

The Game Changing Fiduciary Rule

A Summary of the Finalized Conflict of Interest Rule

A Road of Revision

The retirement landscape has changed drastically with a shift from traditional pension plans to employee-directed 401(k)s. However, the definition of fiduciary and rules governing fiduciary actions have not substantially changed since they were written in 1975. With the shift to participant-directed savings comes an enhanced need for sound financial and investment advice. Most retirement plans are brokered which, historically, only required the investments be “suitable” for the investor. The new elevated standard requires the advisor to operate solely in the best interest of their client.

In April 2015, the Department of Labor released a Conflict of Interest proposed rulemaking aimed at redefining the term “Fiduciary” to ensure that every person receiving retirement investment advice would receive advice in their best interest. This proposal was the DOL’s second attempt as they formally withdrew a similar proposal from 2010. Following the 2015 proposal, the DOL received extensive feedback from stakeholders including industry advocates and professionals as well as Congress and other government officials. The Department evaluated more than 3,000 comments and records from over 100 meetings and 4 days of public hearings. Changes were made to clarify and streamline the proposed rule and exemptions while still enforcing a best interest standard for retirement advice. On April 6, 2016, the final rule was released.

The purpose of this final rule remains to ensure that retirement savers are receiving advice that is in their best interest. Additionally, the rule seeks to minimize the compliance burden for advisors who already adhere to a standard of putting their client’s interests first. The finalized rule has been called a “game changer” for the financial industry and it appears to live up to this name.

The Finalized Definition of the Term “Fiduciary” & Conflict of Interest Rule

A Modern Definition of “Fiduciary”

The definition of “fiduciary”, as drafted in 1975, includes “anyone who gives investment advice for a fee or other compensation with respect to any moneys or other property of a plan, or has any authority or responsibility to do so”. A 5-part regulatory test was used to determine if an investment advisor should be considered a fiduciary. This narrow definition of fiduciary allowed for an advisor to only be held to ERISA fiduciary standards if they, (1) made recommendations on investing in, purchasing or selling securities or other property, or gave advice as to their value (2) on a regular basis (3) pursuant to a mutual understanding that the advice (4) would serve as a primary basis for investment decisions, and (5) would be individualized to the particular needs of the plan.¹

¹ Fact Sheet: Definition of the Term “Fiduciary”. U.S. Department of Labor. Employee Benefits Security Administration. 30 March 2011. <http://www.dol.gov/ebsa/newsroom/fsfiduciary.html>

According to an updated Fact Sheet from the DOL's Employee Benefits Security Administration, "The Department's conflict of interest final rule and related exemptions will protect investors by requiring all who provide retirement investment advice to plans and IRAs to abide by a "fiduciary" standard—putting their clients' best interest before their own profits."²

Noteworthy Changes

Many changes were made to the 2015 proposal to clarify, streamline, and simplify the proposed rule and exemptions. The following are among the most significant alterations made based on stakeholder feedback received by the DOL.³

Recommendations

The final rule clarifies the qualifications of a "recommendation", resolving that general investment education and other non-targeted, general communications are not considered personalized recommendations and thus, do not constitute a fiduciary relationship. In the final regulation, the DOL includes assets allocation models and interactive educational materials as general investment education for ERISA plans. Additionally, an advisor recommending that a potential client hire them to render advisory or asset management services is not considered to be offering fiduciary investment advice in this initial recommendation.

Contract Requirements

The DOL removed the contract requirements for ERISA plans from the final rule. The 2015 proposal included a requirement for the firm and the client to be parties of a contract, but the DOL understood that this would be difficult for firms where the client may speak to several different advisors, such as in firms with a call center. Based on the new rule, the firm must acknowledge in writing that they are acting in a fiduciary capacity when providing investment advice to the plan, but a contract is not required.

The Best Interest Contract (BIC) Exemption

Due to a large amount of comments expressing concern on the topic, the DOL reworked the best interest contract (BIC) from an unworkable standard to a viable, streamlined process. Additionally, the BIC exemption will be available to advisors of small businesses which sponsor a 401(k). The DOL has also clarified how the BIC exemption can be used for recommendation of proprietary products and lifetime income products.

The final rule also contains a special provision for level fee fiduciaries in the BIC exemption. Essentially, the provision requires the advisor to keep documentation explaining why a rollover from an ERISA plan or IRA to a level fee arrangement, or any switch from commission-based to a level fee agreement, was in the best interest of the client.

² Fact Sheet: 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. Employee Benefits Security Administration. April 2016. <http://www.dol.gov/ebsa/newsroom/fs-conflict-of-interest.html>

³ Chart Illustrating Changes from Department of Labor's 2015 Conflict of Interest Proposal to Final. Department of Labor. <http://www.dol.gov/ebsa/pdf/conflict-of-interest-chart.pdf>

Disclosure Requirements

The 2015 proposal required disclosures with 1-, 5-, and 10-year cost projections prior to the sale of an investment, which was a topic discussed by many opponents. As these disclosures would be costly and difficult to comply with, the DOL has significantly streamlined the disclosure requirements. In particular, the projection requirement has been eliminated.

Existing Arrangements

Based on comments that existing arrangements should be treated differently than future ones, the Department created a grandfathering provision that allows for additional compensation based on investments made prior to the applicability date of this regulation.

Transition & Implementation

Due to implementation concerns, the DOL extended the first phase of the implementation of the final rule from eight months to one year. The applicability date for the first phase of implementation is now April 10, 2017. Additionally, the DOL adopted a phased implementation for the Best Interest Contract exemption and the Principal Transaction exemption, giving firms even more time to come into full compliance. Firms should be in full compliance with the disclosure provisions, policies and procedures requirements, and contract requirement by January 1, 2018.

Finally, the DOL has made it very clear that they intend to provide compliance assistance to firms with implementation issues or questions.

The Bottom Line

When dealing with something as important as your retirement savings, something you've spent your entire career working to attain, you deserve the best advice possible. As Robert C. Lawton, an RIA and President of Lawton Retirement Plan Consultants, explains, the message that the DOL and EBSA is sending is "Don't feel that you have to work with a broker who views his/her new responsibilities as a burden. These regulations benefit you, the plan sponsor. Any adviser who whines and complains about taking your best interests into account when providing investment advice is not worth working with."⁴

⁴ Manganaro, John. First Round of Industry Response to Final Fiduciary Rule. PlanAdviser. 06 April 2016.