

A photograph of several classical white marble columns with fluted shafts and tiered bases, receding into the distance on the left side of the page.

A DISCUSSION OF THE NEW DOL FIDUCIARY RULE

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The DOL Fiduciary Rule

Today's Discussion:

- Background on the DOL Fiduciary Rule
- Review of Current Standards
- Summary of the DOL Fiduciary Rule and Related Exemptions
- Likely Industry Consequences
- Questions and Answers

The DOL Fiduciary Rule

Quick Primer on Duties of Investment Professionals:

- Under current law, as a broker-dealer, advisers work as an “agent” for the client
 - Investments recommended must be “suitable” for the client
- As an investment adviser, advisers are deemed to be “fiduciaries”
 - Duty of Loyalty and to act Prudently
 - Required to act in client’s “best interests”
 - Duty to avoid conflicts of interest - Unavoidable conflicts must be disclosed and client can elect whether to do business
- A fiduciary under ERISA and the Internal Revenue Code is held to an even higher standard
 - Conflicts in transactions are generally not permitted – referred to as “prohibited transactions”
 - An ERISA fiduciary cannot engage in a prohibited transaction unless an exemption exists – disclosure does not “cure” the conflict

The DOL Fiduciary Rule

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Background on the DOL Fiduciary Rule ...

- Retirement Plans are generally governed by the Employee Retirement Income Security Act of 1974
 - Enacted at a time when a significant majority of retirement assets were held in defined benefit plans
 - Individual retirement accounts were introduced under ERISA, and defined contribution plans (i.e., 401(k)s) were not available until 1978
- Since the passage of ERISA, there has been a seismic shift in the manner in which Americans save for retirement
 - IRAs and 401(k)s now account for approximately 70% of all retirement assets
 - The vast majority of these retirement assets are self directed

Background on the DOL Fiduciary Rule (cont.) ...

- Given the movement away from defined benefit plans, the government is concerned that Americans are not saving enough for retirement and that current retirement vehicles are unnecessarily expensive
- More specifically, the DOL and the current Administration believe that “conflicted investment advice” is causing significant harm to retirement investors
 - \$17 billion annually in unnecessary costs
 - Conflicts are believed to exist primarily because of differential compensation structures, including variable commissions and 12b-1 fees
 - Belief is that advice given by non-fiduciary advisers (i.e., advisers working for broker-dealers) is often based upon the “best interests” of the adviser and not the client

A Summary of Current Rules ...

- Fiduciary status under ERISA and the Code is determined by meeting each requirement of a 5 part test:
 - Making investment recommendations for compensation
 - On a regular basis
 - Pursuant to a mutual agreement or understanding
 - Primary basis for the plan's decisions
 - Individualized to the plan's needs
- Typically, a non-discretionary adviser to a plan or IRA would not be considered a “fiduciary” because it does not meet each element of the test

The New DOL Fiduciary Rule ...

- Under the DOL Fiduciary Rule, the 5 part test has essentially become a 2 part test:
 - Making investment recommendations for compensation
 - ~~On a regular basis~~
 - ~~Pursuant to a mutual agreement or understanding~~
 - ~~Primary basis for the plan's decisions~~
 - Individualized to the plan's needs
- The rule now explicitly applies to IRAs as well as retirement plans
- Moreover, the DOL has rescinded its prior opinion that rollover advice is not a fiduciary activity

Summary of the DOL Fiduciary Rule (cont.) ...

- Under the new DOL Fiduciary Rule, an adviser now has a “fiduciary obligation” under ERISA and the Code with respect to any IRA account or retirement plan to which he or she is providing investment recommendations for compensation
- Unless an exemption applies, an adviser and firm can only impose a level fee (typically a set percentage or a fixed dollar amount) paid by the investor
- Unless an exemption applies, differential compensation (i.e., commissions and 12b-1 fees) for IRA investments and retirement plans is flatly prohibited (falls within prohibited transaction rules of ERISA)

Applicable Exemptions under the DOL Fiduciary Rule ...

- The exemption most applicable to retail invest service providers is the “Best Interest Contract Exemption” – known as the BIC Exemption or the BICE
- The purpose of the BIC exemption is to preserve, under very limited circumstances, the ability of advisers and firms to continue to charge commissions and other similar fees on IRA accounts and retirement plans
- Among other things, the Rule requires that the firm and the client enter into a written contract at the time the account is opened

BIC Contract Requirements ...

- The Firm and its Advisers must affirm fiduciary status under ERISA and/or the Code
- The Firm and its Advisers will comply with and adhere to the Impartial Conduct Standards
 - Provide advice in the Best Interest of the client without regard to his or her own financial interest
 - Will not receive more than “*reasonable*” compensation
 - No misrepresentations regarding the transaction, fees or material conflicts of interest

BIC Contract Requirements (cont.) ...

- The Adviser and Firm must promise the client that:
 - The Firm has adopted written policies and procedures designed to ensure that Advisers adhere to the Impartial Conduct Standards
 - The Firm has identified all material conflicts of interest that might result in breaches of the Impartial Conduct Standard and has adopted policies and procedures to prevent violations
 - The Firm does not use “quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives to the extent that they would tend to encourage individual advisers to make recommendations that are not in the best interests of the retirement investor.”

BIC Contract Requirements (cont.) ...

- The Contract cannot contain a waiver or limitation on a retirement investor's right to bring or participate in a class action against the Adviser or the Firm
 - But, the Contract may include a waiver of punitive damages or rescission to the extent permissible under federal or state law under state law

BIC Contract and Transaction Disclosures ...

- The Firm and Adviser must, at the time the BIC Contract is signed and, depending on timing, with each transaction thereafter, provide the following disclosure:
 - Stating the Best Interest standard
 - Describing all Material Conflicts of Interest
 - Detailed disclosures of costs, fees and other compensation the Firm and Adviser expect to receive regarding the recommended transactions
 - Informing the retirement investor of the right to obtain copies of the Firm's policies and procedures
 - Containing a link to the Firm's public website disclosures

BIC Website Disclosures ...

- The Firm must maintain a public website that contains:
 - A description of its business model and the Material Conflicts of Interest associated with the model
 - A schedule of typical account or contract fees and service charges
 - A model form of contract and required disclosures
 - A written description of the Firm's policies and procedures relating to conflict mitigation and incentive practices
 - A list of all product manufacturers and other parties with whom the firm maintains arrangements that provide third party payments to the Adviser or the Firm with respect to specific investment products (i.e., 12b-1 fees and other trail commissions), including a statement on whether and how these arrangements impact Adviser compensation
 - Disclosure of the Firm's compensation and incentive arrangements with Advisers, including incentives (both cash and non-cash) to Advisers for recommending particular products, for Advisers to move to the Firm from another firm or to stay at the Firm, and a full and fair description of any payout or compensation grids

Application of the DOL Fiduciary Rule and the BIC to Fiduciary Accounts ...

- The DOL Fiduciary Rule will also be applicable to investment advisory and trust accounts
- Referred to as “Level Fee Fiduciary” – the fee is based upon a fixed percentage or set fee that does not vary with the particular investment recommended
 - Must provide a written statement of fiduciary status and must comply with the Impartial Conduct Standards
 - In the case of rollovers from a retirement plan or recommendations to open a “level fee” arrangement, the Adviser must specifically document the reasons why the recommendation was considered to be in the best interest of the client, including consideration of alternatives and the services to be provided for the fee
 - But, no need to enter into BIC contract, no BIC warranties and no BIC transaction or web disclosures
 - Often referred to as "BIC Light" or "BIC for a day"

Summary of the BIC Exemption ...

- If the preceding requirements of the BIC exemption are met, then the Firm and its Advisers will be permitted to receive commissions and 12b-1 fees on IRA and retirement plan investments
 - To reiterate, the BIC exemption is the ***only exemption*** in the DOL's rule that would allow receipt of ***commissions and 12b-1 fees*** on securities products and fixed index annuities in IRAs and retirement plans
- With respect to individual Advisers, compensation under the BIC is required to be ***"levelized"***, meaning a level percentage of assets or a fixed fee payable regardless of the product sold
 - But, there can be some differentiation in commission where certain types of products may be more difficult or time consuming to sell
 - Referred to as "neutral factors"
- In all circumstances, compensation received by the Firm and Adviser must be ***"reasonable"***

Special Rules for Fixed Rate Annuities...

- Although fixed rate annuities do not fall within the BIC exemption, the DOL rule includes an amendment to Prohibited Transaction Exemption 84-24
- Pursuant to this exemption, an Adviser can receive a sales commission on the sale of a fixed rate annuity to an IRA account so long as it satisfies the Impartial Conduct Standards (i.e., act in the client's best interest), discloses all material conflicts of interest, and does not make misleading statements about the recommended annuity, fees, etc.
- The exemption does not require a BIC contract between the adviser and the client, nor does it require the extensive warranties and disclosures

Implementation and Transition Rules ...

- June 7, 2016 - The DOL Fiduciary Rule became effective
- April 10, 2017 – The rule is applicable for new transactions
 - The best interest standard becomes applicable
 - Disclosures are required for fiduciary status, reasonable compensation and Material Conflicts of Interest
- January 1, 2018 – Full BIC contract requirement must be met
 - Full contract, transaction and website disclosures required
 - Amendment of existing account contracts must be completed
- There have been several legislative and court challenges to the DOL Fiduciary Rule, but the odds of a successful challenge prior to the applicability date are not high

Predicted Industry Consequences ...

- Significant movement toward investment advisory services
- Products and services for small investors become more difficult to provide
- Robo products and other digital solutions become more prevalent
- Product offerings get slimmed down and simplified
- Revenue compression in the near term due to transition to advisory business, “levelization” of commissions and “reasonableness” requirement

Predicted Industry Consequences (cont.) ...

- Retirement plan rollovers become more difficult
- Substantial increase in compliance and operational costs to implement and operate under the rule
- A significant percentage of Advisers will likely exit the industry, and entry into the industry for younger advisers will become more difficult
- Over time, the non-qualified channel begins to mirror the qualified channel

A Discussion of the DOL Fiduciary Rule ...

Questions and Answers