Game Changer

A First Look At The DOL's 2015 Conflict Of Interest Proposal

A WHITE PAPER BY

Pentegra Retirement Services
2 Enterprise Drive, Suite 408
Shelton, CT 06484-4694
800.872.3473 tel 203.925.0674 fax
www.pentegra.com

PENTEGRA

The retirement plan industry has been waiting for an updated "definition of fiduciary" regulation from the Department of Labor since 2010. On April 14, 2015, we got it—and at first glance, it's a game-changer.

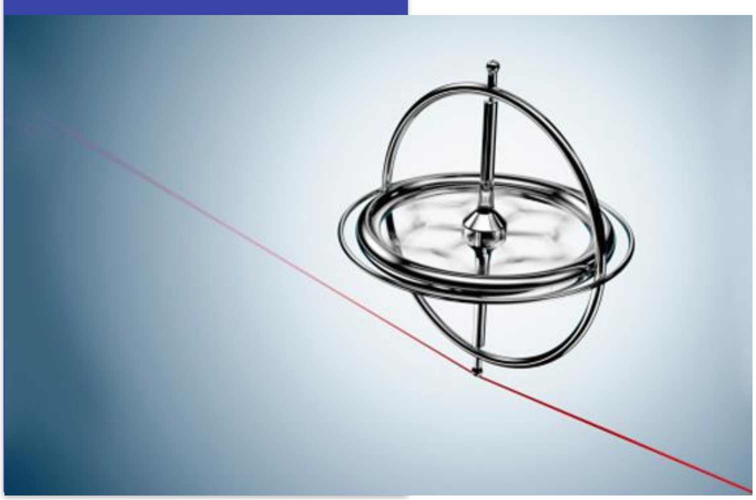
Introduction

Providing investment products and services to retirement plan sponsors and participants is big business. Providing financial products and services to Individual Retirement Accounts (IRAs) is even bigger business—roughly $7 trillion in assets in IRAs compared to about $5 trillion in 401(k)s and similar plans[1]. Financial advisors of all types—brokers, insurance agents, and registered investment advisers (RIAs)—are the intermediaries who bring these products and services to retirement plans and individuals, and they get paid for their efforts.

The Department of Labor's (DOL's) 2015 "Conflict of Interest" proposal is a package of new rules aimed at curbing perceived abuses by advisors, some of whom the Department and the White House see as promoting expensive, lower-performing investments to line their own pockets at consumers' expense.[2] The DOL backs up its claims as to the existence and detrimental effect of such abuses with extensive data[3]. The proposed solution is a combination of updates to existing rules:

- An updated "definition of 'fiduciary'" regulation, 29 CFR 2510.3-21(c)
- A targeted update of existing prohibited transaction exemptions (PTEs) to change some, eliminate others, and add a few new ones.

This is an ambitious proposal that makes a genuine attempt to eliminate or mitigate the effects of conflicts of interest in ALL retirement plans, including IRAs. It is too soon to tell if the proposal, in its current form, will actually accomplish this goal, or what the intended and unintended consequences might be, but clearly the folks at the Department of Labor have poured their hearts into the effort and delivered a thoughtful, well-written proposal.



1 According to the Investment Company Institute.
2 If this language offends you, get used to it. The White House and DOL have made clear their feelings on this subject, and the language above is mild by comparison. See, for example, Presidential media appearances on February 23, 2014, or the video on the DOL website.
3 Visit the DOL website for a list of cited "Documents Supporting the Regulatory Impact Analysis" and read the analysis itself in the preamble to the proposed regulation.

There can be no doubt that the proposal will be contentious. We in the retirement industry now have the obligation to find the flaws and unintended consequences in the proposal and work with our partners in government to achieve a final regulation and/or effective legislative alternatives that truly serve the country's best interests.

The purpose of this article is to provide a technical, "first glance" overview of the proposal and some early thoughts about possible ramifications.

Historical Context: 1975 and 2010 vs. 2015

ERISA became law in 1974. For several years thereafter, the Department of Labor was called upon to issue ruling after ruling with respect to fiduciary rules so that the industry could understand the boundaries. The 1975 "definition of 'fiduciary'" regulation was one such ruling. We therefore have a series of regulations, advisory opinions, interpretive bulletins, and prohibited transaction exemptions (PTEs) that are quite old, dating to the '70s and '80s—before the existence of 401(k)s and the proliferation of IRAs. The 2015 Conflict of Interest proposal is, in part, an attempt to modernize this body of rules.

The 2015 proposal is not the first DOL modernization effort. The first was in 2010, and it was quite different. The emphasis in 2010 was on broadening the "net" with which the Department could scoop advisors into fiduciary status for the purpose of prosecuting them for fiduciary abuses4. The 2010 rule met with significant opposition and was eventually withdrawn, and the DOL has been working on a new proposal ever since. In the resulting 2015 proposal, the emphasis has shifted dramatically—IRAs are now a primary focus.

The Big Stuff: IRAs And The Fiduciary "Net"

The potential impact of this proposal is significant. The Big Stuff with the greatest potential impact includes:

1. ERISA-Style Fiduciary Rules for IRAs. The proposal creates a new category of fiduciary which we might call an "IRA Fiduciary," who is obligated to follow loyalty, prudence, and prohibited transaction standards modeled after—but not identical to—ERISA's. These rules would effectively apply to nearly all financial advisors who serve IRAs. We would therefore have four standards of care in the financial industry: ERISA, IRA fiduciary, common law fiduciary, and suitability.
2. More Advisors are Scooped into the Fiduciary "Net". Any "recommendation" for compensation triggers fiduciary status, and the definition of "recommendation" is very broad—it is based on FINRA Rule 2111[5], which governs when the "suitability" requirement is triggered. It therefore appears that a very high percentage of advisors would be considered fiduciaries under the proposal in part because a very high percentage of customer interactions would be seen as involving "recommendations."

[4] This was one of the primary reasons cited by the DOL in the preamble to the 2010 proposed regulation.
[5] FINRA is the Financial Industry Regulatory Authority

The collective changes create a package of new rules that would require a fairly massive retooling and compliance effort across the industry.

Basic Structure Of The Proposal

We can divide the proposal into two main parts: the updated "definition of 'fiduciary'" regulation and the updated package of PTEs.

The Definition Of "Fiduciary" Regulation

The 2015 Regulation replaces the 1975 Regulation. Its key provisions are summarized below.

The Fiduciary Net: Who Is And Is Not A Fiduciary?

Instead of the five-part test of the 1975 regulation we have a more broadly applicable four-part test:

1975 Rule: 5 Part Test	2015 Proposal: 4 Part Test
A person **renders advice** to the plan as to the value of or advisability of buying, selling, investing in securities or other property	A person **renders advice** (a "recommendation" regarding buying, selling, managing, hiring managers/advisors for, rolling over, or valuing plan assets) to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner
On a **regular basis**	[regular basis NOT required; once is enough]
Pursuant to a mutual agreement, arrangement, or understanding, written or otherwise, between the plan or a plan fiduciary…	Pursuant to a written or verbal agreement, arrangement, or understanding…
…that the services will serve as a **primary basis** for investment decisions	…that the advice is given **for consideration** in making investment or management decisions, and…
The advice will be individualized to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification	…that the advice is individualized to, or that the advice is specifically directed to, the advice recipient

There are several notable differences between the existing (1975) regulation and the proposal, including:

- Advice is with regard to individuals as well as plans. This is the accepted interpretation of the 1975 rule but it is made explicit in 2015.
- Fiduciary status applies to IRAs and rollover transactions in the 2015 proposal. The proposal states that the 2010 proposal also applied to IRAs[6] but this claim seems a bit of a stretch considering that there was only a short, off-handed reference to the applicability of IRC §4975 in 2010.
- One instance of advice is enough; the "regular basis" requirement that required ongoing advice is eliminated (as it was in the 2010 proposal—this was expected).
- The advice need not be a "primary" basis for decisions, merely a consideration.
- The advice in the proposal may merely be "specifically directed to" a recipient, not necessarily "individualized." What does this mean? There is some explanation in the preamble but this is may be an area where clarification is needed.
- The overall structure of the fiduciary definition is different: the proposal identifies types of advice, the circumstances in which those types of advice lead to fiduciary status, and specific carve-outs. The 1975 regulation was limited primarily to the five-part test.
- Under the 1975 rules, saying one is a fiduciary did not necessarily make one a fiduciary, and vice versa. Under the 2015 proposal, if you give advice and say you are a fiduciary, you are a fiduciary. You may not later claim non-fiduciary status and you may not take advantage of the carve-outs below. Claiming fiduciary status causes the four-part test to be irrelevant.

It is interesting to note that, under DOL Reg. Sec. 2550.408b-2(c) ("408b-2"), fiduciaries are required to disclose their fiduciary status to the ERISA plan fiduciaries who hire them. Thus, in effect, the new four-part test applies to determine fiduciary status, but once fiduciary status is found to apply, it must be disclosed in writing, and this disclosure makes one a de facto fiduciary and makes the four-part test irrelevant. This quirk of the proposal only applies to ERISA plans, not IRAs.

The 7 Carve-Outs

The following are specifically identified as not constituting fiduciary advice, subject to extensive conditions and compliance requirements that must be met in each case:

1. **The Seller's Carve-Out.** Selling products or services to ERISA plans with 100+ eligible participants or $100 million (large plans) whose fiduciaries have appropriate expertise.
2. **Swaps.** Sales of swaps or security-based swaps to plan fiduciaries.
3. **Employees.** Advice by an employee to a plan sponsor as part of the employee's job so long as no compensation is paid for the advice beyond ordinary salary. This applies, for example, to an HR manager preparing recommendations for an investment committee.
4. **Platform providers.** Marketing and making available a platform whereby plan fiduciaries can choose investments for participant-directed plans. Applies both to the platform and to brokers who sell the platform.
5. **Selection and monitoring assistance.** Identifying investment alternatives meeting criteria specified by the plan fiduciary or providing objective financial data with independent benchmarks.

[6] See, for example, the top of page 67 of the preamble to the Regulation.

6. **Financial reports and valuations.** Providing appraisals, fairness opinions, or statements of value to ESOPs, CIFs, separate accounts, or for plan reporting purposes (e.g., Form 5500 financials).
7. **Investment education.** The "education safe harbor" of DOL Interpretive Bulletin 96-1 is largely preserved, but there are some significant changes and the final rule would supersede 96-1. You can provide general plan information, asset allocation models, and other generic information with appropriate disclosures. One significant difference is that the not uncommon practice of providing asset allocation model examples that include specific funds will no longer qualify as education—it becomes advice.

Treatment Of IRAs

The proposal makes clear that IRAs are subject to the DOL's jurisdiction with respect to interpreting both ERISA and the Internal Revenue Code (IRC or Code) when it comes to fiduciary issues, including the prohibited transaction (PT) rules. The path the DOL follows to effectively extend ERISA-style fiduciary rules to IRAs is via IRC §4975, a mirror image (almost but not quite identical) to the prohibited transaction rules of ERISA §§406(a) and (b). Here is the basic logic:

- IRAs are not subject to ERISA except in very unusual circumstances.
- The DOL's authority is limited to ERISA plans.
- However, under a Presidential order from 1978, the DOL does have authority over the interpretation of the Code for purposes of the fiduciary definition and PT rules. The IRS retains control of enforcement.
- DOL therefore gets to write the rules on PTs for IRAs, though they have no power to enforce them.
- In the proposal, the DOL uses its rule-making authority to:
  - Paint nearly all advisors as fiduciaries so that the PT rules apply as broadly as possible
  - Use the PT rules to prohibit advisors from serving IRAs unless they adopt a "best interest" standard of care that is distinct from both ERISA and common law fiduciary standards, but which is patterned after ERISA's loyalty, prudence, and conflict of interest rules.

The old line of thinking was that the DOL could not regulate IRAs because they are not ERISA plans, but the DOL has apparently found a way. It is safe to say that this is largely an unexpected development, at least in scope.

The Updated Package Of Prohibited Transaction Exemptions

The existing body of PTEs is a bit messy and outdated, so the DOL consolidates and updates a number of related PTEs as well as issuing some new ones. Regardless of whether you like the outcome, these rules are due for some cleanup. The changes include revisions to existing PTEs, revocation of others, and addition of two new exemptions.

Two New Exemptions

1. **The Best Interest Contract PTE.** The significance of this proposed PTE cannot be overstated, and a proper treatment of it is beyond the scope of this article. Some key provisions are identified below.
2. **Principal Transaction PTE.** Broker/Dealers selling debt securities from their own accounts may qualify for this exemption from fiduciary status.

The DOL is also considering a new exemption for situations in which advisors recommend certain low-cost investments.

Key Provisions Of The Best Interest Contract PTE

The Best Interest Contract PTE ("BIC" or "BIC PTE") is the mechanism whereby advisors are held to ERISA-like loyalty, prudence, and conflict of interest standards in IRAs. Key provisions include:

- Provides "broad and flexible relief" from the PT rules to "permit common compensation structures that create conflicts of interest, while minimizing the costs imposed on investors by such conflicts."[7]
- The PTE is principles-based rather than rules-based or prescriptive, a significant departure from common PTE practice but one that is consistent with a growing movement within the financial industry to focus on principles-based approaches to fiduciary regulation.
- Applies to both advisors and their parent broker-dealers or Corporate RIAs, or their affiliates
- Requirements include:
  - Contractually acknowledge fiduciary status with written signatures from multiple parties
  - Commit to adhere to basic standards of impartial conduct
  - Warrant that the advisor will comply with federal and state laws on advice
  - Warrant that the advisor has adopted policies and procedures reasonably designed to mitigate harmful impact of conflicts of interest
  - Make a series of disclosures:
    - A point of sale disclosure that includes an illustration of the impact of fees over five years
    - Material conflicts of interest disclosed in the contract
    - A public website disclosing your fees
    - An annual fee disclosure
    - Notification of the DOL's Employee Benefit Security Administration (EBSA) that you are taking advantage of the exemption.
- The basic standards of impartial conduct include:
  - Give advice that is in the customer's best interest
  - Avoid misleading statements
  - Receive no more than **reasonable compensation**. In case you can't tell at first glance, this is huge. What is "reasonable?" And what is "reasonable" in the eyes of the DOL versus ordinary Americans?
- As in ERISA Section 410, exculpatory provisions are not permitted, though FINRA-style arbitration clauses are permitted so long as a client's right to join a class action is not infringed
- When the advisor sells proprietary products or products for which he receives special compensation, additional rules apply.
- Firms relying on this exemption must notify DOL that they are doing so and agree to make information on the services available for inspection by the DOL.

Revised And Revoked Exemptions

There are a number of existing PTEs from the 1970s and 1980s8 that the DOL is consolidating and amending. For example, there are existing PTEs allowing fiduciary advisors to sell insurance or annuity

[7] From page 75 of the preamble to the proposed "definition of 'fiduciary'" regulation.
[8] Such as PTEs 86-128, 84-24, and 75-1

products to plans for a commission, or for broker-dealers to engage in a variety of transactions with plans when they are also advisors to the plans. A full discussion of the changes to the PTEs is beyond the scope of this article.

The best way to summarize the changes is that the BIC PTE would become the primary mechanism whereby fiduciary advisors could receive various types of compensation, and many of the situations not covered by the BIC PTE would be covered in other revised PTEs. The DOL's overall intent is to preserve common compensation arrangements while improving protections. A thorough analysis of the changes is needed before the industry can judge whether this is, in fact, the effect.

Two things seem clear: first, virtually every IRA client relationship will require one or another of the new PTEs. Second, figuring out which exemption one must use and building a compliance regimen around the rules is not simple. Contrast this with the situation today, in which PTEs are not routinely needed or used. The legal community is doubtless appreciative.

The Concern Over IRA Rollovers

The industry was highly concerned over the expectation that the DOL would severely limit the types and amounts of compensation available to ERISA fiduciaries who assist participants with rollovers. It seemed likely to many industry observers that the DOL's approach would make it very difficult for trusted plan advisors to serve participants after retirement despite years of unbiased service. This concern appears to have been misplaced in some ways, but the proposal raises a number of new concerns, such as:

- Are discretionary fiduciaries prohibited from helping participants with rollovers? This may be so under the terms of the BIC exemption. An ERISA §3(38) investment manager might therefore be prohibited from helping whereas an advisor would not be.
- The exemption is also not available to "robo-advice" arrangements.
- The compliance burdens for rollovers appear to be significant, such as: written contracts with multiple signatures; initial and annual disclosures with five year fee impact analysis; a public website with disclosure and fee information; notification of EBSA that you intend to take advantage of the exemption.
- It is unclear whether the DOL's contention that common forms of compensation are preserved will prove true. A great deal of clarification is needed, at a minimum.

But the original concern—that plan advisors would not be permitted to serve retirement participants, or would be severely limited in their ability to charge more than they charge within the plan despite providing dramatically different/more services—appears to be a concern no longer. For example, it would appear that, aside from concerns like those above, an advisor might receive 25 basis points compensation in a plan but charge 100 basis points to a participant rolling into an IRA, based on the provision of more extensive services like financial planning.

Who Will Enforce These Rules?

The DOL has the power to write these rules, but has no enforcement authority over IRAs— enforcement is up to the IRS, who has very few people nationally focused on IRA compliance. This has always been a concern to industry commentators, who observe that regulation without enforcement simply results in the worst offenders continuing to offend. Only the Good Guys are affected if there is no enforcement mechanism to find and hold accountable the Bad Guys. It will therefore be interesting to hear the DOL and/or IRS enforcement proposals.

Effective And Applicability Dates

- Comment Period. The proposal calls for a 75 day comment period. The comment period would therefore end on approximately July 2nd.
- Public Hearing. Will be held within 30 days of the close of the comment period.
- Preparation of Final Rule. The DOL will need time to absorb the public comments and prepare the final rule, which would then need to be sent to OMB[9] for review.
- Effective Date. The rule would become effective 60 days after publication in the Federal Register once it is back from OMB.
- Applicability Date. The requirements would all be applicable eight months after publication in the Federal Register. The PTEs would become available at the same time.

Realistically, this means the industry would need to plan on being fully converted and ready for business under the new rules sometime late in 2016.

Shock Waves

The potential implications of the proposal are profound. A surface reading of the proposal's intent might make it appear that industry methods are preserved so long as advisors embrace the "best interest" standard, but the devil is in the details, and the details raise serious questions and could lead to major upheavals and restructuring costs for advisors. It is possible that there are serious, significant, unintended consequences, which the industry will need time to identify.

Here is a small sample of questions and comments one might logically raise:

- What is "reasonable" compensation in an IRA?
- Despite the fact that the DOL states that common forms of compensation are preserved, are they really? One possible interpretation of the rules is that compensation must be revenue neutral, ERISA-style (see page 37 of the "definition of 'fiduciary'" preamble, for example). This would eliminate a large number of products, services, and compensation arrangements from consideration.
- The compliance burden of the Best Interest Contract (BIC) exemption is substantial.
- The requirement in the BIC exemption to post one's fees on a public website is troubling since it amounts to a requirement to disclose one's business model and fees to one's competition—a government intervention that is fairly significant in scope.

The potential for upheaval cannot be overstated: there are seven trillion dollars in IRAs, covering 35 million households, and an enormous private infrastructure serving those accounts. Possible responses to the proposal therefore include:

- Support. Some industry members and consumer advocacy groups will be in favor of the rule substantially as written.
- Push for Changes. Some groups will support the rule in spirit but would require significant changes before embracing a final rule.
- Fight. Some groups and legislators might reject the proposal due to the potential for upheaval, cost, and unintended consequences, and could move to delay or outright put a stop to the proposal through legislative action.

---

[9] The Office of Management and Budget, which can take up to 90 days to review.

Closing Thoughts

The people at the Department of Labor who brought this proposal to fruition invested years of study and toil, and they deserve applause for the quality, professionalism, and good intentions of the proposal. It seems likely that there will be significant concerns with the proposal and that there will be numerous calls for change, but that's what the public comment period is for.

This should be fun. Enjoy the fireworks!

Pete Swisher is Senior Vice President and National Sales Director of Pentegra Retirement Services in White Plains, New York. He is the author of 401(k) Fiduciary Governance: An Advisor's Guide, a textbook used for credentialing of advisors through the American Retirement Association. As past Chair of the Government Affairs Committee of the National Association of Plan Advisors, he has spent years studying and preparing for the issues surrounding the "definition of 'fiduciary'" regulation.

Follow us on