The New DOL Conflict of Interest Regulations

EIGHT THINGS YOU NEED TO KNOW ABOUT THE FINAL RULING

On April 6th, 2016, the Department of Labor (DOL) issued the final version of the “Conflict of Interest” rule. Starting with the rule’s infancy in 2010 and its well documented follow up in the 2015 proposal, the focus of the Department of Labor has remained steady in striving to protect Retirement Investors by expanding stringent fiduciary standards to a broader scope of financial Advisers.

Throughout the extensive comment period for the 2015 proposal, multiple stakeholders weighed in — broker-dealers, investment and insurance providers, advisers, members of Congress, plan sponsors and participant advocacy groups — voicing their criticism or support. In the final rule, the DOL frequently cited comments to justify the guidelines or provide clarifications on areas of concern. While the 2015 proposal was onerous in its compliance minutia, the final Rule has alleviated some provisions while maintaining or expanding on others. Best Interest Contract Disclosures specifically appear to be operationally friendly, however, firms will still need to assess the need to change business practices, as safeguards for Retirement Investors such as legal recourse in cases of concern remain. While some uncertainty persists, the following article will highlight some of the most important aspects contained in the much anticipated final “Conflicts of Interest” rule.

1 The core of the rule has not wavered.

In the final rule, the DOL reaffirms its fiduciary classification as any Adviser who receives direct or indirect compensation in correlation to providing advice to a retirement investor. In addition to the distinction of compensation, the rule further identifies advice as:

- A recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, or a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA;
- A recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., brokerage versus Advisory); or recommendations with respect to rollovers, distributions, or transfers from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer or distribution should be made.

Purposefully casting their wide net, the DOL notes Advisers and Financial Institutions who previously may have engaged in prohibited transactions will now need to comply with Impartial Conduct Standards. As with the proposed rule, the DOL maintains a provision that effects an exception to the prohibited transaction consequences in the form of the Best Interest Contract Exemption. Through the exemption, firms may generally continue with their current business models as long as they meet certain standards set forth in the rule. However, use of the Best Interest Contract Exemption will allow Retirement Investors to have recourse in the form of a civil action should the defined standards of the exemption not be adhered to. Of most significance is the DOL’s extension of its claimed authority over IRAs and other non-ERISA plans like Keogh plans.

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2 The Rule expands Best Interest standards coverage.

By casting this wide net that identifies newly-found fiduciaries, the impact of this rule encompasses various retail investors. These investor types include individual plan participants and beneficiaries, IRA owners, HSA owners and "retail" fiduciaries. Retail fiduciaries are defined as plan fiduciaries with assets of less than $50 million, fiduciaries of both participant-directed and non-participant directed plans, participants who invest in self-directed brokerages and are not considered 'independent'. The rule notes that Independents with arm's-length transactions who may have activity that qualifies as a fiduciary, may avoid being classified as a fiduciary. In contrast to the proposal, the final rule includes small participant-directed plans in the "retail" fiduciary definition.

3 The implementation period is extended with a phased-in approach.

While the rule becomes effective June 7, 2016, the DOL has outlined a phased-in approach to implement the required changes. As opposed to the 8 month proposed timeframe documented in its proposal, the DOL has extended its applicability date to 1 year after the final ruling, April 10th, 2017, with a transition timeframe primarily for compliance with the best interest contract exemption through January 1, 2018. On April 10th, 2017, investment providers not currently fiduciaries who are described within the context of the rule are officially re-designated from non-fiduciary to fiduciary status. During the transition period, it is expected that Financial Institutions and Advisers, among other things, must acknowledge their Fiduciary status, comply with Impartial Conduct Standards, and disclose any Material Conflicts of Interests. The rule allows that during the transition period, there is relief from the prohibited transactions of ERISA and the Code consistent with the current five-part test that defines an investment advice fiduciary. On January 1, 2018, the rule stipulates that the transition period no longer allows current prohibited transaction exemption provisions and the full conditions of the exemption would be required.

4 Level Fee Fiduciaries have specific provisions that they must adhere to.

Level Fee Fiduciaries are defined as fiduciaries who, in connection with their affiliates, only receive a level fee for the advice or services they provide with respect to plans or IRA assets. The 'level fee' must be clearly disclosed to Retirement Investors prior to any transaction and is typically a fixed percentage or set fee that does not vary based on asset recommendations, as opposed to commission or transaction based fees. In order to maintain 'level fee' designation, the DOL has excluded receipt of commissions or transaction based payments (such as 12b-1 fees) by the Adviser, Financial Institution or any Affiliate. Where there is the need for a recommendation to rollover to an IRA or switch from commission-based accounts to a level fee arrangement, the Level Fee Fiduciary must clearly document the reason the arrangement is in the best interest of the Retirement Investor, specifically citing the services and corresponding fees, providing comparison to fees they are currently paying while also accounting for any employer paid expenses. The DOL has streamlined disclosures of Level Fee Fiduciaries, requiring a written statement to Retirement Investors which acknowledges their fiduciary status and their intent to comply with the standards of impartial conduct. Although there is no contract in place, the DOL concludes that the acknowledgement of Fiduciary standards by Level Fee Advisers allows a Retail Investor recourse through established ERISA standards for breach of fiduciary duties.

5 The Best Interest Contract Exemption may allow some Firms to maintain current business practices.

The Best Interest Contract (BIC) Exemption remains in the final regulation, but has some nuances that were not in the proposal. Firms may generally rely on the exemption to maintain current business practices. Additionally, Advisers who recommend annuities such as variable and fixed index annuities that are not considered 'fixed rate' must also rely on the exemption. In order to leverage the exemption, firms must first notify the DOL of their reliance on the exemption. Firms and their Advisers must also follow 'best interest' standards including acknowledging fiduciary status, creating and adhering to policies that ensure compliance with Impartial Conduct Standards, charging reasonable compensation, refraining from incentives and disclose all fees and conflicts of interest associated with investment recommendations.

Where the proposal required the BIC to be signed prior to any discussion of investment advice, the final rule now allows for the BIC to be included in account opening documents as a two-party contract executed between the Firm (and not the Adviser) and the Retirement Investor, as long as it is signed prior to the execution of any transactions. Any advice rendered prior to the execution of the BIC is covered by the BIC. The distinction of a two party contract alleviates multiple industry concerns, including concerns that pertained to investors speaking to multiple contacts, such as in the case of call-centers. The BIC must be used in order to obtain a prohibited transaction exemption for IRAs and non-ERISA plans (such as Keogh plans), while ERISA plans and their participants only require fiduciary acknowledgement by their Adviser. Investors within ERISA plans may leverage guidelines established by ERISA regulations, such as mediation as opposed to civil litigation, to enforce their rights. Furthermore, existing accounts are grandfathered when the Retirement Investor is sent a copy of the BIC, and then has 30 days to accept the terms by negative consent in place of a physical signature.

The BIC must clearly state the following:

- The Financial Institution's warranty of a Best Interest Standard of Care, set forth in policies and procedures by the Adviser and Financial Institution, including the services provided and how the investor pays for these services (i.e. directly or through Third Party Payments).
- Identify Material Conflicts of Interest, specifically any fees that the Financial Institution or Adviser imposes on the Investor's account, as well as third party payment received in connection with recommendations.
- Allow the Retirement Investor to receive additional written detail depicting, among other things, policies, procedures, firm's fees and compensation models including third party payments.
- Identify the mandatory Website URL where the Investor can view the most recent contract disclosures, policies and procedures.
- Indicate any proprietary products or third party payments received as a result of recommendations and specific information regarding any limitation on recommendations.
- Contact information the Retirement Investor may use in the event there is a concern with the advice they received and instructions on leveraging any public databases to research the Financial Institution and Adviser.
- How the Financial Institution monitors and provides alerts to the Retirement Investor regarding their investments and recommended changes.

The 'grandfathering' of existing accounts was a major concern of Financial Institutions during the proposed Rule. In the final Rule, the DOL designates that any asset transaction that occurred prior to the applicability may continue to receive advice, including recommendations for holding an asset as long as the compensation received satisfies standards and additional advice is prudent. The Best Interest Contract exemption is required for any transactions that occur after the applicability date; however any transaction that occurred prior to it would not require compliance with the new exemption.

6 The disclosures have significantly changed from the proposal to the final rule.

In the final rule, the department has extensively revised the Best Interest Contract exemption disclosure requirements, making the BIC more operationally feasible. Overall, the disclosures are less tailored to individual transactions and Adviser compensation is no longer the focus of disclosures, as fee practices are mostly limited to the Firm level. The annual disclosure, where the proposed rule required detailed personalized fee disclosure for each transaction, has been entirely removed from the regulation. There are now three different stages at which Financial Institutions leveraging the exemption are required to provide disclosures:

1. At Account Opening

   a. BIC - The DOL has taken a two-tiered approach with the BIC, requiring the disclosure prior to any transaction depicting 'high-level' information (the details of which were documented in the prior section). Consequentially at the 'second tier', Retirement Investors may request written information detailing firms policies, procedures and information expanding on compensation models.

   -OR-

   b. Acknowledgement of Fiduciary Status - Advisers of ERISA plans and Level Fee Fiduciaries are required to disclose, among other things, written acknowledgement of Fiduciary Status.

2. Ongoing

   a. Web Page - In contrast to the proposal, the webpage has been altered to provide mostly for information at a Financial Institution level and is not required to detail Adviser compensation. The web page must be publicly available and maintained by the Financial Institution, with quarterly updates, containing (1) a depiction of the Financial Institution's business model and any Material Conflicts of Interest, (2) fee schedules including all service charges, (3) a model contract, (4) policies and procedures for mitigating conflict of interests, (5) third party arrangements and their impact on Adviser compensation and (6) Financial Institutions compensation and incentive arrangements. The web page is purposefully detailed, allowing Retirement Investors to have the ability to "shop" for Advisers and Firms that meet their needs in principle and financially. Adviser compensation disclosures, while significantly reduced, still need to provide enough information to allow Retirement Investors to understand arrangements between the Financial Institution, third parties and the Adviser. As was indicated in the proposal, the web page archival requirement of six years remains in effect.

3. Transactional

   a. Point of Sale Disclosure - The DOL has removed the need for an individualized 1, 5 and 10 year cost projection of an investment at the Point of Sale and made the new pre-Transactional Disclosure more operationally feasible for Firms and Advisers to execute. An Adviser must provide a written disclosure that reaffirms the contract's principles in order to comply with the Pre-Transaction Disclosure prior to the purchase or execution of a transaction. It must

(1) state the Best Interest Standard of Care and describe any material conflicts of interest (2) provide a vehicle by which Retirement Investors can obtain more detailed information regarding the costs of the transaction and policies and procedures of the Firm* and (3) provide the website address where a Retirement Investor can read more information should they wish to do so. This disclosure is only required once annually per investment product, and should be archived in accordance with other compliance documentation.

**As noted with the BIC, Investors may request and be sent a physical disclosure detailing firms policies, procedures and expanding on compensation models.*

7 Insuring a firm is compliant is an ongoing effort.

Financial Institutions are required to establish comprehensive systems to monitor, evaluate and insure that Adviser recommendations meet the prudent standards of care as set forth in the ruling, as well as maintain that all advice continues to be in the best interest of the retirement investor. With Retirement Investors having the right to leverage ERISA mediation guidelines for Fiduciaries and the ability under the BIC Exemption to bring lawsuits, including class action lawsuits, against Advisers and Firms that utilize the BIC, continued scrutiny for compliance will be a significant concern to all Firms. Clearly, the risk of expensive litigation has increased dramatically for all of those deemed to be Fiduciaries under the rule.

The establishment of clear policies and procedures, as well as ongoing training to Advisers will be a key component to drive adherence. Additionally, firms will be required to develop systems that can evaluate and identify outliers that may not necessarily be aligned with the Investors goals. In this vein, metrics measuring behavior to identify non-compliance activities such as excessive trades in transaction-fee based accounts, recommendations to low-activity accounts to move from a fee based to a level fee structure, and validating assumptions made by advisers will go a long way in protecting Financial Institutions from litigation exposure. While it is unclear as to the extent that the DOL requires certain metrics be maintained, we expect in the coming months to be provided with additional clarity around various monitoring requirements.

To further enforce stringent Firm guidelines, the DOL lays out policy examples, such as financial ramifications to Advisers or Supervisors that do not comply with Best Interest Standards as well as dedicated resources within the Financial Institution, to monitor and enforce compliance to the Conflicts of Interest rule. Firms should also consider remedies and controls above what the Department is suggesting to insure they are well positioned to prevent or defend against any litigation or arbitration that may arise. Some preliminary industry views have firms entertaining additional controls beyond what is cited in the Rule, including requiring mutual consent for grandfathered BICs, more detailed disclosures and more detailed recordkeeping.

8 There are resources for more information.

The DOL has recognized the impact this rule has on the industry and the complexity of the intricacies detailed within. As such, the DOL has made clear that it will provide ongoing guidance to Advisers, plan sponsors, fiduciaries and all other parties with ongoing education and assistance. The DOL has established a website, http://www.dol.gov/ebsa/compliance_ assistance.html that provides tools geared towards compliance, such as fact sheets and guides, to help parties satisfy requirements for compliance. The rule also provides direct contact information for detailed information around the general rule, prohibited transaction exemptions and regulatory impact and analysis. In addition, partnering with consultants, outside legal counsel and technology providers can provide further insight to the regulations and operational feasibility of new practices.

This piece is a preliminary snapshot of the regulations and is not intended to be a full analysis. Firms should consult with counsel for more specific details on how certain aspects of this ruling may affect their business. Broadridge Financial Solutions will continue to keep you apprised of developments regarding this significant regulatory initiative. Reach out to your Broadridge Representative to learn more about how Broadridge can help solve your compliance needs. Or call us at +1 800 353 0103.

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