The Department of Labor's Conflict of Interest Rule – Impact on Plan Sponsors

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The US Department of Labor (DOL) has released the final version of its conflict of interest rule (also known as the fiduciary rule), representing the most significant change in the retirement marketplace since the passage of the Employee Retirement Income Security Act (ERISA) in 1974. Coming in at just over 1,000 pages, this recently-released version is the culmination of several years of discussion between government regulators and the financial services industry.

For the Administration, the rule represents an important step toward minimizing conflicts of interest between financial advisers and their clients. The principal concern is that many advisers currently do not have to act in their clients' best interest, leading to lower returns and higher fees. The White House Council of Economic Advisers (CEA) estimated these conflicts of interest result in $17 billion in annual losses and roughly 1% lower annual returns for retirement savers.

For the financial services industry, the rule significantly expands the number of advisers who will be held to a higher standard of care when dealing with clients' retirement savings. In the past, many advisers have only had to demonstrate that their recommendations were "suitable," meaning their recommendations simply needed to fit a client's general needs and risk tolerance. Now, they will be expected to adhere to a "fiduciary" standard, essentially meaning they must put their clients' best interests first.

At Summit, we have been serving as a fiduciary to a broad spectrum of defined benefit, defined contribution, and other plan sponsors for more than 20 years. Over the next few pages, we will review the evolution of the fiduciary rule, the impact to plan sponsors, and discuss what we anticipate will unfold next.

Evolution of the Fiduciary Rule

As can be seen in Figure 1, the current fiduciary rule can trace its origins back to the passage of the Employee Retirement Income Security Act of 1974 (ERISA). In particular, ERISA required plan fiduciaries to act prudently and solely in the interests of a plan's participants and beneficiaries.

In 1975, the DOL issued a five-part regulatory test for investment advice. In order for the fiduciary standard to apply, an individual must: (1) make recommendations on investing in, purchasing, or selling securities or other property, (2) on a regular basis, (3) pursuant to a mutual understanding that the advice (4) will serve as a primary basis for investment decisions, and (5) will be individualized to the particular needs of the plan.

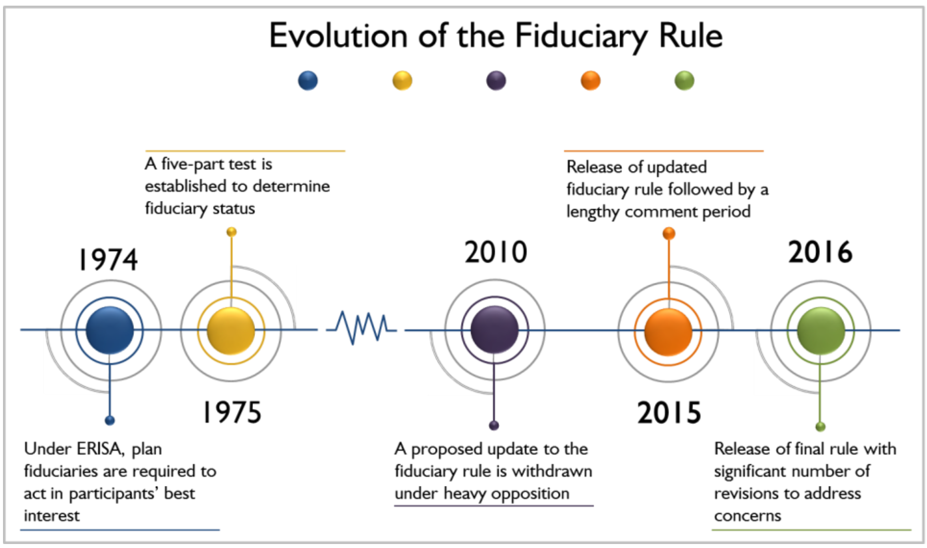

Figure 1 - Evolution of the Fiduciary Rule

It's important to note that the fiduciary standard was not applied unless all five conditions were met for each instance of advice. As a result, many investment advisers had no obligation to abide by the fiduciary standard. This narrow definition of fiduciary was created in a very different retirement planning environment. At the time, defined benefit plans were the standard and participant-directed 401(k) plans didn't exist. Over the next few decades, individuals increasingly assumed more responsibility for complex retirement planning decisions.

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In October 2010, the DOL submitted an update to expand the definition of fiduciary by removing the regular basis portion of the five-part test. The proposal was greeted with strong opposition concerned that the revised definition would lead to additional legal liability, reduced access to investment education, and higher costs. The DOL withdrew the proposal in September 2011 with plans to re-issue the rule the following year.

Conflict of Interest Rule

On February 23, 2015, President Obama stated that he was "calling on the Department of Labor to update the rules and requirements that retirement advisers put the best interests of their clients above their own financial interests." In April 2015, the DOL unveiled an updated version of the fiduciary rule. The rule completely replaced the five-part test with a description of communications and activities that would be considered a fiduciary act. There was also a new provision, the Best Interest Contract Exemption (BICE), which would allow advisers to continue receiving commissions or other fees as a result of their advice, provided certain conditions are met. Full implementation of the rule was expected to be in place within eight months.

Over the past year, the DOL received more than 3,000 public comments and held four days of public hearings. Finally, on April 6, 2016, the DOL released the final proposal for the Conflict of Interest Rule. The initial review is that it appears the DOL made a number of changes to simplify and clarify the previous proposal in order to address many of the criticisms leveled against the rule. However, the key goal of preserving a best interest standard to protect retirement savers remains intact. From our perspective, most of the provisions in the final version are aimed at individual client-advisor relationships. Still, we have identified several areas of particular interest to plan sponsors.

Impact on Plan Sponsors

Education

The final rule lists the types of information that will not rise to the level of fiduciary advice, including plan information and general investment and retirement information. In addition, the DOL changed the final rule to allow model portfolios to identify specific investment alternatives without being considered investment advice as long as the investments are monitored by an independent fiduciary.

While we expect participant education to continue to be an important part of the retirement plan offering, we would anticipate educational sessions to be more general in nature going forward. Therefore, we would encourage plan sponsors to ask their retirement education provider what impact the fiduciary rule will have on these services.

Best Interest Contract Exemption (BIC)

Under the final rule, the DOL created an exemption to allow financial advisers to continue to receive forms of compensation (commissions, 12b-1 fees, revenue sharing, etc.) from transactions that would otherwise be prohibited. However, in order to qualify for this exemption, the financial institution must acknowledge fiduciary status and charge no more than "reasonable compensation," among other things. The final version of the rule made several adjustments to address a number of criticisms. The exemption is targeted toward retail investors as well as plan sponsors with <$50 million in assets.

For plan sponsors with $50 million or more in assets, the final rule contains a "seller's exception." At this asset level, the plan fiduciary is presumed to have a certain degree of financial expertise. Therefore, a BIC is not required, provided the plan has an independent plan fiduciary in place along with an established governance structure and the authority to make investment decisions. While this exemption provides a number of protections for retirement investors, we anticipate the "reasonable compensation" clause will be the subject of considerable debate going forward.

Rollovers

The final rule will have a significant impact on rollovers from defined contribution plans. Going forward, the recommendation of a distribution or a rollover to an IRA will now be considered a fiduciary act. However, information or education may still be provided without being considered investment advice. Advisors will also need documentation to explain why assets were moved from a defined contribution plan to an IRA, particularly when it is a more expensive proposition.

This will likely impact plan sponsors in two primary areas. First, we would anticipate more employees will decide to stay in a plan after leaving the employer due to the more stringent rollover requirements. Another possibility is that financial services call centers diminish or discontinue rollover advice services due to concern of triggering fiduciary obligations. This is another area where Summit will work with plan sponsors to fully understand any changes from their service providers.

Health and Welfare

In the initial proposal, there was concern that the rule could be applied to health, dental, and disability insurance policies. As part of the final proposal, the DoL issued a clarification that "investment property" does not include health, disability, or term life insurance policies or other assets that do not have an investment component.

Timing

The proposed rule called for an eight-month period for implementation. After hearing feedback that this was too short a time frame for this type of rule change, the DOL extended the length of time for implementation and introduced a phased implementation period. This will give firms impacted by the rule more time to become fully compliant.

Plan sponsors now have until April 10, 2017 to decide how best to react to the new rule. Other provisions, such as BICE, are being phased in and won't be fully implemented until January 1, 2018. At Summit, we have incorporated the various components of the final rule into our review of fiduciary best practices, scheduled for release this summer. In addition, we will be helping plan sponsors review any new written documentation provided to them by service providers in order to ensure compliance.

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Final Rule Aftermath

Over the next 60 days, lawmakers have an opportunity to block a rule after it has been released in final form under the Congressional Review Act. One resolution to eliminate the rule has just passed a House committee and is widely expected to pass the full House and Senate. However, the resolution doesn't appear to have enough bipartisan support to override a Presidential veto.

Another potential course of action could be to derail the rule through litigation. A couple of industry trade groups – the Financial Services Institute and the Securities Industry & Financial Markets Association – have been vocal about their opposition to the rule and are currently analyzing the rule. We will continue to monitor any legal efforts to change or eliminate the rule.

Something else to watch for will be if the US Securities and Exchange Commission (SEC) proposes its own rule later this year. The SEC was explicitly authorized by the 2010 Dodd-Frank financial overhaul law to make brokers act as fiduciaries. It appears thus far that the SEC has been hamstrung by a partisan divide among the commissioners, allowing the DoL to assume leadership in this area. If the SEC proposes a rule, it would potentially cover retirement and non-retirement investing alike.

Finally, we've already seen evidence the industry is quickly adjusting to the new rule. In the past several weeks, we've seen multiple announcements of reduced fees for wrap portfolio programs as well as lowered minimums for fee-based portfolios. This could also lead to consolidation in the financial services industry as smaller players may be unable to compete in an environment of reduced fees and higher compliance costs.

The Fiduciary Rule Overseas

As we consider these new rules, it's too early to forecast what the impact will be for retirement investors. Proponents of the rule believe the new standards will improve investor outcomes by removing conflicts of interest and producing higher-quality advice. Those opposed to the rule are primarily concerned that the costs to comply could lead to fewer investment advisers and less investment information available to retirement investors, especially those with smaller balances.

However, it may be instructive to consider the experience of the United Kingdom and Australia, which have implemented similar rules over the past few years. One key distinction is that the changes in those countries were applied to all investors and not just retirement investors. Based on the initial results, those in favor and those opposed to the rule may both be right.

In the United Kingdom the standards, known as the Retail Distribution Review, were adopted in early 2013. The key provisions included a ban on commissions; advisers must now be licensed and are also required to complete 35 hours of continuing education annually. Australia enacted the Future of Financial Advice laws in 2012 with an elimination of commissions, a disclosure of all fees, and a mandate that all advisory agreements are reaffirmed every two years.

Over the past five years, there has been a roughly 25% reduction in the number of advisers in the UK, although a third of firms intend to add advisers this year. In addition, a recent survey found that nearly 70% of British advisers had turned away potential clients over the past 12 months due to small portfolio size and increased regulatory burden. However, in Australia, there has been very little change in the number of advisers available.

Conclusion

The release of the final conflict of rule represents the biggest change for retirement investors in the past 40 years. We are in favor of the Labor Department's rule and believe the agency made a significant effort to address the concerns of the financial services industry in their final release. Over the next 12 to 18 months, the financial services industry will be taking steps to ensure they are in compliance with the new rules. For many plan sponsors, there will only be a modest impact to their current structure. However, we encourage all plan sponsors to review their plan documents and all agreements with advisers to fully understand if their roles or responsibilities have changed.

Summit was built on the foundation that investment advice should be free of conflict. In that regard, we believe that all investment advisors should work in their clients' best interest at all times. For the past 20 years, we have proudly served as a fiduciary alongside our clients and we will continue to do so in the years to come.

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