ALTERNATIVES

In the Know: DOL Expands Fiduciary Definition

April 13, 2016

In the Know: Professionals at Franklin Templeton Investments offer a quick but insightful update on a pressing investment topic.

The US Department of Labor (DOL) significantly expanded the scope of persons deemed to be a fiduciary with a new rule that goes into full effect January 1, 2018. The intent of this new rule is to protect consumers by ensuring financial advisors put their clients' interests above their own financial interests. More than 40 years ago, the Employee Retirement Income Security Act of 1974 (ERISA) gave the DOL authority to protect tax-preferred retirement savings, but the basic rules governing retirement investment advice haven't been meaningfully changed since then despite a dramatic shift in our private retirement system away from defined benefit (DB) plans and into defined contribution (DC) and self-

directed Individual Retirement Accounts (IRAs). While we are still in the early phase of analysis and understanding of a very complex rule, here, Yaqub Ahmed explains what this new rule can potentially mean for financial advisors—and retirement investors.

What is the new DOL rule about?

On April 6, the DOL released a rule that expanded the scope of activities resulting in "fiduciary" status, which can result in a greater risk of engaging in prohibited transactions for persons and institutions that provide "investment advice" or "recommendations" to benefit defined contribution (DC) and defined benefit (DB) plans, plan fiduciaries, plan participants and also individual IRA accountholders. Because of this reach into the IRA market, the rule has a very broad impact on most advisor/client relationships and will capture many types of interactions with retirement clients.

The vast majority of IRA assets are rollover IRAs. So in other words, these assets are coming in mostly from DC and DB plans, which gets to the heart of a key reason IRAs were included in the scope of this new rule. In part, I think, regulators were concerned about people moving long-term savings from a potentially low-cost environment to one that is perceived as more expensive. Simply put, they want to ensure that participants are making well-informed decisions with the assistance of advisors who have their clients' best interests as their first priority.

Why did the DOL propose this change?

The intent of the DOL's new rule is, in its words, to enhance consumer protection and ensure that advisors and financial institutions put their clients' best interests first. These are principles we can all support.

The prior ERISA fiduciary definition had been unchanged for over 40 years, even prior to the first 401(k) coming into existence, so an update was probably long overdue. Total retirement assets are well over $20 trillion in the United States, and when something is that big it will draw the attention of Washington, DC. More broadly, this was a component of President Obama's Middle Class Economics initiative as many Americans that are part of this country's shifting demographic feel unprepared for retirement.

What is the new fiduciary definition?

The scope of persons now deemed to be a retirement plan or IRA fiduciary has broadened to include financial advisors or firms who receive a fee or other compensation in connection with providing a recommendation to acquire, hold, or sell securities, investing securities that are rolled over or distributed from a plan, a recommendation as to investment policies or strategies or the selection of other persons to provide investment advice, the selection of account arrangements (brokerage versus advisory), or what form, and to what destination a rollover, transfer, or distribution should be made. The recommendation must be, essentially, individualized or directed at an individual or plan fiduciary—general communications that are not individualized are not considered fiduciary communications.

This new standard is much broader than the standard that applied under the prior “five part” test that dates back to 1975. Under the prior standard, fiduciary advice had to be based on a specific recommendation, made pursuant to a mutual understanding that the advice would be provided on a regular basis, individualized and the primary basis for decision-making. Under the new definition: (1) fiduciary status can occur based on a “recommendation”; (2) advice would no longer required to be on a regular basis—that is, it could be a one-time event; and (3) advice need not serve as the primary basis for the decision.

Generally speaking, the definition of a fiduciary with respect to a plan or IRA, and what constitutes fiduciary investment advice, has been greatly broadened as to who and what it covers.

What is the BIC?

The DOL also enacted a new Best Interest Contract (BIC) exemption, which permits advisors and financial institutions that are fiduciaries to receive various forms and levels of compensation, including variable compensation. As a condition of receiving that compensation, the exemption requires financial institutions to acknowledge their fiduciary status and the fiduciary status of their advisors in writing. The financial institution and advisors must adhere to enforceable standards of fiduciary conduct and fair dealing with respect to their advice. In the case of IRAs, the exemption requires that the standards be established in an enforceable contract with the retirement investor.

What is the potential impact to advisors—and investors at large?

Since this proposal affects IRA assets themselves, most advisors are impacted. This, in turn, impacts their clients. Some of the issues advisors, the firms they work for and asset managers like us are looking into include:

- Practice models: Fee-based, commission, or a hybrid of the two?
- Product types: Which ones fit the guidelines established by the new rule?
- Client interactions: How do those need to change based on the new fiduciary definition and expanded scope of the rule?

These and other questions will undoubtedly impact how investors get financial advice. As a firm, we are exploring all of these questions and more, and working with others in the industry to find the right answers and continue doing what is right for our clients.

What hasn't changed, in our view, is the importance of advice in preparing financially for retirement. In our most recent survey[1] on the subject, the majority of respondents (60%) consider a financial advisor important to both the planning process and generating income during retirement. Across all age groups, Millennials were most likely to reflect this attitude (69%).

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1. Source: The 2016 Franklin Templeton Retirement Income Strategies and Expectations (RISE) survey was conducted online among a sample of 2,019 adults comprising 1,011 men and 1,008 women 18 years of age or older. The survey was administered between January 4 and 18, 2016, by ORC International's Online CARAVAN®.

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