

UNDERSTANDING DOL FIDUCIARY AND THE BEST INTERESTS CONTRACT

10.12.2016 | FPA IOWA

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DOL FIDUCIARY & THE BIC

- New DoL Fiduciary Rule timeline
 - First update proposed on October 22, 2010
 - Public comments through spring 2011
 - Withdrawn September 19, 2011 to re-propose
 - Re-proposed February 23, 2015
 - Public comments & hearings through fall 2015
 - Final rule issued April 6, 2016

DOL FIDUCIARY & THE BIC

- Current Fiduciary Status Under ERISA
 - Applies to those who provide “investment advice” regarding plan assets, for compensation
- Investment Advice is defined as:
 - 1) Investment recommendations made
 - 2) On a regular basis
 - 3) Based on mutual understanding that it is the
 - 4) Primary basis for investment decisions, and is
 - 5) Individualized to the needs of the plan

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DOL FIDUCIARY & THE BIC

- New DoL rule sought to plug fiduciary gaps
 - Prior 5-part test was very limited in scope
 - Reasonably relevant in 1975 when most advice was directly to institutional plans
 - Viewed as outdated in a world of defined contributions and self-directed retirement accounts (401(k) plans and IRAs)

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DOL FIDUCIARY & THE BIC

- New DoL fiduciary definition:
 - Fiduciary advice occurs when Investment Advice is given, for compensation, to a Retirement Investor in an advice relationship

DOL FIDUCIARY & THE BIC

- New DoL fiduciary definition – *Retirement Investor*
 - Defined to include participants of an ERISA plan, *IRA owners*, and *those who are acting as fiduciaries for an IRA or ERISA plan*
 - Also includes Education IRA (Coverdell) accounts, and HSAs & MSAs as well

DOL FIDUCIARY & THE BIC

- New DoL fiduciary definition – *Investment Advice*
 - Applies when a recommendation is given on:
 - Whether to buy/hold/sell/exchange
 - Whether to roll over an IRA
 - How to invest after a rollover
 - Which managers or strategies to use
 - Switch from brokerage to advisory
 - Advisor must receive (direct or indirect) fee or other compensation for the recommendation

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DOL FIDUCIARY & THE BIC

- New DoL fiduciary definition – *Advice Relationship*
 - Applies to a person who:
 - Holds out as a fiduciary
 - Provides advice to a specific person
 - Provides advice *that the recipient believes is based on their particular needs*

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- New DoL fiduciary definition – Key Changes
 - If the client believes you're giving fiduciary advice... you are!
 - No longer just ongoing/regular advice
 - Nor even limited to investments; the act of rolling over counts, too!
 - “Retirement Investor” includes IRAs, too!

DOL FIDUCIARY & THE BIC

- Why being a DoL fiduciary matters
 - Prohibited Transactions
 - A potential conflict of interest deemed material enough that it is prohibited (unless otherwise exempted)
 - Have a long history in (ERISA and trust) fiduciary law, particularly regarding “self-dealing” transactions

DOL FIDUCIARY & THE BIC

- DoL fiduciary prohibited transactions include:
 - Shifting to another investment or account that will pay the advisor more than the prior
 - Shifting to an investment or account that will pay an advisor not previously paid
 - Includes switching from a commission-based account to a fee-based wrap account
 - Also just includes any rollover in the first place!

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- DoL fiduciary prohibited transactions
 - A prohibited transaction would normally prevent the advisor from engaging in that action *at all*
 - DoL has the ability to grant a Prohibited Transaction Exemption (PTE) permitting specific advice situations
 - Advisors will be able to engage in 'typical' fiduciary advice by following the "Best Interests Contract Exemption" (BICE)

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- Understanding the Best Interests Contract
 - Advisors can avoid the prohibited transaction on their advice recommendations by signing a “Best Interests Contract” (BIC) with their clients, stipulating that their advice is in the “best interests” of the client
 - Functionally allows fiduciary advisors to provide investment advice for compensation

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- Requirements of the Best Interests Contract
 - 1) Acknowledge fiduciary status
 - 2) Adhere to Impartial Conduct Standards
 - Give Best Interests advice
 - Charge Reasonable Compensation
 - Make no misleading statements about transactions, compensation, & conflicts

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DOL FIDUCIARY & THE BIC

- Requirements of the Best Interests Contract
 - 3) Implement Policies & Procedures to mitigate potential violations of Conduct Standards
 - 4) Refrain from advisor incentivizes that may lead to acting contrary to clients' best interests
 - 5) Fairly disclose fees, compensation, & material conflicts of interest

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- BIC Requirements: Acknowledge Fiduciary
 - Fiduciary advisors are required to acknowledge, in writing, their fiduciary relationship to the client
 - May be included as part of the advisory or account opening agreement
 - Will generally be between the client and Financial Institution (regarding the advisor)
 - Meant to eliminate the “I wasn’t really acting in a fiduciary capacity” legal defense

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- BIC Requirements: Best Interests Advice
 - Part of Impartial Conduct standards
 - Will draw on what constitutes “Best Interests” advice from ERISA fiduciary rules
 - *“Prudent advice is advice that is based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution, or their Affiliates, Related Entities, or other parties.”*

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DOL FIDUCIARY & THE BIC

- BIC Requirements: Best Interests Advice
 - Part of Impartial Conduct standards
 - *“A fiduciary should act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man, acting in a like capacity and familiar with such matters, would use in the conduct of an enterprise of a like character with like aims.”*
 - Best Interests Advice is really “the prudent advice other (non-conflicted) experts would recommend in the same client situation.”

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- BIC Requirements: Reasonable Compensation
 - Compensation must not be excessive based on the going market value for services rendered
 - Similar to the prudent advice standard, it's based on expert-peer comparisons
 - Will depend on scope of services provided, and the experience and expertise/credentials of the advisor
 - » Permits varying models for different services
 - Primarily targets “above average” compensation
 - » Benchmarking will be more important than ever!

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- BIC Requirements: No Misleading Statements
 - Must be ‘reasonably’ clear about compensation and disclosing conflicts of interest
 - Limited current standards for what is “misleading” in the first place though?
 - Will increase scrutiny on sales/product illustrations
 - Equity-indexed annuities?
 - Variable annuities?
 - Non-traded REITs and BDCs?

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- BIC Requirements: Policies & Procedures
 - Primarily a focus for the Financial Institution, not the Advisor themselves
 - Of limited issue for RIAs, though compensation structures may be scrutinized?
 - Broker-dealers will formulate these policies & procedures, and hand them down via compliance
 - Remains to be seen how this will be implemented
 - Could actually be the “biggest” change of all?
 - » An attempt to force cultural change?

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- BIC Requirements: Advisor Incentives
 - Financial Institutions will be barred from having:
 - *“Quotas, [job] appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other actions or incentives that are intended or would reasonable be expected to cause Advisers to make recommendations that are not in the Best Interest of the Retirement Investor”*
 - Includes compensation to advisor, Institution, Affiliates and Related Parties
 - Sales contests, shelf space, rev sharing, etc.
 - Could impact GDC grids based on volume?

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- BIC Requirements: Disclosures
 - Must disclose *all Material conflicts of interest*
 - Also disclose policies/procedures to mitigate them
 - And designate a person responsible for it
 - Disclosures are not automatically provided, but must be provided upon request
 - Also required to be made available on the firm's website for anyone to view
 - A roadmap for litigation if not done well?

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- Level-Fee Fiduciaries and a streamlined PTE
 - Requires that compensation from clients be level, regardless of what investments/accounts they're directed towards
 - “Level” fees include percentage of AUM, or a set flat/retainer fee arrangement
 - Can include 12(b)-1 fees or other levelized commissions, as long as they're uniform
 - Doesn't require all clients to be charged the same, just the same compensation 'within' the client accounts

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- Level-Fee Fiduciaries and a streamlined PTE
 - Level Fee Fiduciaries must:
 - Acknowledge fiduciary status in writing
 - Comply with the Impartial Conduct Standards
 - Document the reason for recommendations
 - Level Fee Fiduciaries do NOT have to:
 - Follow the full policies & procedures requirements
 - Implement rules to mitigate conflicts of interest (as they're presumed to be sufficient minimized already)
 - » Also why additional disclosures not required

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- Enforcement of the Best Interests Contract
 - DoL will enforce for:
 - ERISA plan fiduciaries
 - Policies & Procedures for BICE
 - DoL cannot enforce directly against IRAs
 - Instead, clients must 'enforce' through litigation
 - BICE requires that clients retain the right to pursue a class action lawsuit
 - » Mandatory arbitration can only apply individually

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- Fiduciary Exceptions not subject to BICE
 - “Hire Me” vs “Hire [Them]” recommendations
 - DC plan “platform providers” that offer choices
 - Investment Education & General Information
 - But limitations on models and guidance
 - General Communication
 - Newsletters, speeches, research reports, etc.
 - Employees of Plan Sponsors
 - Certain Institutional Relationships

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- Pre-BICE Grandfathering Fiduciary Rules
 - Ongoing commission payments for pre-BICE advice
 - No requirement to give up existing trails
 - New contributions that were previously ‘committed’
 - Though any new recommendations (including new additions to existing account) are subject to BICE
 - Any new transactions after BICE takes effect, fully subject to new rules

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- Effective Date for New DoL Fiduciary Rules
 - General BICE Rules take effect April 10, 2017
 - Full policies and procedures do not need to be implemented until January 1st, 2018
 - Full disclosure details also part of delayed implementation timeline

DOL FIDUCIARY & THE BIC

- Other Notable Issues Of DoL Fiduciary
 - Annuities in retirement accounts are subject to BIC!
 - Includes fixed-indexed and variable annuities
 - Fixed (and immediate) annuities subject to less stringent PTE 84-24 instead
 - Does *not* ban commissions or limit investment choices
 - But does subject them to much higher scrutiny
 - And some firms may eliminate them just for the expedited Level Fee Fiduciary exemption
 - Still *only* applies to Retirement Investors/accounts!

DOL FIDUCIARY & THE BIC

- What Advisors Should “Do” With DoL Fiduciary
 - Depends on whether you’re an RIA or under a B/D
 - For RIA firms...
 - Verify you’re eligible for Level Fee fiduciary
 - » Take a hard look at how you’re compensated!
 - » Just being an RIA fiduciary is *not* a free pass!
 - Will need to add fiduciary acknowledgement to client agreements
 - Establish/affirm process for documenting advice

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DOL FIDUCIARY & THE BIC

- What Advisors Should “Do” With DoL Fiduciary
 - For advisors with a B/D...
 - Most changes will be handed to you
 - » Adjustments to grid/comp structures
 - » Different product line-ups
 - » Different commission options?
 - » A push to shift clients to fee-based accounts?
 - » Additional compliance oversight/requirements?

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- What Advisors Should “Do” With DoL Fiduciary
 - For advisors who are hybrid RIA & B/D...
 - Need to comply on “both” sides of the arrangement
 - More scrutiny of which side you send clients to?
 - » Expect more pushback for outside RIAs
 - » Choice between RIA and B/D means your RIA isn’t a Level Fee Fiduciary, either!

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- DoL Fiduciary Implications
 - DoL did make the final rule significantly less restrictive
 - But doesn’t necessarily mean anything goes
 - » Just that enforcement will fall to the courts instead
 - » Commissions may still die a slow death?
 - Will be more disruptive for broker-dealer entities
 - Forces them to reconfigure their business models
 - Some may stay “taxable-account-only” to avoid DoL?
 - Some will go Level Fee Fiduciary only, others not
 - » If you’re RIA-like, why not just be an RIA?

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- DoL Fiduciary Implications
 - Creates an ‘untenable’ difference between retirement and taxable accounts
 - Will eventually compel the SEC to act?
 - Will be ‘messy’ for years until the courts clarify issues
 - Likely pushes most compliance departments to err on the side of caution?
 - Will spur new product design
 - Both to comply with Level Fee compensation, and because commissions can’t be used to incentivize

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- DoL Fiduciary Implications
 - Will increasingly homogenize advisory firms
 - Similar (AUM) business models for similar compensation (with similar services?)
 - “I’m a Fiduciary” is no longer the differentiator it was?
 - Creates new pressures for differentiation and new business models?
 - Impact on “small account” households still debated
 - Shifting to centralized advisor platforms?
 - “Robo” technology tools?

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- DoL Fiduciary Long-Run Implications
 - The beginning of the next era of financial advisors
 - All bona fide professions have fiduciary standards!
 - Ultimately, “everyone” may be a Level Fee Fiduciary?
 - With duty of loyalty “solved”, duty of care is the next battleground issue
 - Competency matters, too!
 - Will play out slowly over time, but the fiduciary rule is here to stay!

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