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IMPACT OF THE DOL'S PROPOSED FIDUCIARY STANDARD ON FINANCIAL PROFESSIONALS

I. IMPETUS FOR THE RULE - CONCERN OVER CONFLICTS & "QUALITY ADVICE"

"Conflicted Advice" Costs Consumers

The DOL's final Rule (and related exemptions) is designed to address concerns that investment advisers are presented with a conflict of interest when they are compensated more for recommending certain investment products over others to their customers, but the products they are recommending may not be in the "best interest" of the customer. The DOL contends that many retirement accounts have been significantly underperforming due to such conflicts. The DOL reasons that the final Rule is a necessary mandate designed to protect consumers who are often unaware that their financial adviser has a conflict of interest because the fees/commissions received are often hidden in fine print or not disclosed at all. According to the DOL, such fees and commissions can improperly incentivize advisers to make recommendations that generate the highest fees for them, rather than the best return for their retirement clients. This is the first major update to the regulations governing retirement advice sine 1975. The DOL final Rule is a component of a recent trend toward consumer protection laws that are some of the strongest in American history.

Aligning Consumer and Adviser Interests

In explaining its motives behind the final Rule, the DOL notes that the market for retirement advice has changed dramatically since 1975. Among other changes, the DOL notes that individuals, rather than large employers and professional managers, have become increasingly responsible for managing retirement assets as IRAs and participant-directed plans, such as 401(k) plans, have supplanted defined benefit pensions. The new "fiduciary standard" makes clients' retirement security advisers' top priority. Advisers now must guarantee they are putting their clients' interests ahead of their own. According to the DOL, this is now a mandate as opposed to a marketing tool. The Rule requires advisers to abide by a fiduciary standard in rendering retirement advice and to act in their clients' exclusive best interest. By ensuring that any conflicts of interest are disclosed, the Rule's stated purpose is to provide meaningful protection to plan participants and sponsors.

Significance of the Rule

The primary significance of the Rule is that it requires individuals and firms to act impartially and render advice in their clients' best interest. The Rule will change the landscape of providing investment advice as individuals and firms with longstanding relationships with large financial companies cannot simply default to utilizing investment vehicles which have provided favorable returns to their clients in the past. Advisers must specifically tailor their investment advice to ensure that retirement accounts are not just performing, but exceling for the benefit of their clients. Under the new Rule, retirement advisers will not be permitted to receive payments that would create a conflict of interest unless they comply with the Prohibited Transaction exemption designed to minimize the potential effects of a conflict.

II. WHAT DOES THE NEW RULE LOOK LIKE?

What is Different?

Prior to the Rule, a person was a fiduciary with respect to a plan to the extent he/she (1) exercises any discretionary authority or control with respect to management of an employee benefit plan or its assets; (2) renders investment advice for a fee or other compensation, direct or indirect, with respect to the money or property of such plan; or, (3) has any discretionary authority or responsibility in the administration of such plan. Currently, whether "investment advice" is considered to be fiduciary advice depends upon a five-part regulatory test.

In the view of the DOL, as the marketplace for financial services has evolved since 1975, the prior five-part test for determining whether a person can be treated as rendering investment advice for a fee has come to undermine rather than promote the statute's text and purpose. By way of illustration, the DOL notes that the narrowness of the 1975 regulation allows advisers, brokers, consultants, and valuation firms to play a central role in shaping plan and IRA investments, without ensuring the accountability that Congress intended for persons having such influence and responsibility. Such accountability is provided in ERISA's statutory language. The DOL Rule amends the definition of "investment advice" that is presumed to be fiduciary in nature.

Who Will Be Affected?

The Rule affects advisers who manage qualified assets (such as an IRA) on behalf of clients when those assets include compensation paid to the adviser by the sponsor and not the client. Pursuant to the new Rule, an adviser will now be treated as a fiduciary if the individual or firm receives compensation for providing advice with the understanding that it is based on a person's needs or is directed toward a specific plan sponsor, participant or IRA owner.

Under the Rule's revised definition of fiduciary, the scope of what type of recommendations constitute fiduciary investment advice is expanded. As a result, advisers making these recommendations will be considered fiduciaries, will be subject to the existing ERISA Prohibited Transactions rules, and will need exempted relief to avoid the consequences of engaging in a Prohibited Transaction. To this end, the DOL simultaneously published a new Best Interest Contract Exemption and a new Exemption for Principal Transactions, and revised other exemptions from the Prohibited Transaction rules of ERISA and the Code. As explained by the DOL, the exemptions and amendments would allow, subject to appropriate safeguards, certain broker-dealers, insurance agents and others that act as investment advice fiduciaries to nevertheless continue to receive a variety of forms of compensation that would otherwise violate Prohibited Transaction rules and trigger penalties/excise taxes.

Presumption of Fiduciary Advice

Under the new Rule, advisers are presumed to be providing fiduciary investment advice if they make (1) investment recommendations, including a recommendation to take a distribution of benefits or roll overs, (2) investment management recommendations, (3) appraisals, fairness opinions, or similar statements (whether verbal or written) concerning the value of securities or other property provided in connection with a specific transaction, or (4) recommendations of persons to provide any of the aforementioned advice for a fee or other compensation. Persons who provide the foregoing advice will now fall within the general definition of a fiduciary if they either represent that they are acting as a fiduciary with respect to the advice or provide the advice pursuant to an agreement, arrangement, or understanding that the advice is individualized or specifically directed to the advice recipient for consideration in making investment or investment management decisions regarding retirement assets.

The Rule specifically provides that "recommendation" means 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. Thus, the determination of whether a "recommendation" has been made is an *objective* rather than *subjective* inquiry. Thus, the Rule significantly expands the role and responsibilities of registered representatives and broker-dealers by expanding the definition of an ERISA fiduciary.

Prohibited Transaction Exemptions

There are certain exemptions also passed by the DOL which allow a fiduciary to continue to receive compensation that would otherwise be prohibited under ERISA. Two such exemptions are the "Best Interest Contract Exemption" ("BICE") and the "Principal Transaction Exemption." The BICE allows commissions paid by the Plan or a participant, and commissions, sales load, 12b-1 fees, revenue sharing or other forms of payment from a third party providing the product provided the adviser adheres to the requirements of the exemption. The adviser must execute a written contract acknowledging that the adviser is a fiduciary under ERISA, stating that the adviser will agree to the "impartial

conduct standard," and providing a contractual warranty of written policies and procedures to mitigate conflicts of interest and ensure compliance with all applicable laws and regulations as well as disclosure of material conflicts of interest and fee and compensation arrangements. The adviser must notify the DOL in advance that it is relying on the exemption and maintain its records for six years following any transaction.

Additionally, the DOL amended the exemption that covered certain transactions involving insurance agents, insurance companies, and other parties. Under the new Rule, PTE 84-24 has been amended such that all securitized insurance products, including indexed annuities, no longer qualify for this exemption. Rather, transactions involving those products must now meet BICE to be exempted.

III. EXPOSURES/LIABILITIES

New Pressures on Employers and Advisers under BICE

The new regulation puts additional responsibilities on employers to supervise their advisers and ensure the character of their advisers. Under the new DOL standard, when firms sign a Best Interest Contract Exemption, they will be acknowledging that their advisers may have conflicts of interest because of the manner in which they are compensated. By signing a BICE, an employer may faces increased liabilities and exposures that come with the accepting a fiduciary duty. Firms and advisers now must re-evaluate their business models and relationships to ensure they are acting responsibly as fiduciaries.

The BICE further opens the door for other civil actions such as a breach of contract claim and more class actions. Under the BICE, the contract may not include exculpatory provisions limiting firm or adviser liability and may not contain a class action waiver. Additional considerations include the duty to monitor customer accounts.

Regulatory Considerations

The fiduciary standard has significant compliance considerations for many market participants, including registered investment advisers and broker-dealers. Registered representatives must now prepare to operate under the enforcement scheme of the DOL in addition to other regulatory bodies. For example, the Form ADV conflict of interest disclosures may not satisfy the stringent standards of the DOL. Investment advisers must now be prepared to be jointly regulated by the SEC and the DOL. Broker-Dealers too will encounter another layer of standards beyond the existing suitability rules.

Adapting Business Practices to Implement the Rule

BICE requires that firms implement and adhere to written policies and procedures reasonably and prudently designed to ensure that its advisers adhere to the impartial conduct standards. This includes designating a specific person or role to handle customer inquiries and monitor firm compliance with the policies and procedures. There are also

several required disclosures to satisfy the BICE, which include disclosures related to compensation practices, third-party payments, as well as fees and charges. Firms must have specific disclosures in the contract as well as web based disclosures.

Multiple Accounts

Firms must now decide how they are going to monitor the situation where a client holds both a retirement account and other asset accounts with their firm. Developing a supervisory system for such clientele will be critical as financial advisers often advise their clients regarding their total portfolio. Thus, firms must decide how they will supervise advisers who advise clients on retirement accounts and other asset accounts.

Good Advice vs. Best Advice

It is incumbent on firms to add another layer of supervision over their registered representatives to ensure that they are administering the best possible retirement advice to clients – not just good advice. Firms must implement policies that ensure that advisers are narrowly tailoring their advice to each client to maximize performance within retirement accounts and monitor representatives whose practice may have been to default to a large financial company with whom they established a relationship or defaulted to a recommended investment vehicle. We can expect that this heightened standard for individuals and firms will lead to expanded litigation.

Phased Implementation

The updated Rule, now known as the conflict of interest standard, begins to take effect in April 2017 and will be fully in force by January 2018. The final ruling delayed the requirement for new formal policies, procedures, disclosures and contract provisions until January 1, 2018 to give employers time to adjust and develop compliance procedures.