies and procedures, establish full disclosure practices and implement use of the BIC exemption into their and the advisers' process of establishing and managing client relationships.

Compliance Integration and Current Event Monitoring

The fiduciary rule has the potential to introduce significant and disruptive change to the retirement investment industry. Because advisers' conduct is subject to the new ERISA definition of "fiduciary," broker-dealers are subject to FINRA "suitability" standards, and even retirement investment advisers are subject to the Securities and Exchange Commission's (SEC) definition of "fiduciary." They now have to adapt their business practices and client relationships to comply with the new standards.

Similarly, financial institutions must adapt to the same increased standards, as well as establish an effective compliance program. Achieving compliance with the fiduciary rule will require a comprehensive risk assessment and integration of a robust compliance program that supports management of client relationships. Initial steps include conducting an inventory of business activities and aligning those activities to the new fiduciary rule requirements.

This change to the definition of fiduciary will also force firms to analyze whether their business model is still viable. We have already begun to see the consolidation of smaller firms that do not feel they can survive in this new environment.

In this context, many are questioning whether smaller investors will still be a profitable business for firms, and whether these investors will get the necessary advice to make informed decisions about their retirement accounts.

Considering the industrywide impact of the fiduciary rule, we believe that financial institutions and advisers should immediately take action to assess the impact of the new fiduciary standards and exemptions, integrate a robust compliance program to mitigate risk and support business operations, assess how to efficiently adapt where necessary and consider business development potential that may emerge from the industrywide reform.

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