The Beacon

LOCKTON RETIREMENT SERVICES

UNDERSTANDING THE DOL'S NEW CONFLICT OF INTEREST RULE

After nearly six years of positioning, the Department of Labor (DOL) released its final rule on the redefinition of advice under ERISA. Formally called the "Conflict of Interest Rule," it drastically changes what constitutes advice, limits how advisors can be paid, and defines "education."

Who Is a Fiduciary Advisor?

For more than 40 years, a five-part test defined whether an advisor was an ERISA fiduciary. The test evaluated whether the advice:

1. Recommended investment in securities.
2. Was provided regularly.
3. Constituted a mutual agreement or understanding between the investor and advisor.
4. Was the primary basis for the investor's decision.
5. Was individualized to the investor.

The new rule defines an advisor as a fiduciary when he or she provides a "communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action."

When an advisor is a fiduciary, he or she is held to a higher standard of care. This means their advice must be made in the best interest of the recipient and there cannot be any conflicts of interest. While this has generally applied to plan sponsors, now anyone classified as a "protected investors" is covered.

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Inside:

The DOL's new Conflict of Interest Rule changes the definition of advice, protected investors, advisor pay, and the line between education and advice:

Advice: Any communication reasonably viewed as a suggestion to take, or not take, action.

Protected Investor: Includes participants, IRA investors, rollovers, and small plans.

Pay: Must be level except in limited, specifically disclosed situations.

Education: In-plan asset allocation models and interactive tools are not advice.

Who Is a Protected Investor?

In addition to advice to ERISA-covered plans, the new rule now covers advice made to:

- Plan participants and beneficiaries.
- Individual Retirement Account (IRA) owners.
- Anyone seeking rollover advice.
- Retail fiduciaries (plans sponsors overseeing less than $50 million in assets).

How Can Fiduciary Advisors Be Paid?

Conflicts of interest in advice now are prohibited under ERISA. For example, when an advisor's pay varies based on the recommendation made, there is an inherent conflict from the potential incentive to make recommendations that generate higher compensation. To avoid this, an advisor's compensation must now be level, meaning either a fixed-dollar arrangement (such as $25,000 per year) or an asset based fee (such as 25 basis points per year). In the past, nonlevel compensation could arise from recommendations that paid differing fees to the advisor (such as a commission, 12b1, or referral fee). Many advisors and sponsors still managed their relationships to a level amount and simply used a combination of variable fees and directly paid fees to manage to a specific fee. But, to remove potential conflicts, the new rule now says that advisor compensation cannot be contingent on the advice provided.

The Best Interest Contract Exemption (BIC)

The DOL understands that many of those providing advice to "protected investors" (small plans, participants, and IRA holders) are currently and legitimately paid under nonlevel arrangements. For accounts that are too small to generate sufficient, asset-based compensation, for example, commissions or referral fees may be appropriate. Banning variable compensation arrangements could drive those best able to provide advice from those most in need of it.

As a result, the DOL created a new exemption called the Best Interest Contract Exemption, or BIC, that allows advice to be made under certain nonlevel compensation arrangements. The BIC is limited to advice provided to "protected investors" and in specific situations such as a fiduciary advisor selling a proprietary product. Simplified, the BIC requires the advisor to enter into a written contract with the investor which provides significant disclosure of potential conflicts. In addition, the advisor must openly acknowledge its fiduciary status and provide advice in the best interest of the recipient.

The Level-Fee Fiduciary Exemption

For those who provide advice to protected investors and receive level compensation, the DOL provided a streamlined version of the BIC. The simplified approach recognizes the reduced potential for conflict created by level fees and, as a result, no contract is required. The advisor must, however, still acknowledge his or her status as a fiduciary and adhere to the best interest standard.

Impact on Education

Based on the DOL's original proposal, the industry expressed significant concern that services previously considered participant education would be swept into the fiduciary advice definition. The final rule confirms that the following broad educational categories would not be considered fiduciary advice:

- Plan education.
- General financial, investment, and retirement information.
- Asset allocation models.
- Interactive investment materials.

Asset allocation models and interactive investment materials are limited to the plan investment alternatives offered, which are already subject to the sponsor's fiduciary oversight. However, when a specific investment alternative is used in a model or materials, all similar risk and return alternatives must also be presented. The plan fiduciary also retains an obligation to properly select and monitor the education provider, but would not have co-fiduciary liability in the event that provider delivered fiduciary advice.

Next Steps

The DOL recognizes the importance of providing adequate time for impacted parties to comply with the rule. The first important date is April 2017, a year from when the final rule was published. At that time, the change in the advice definition and parts of the exemptions become applicable. Full compliance with the BIC becomes enforceable January 1, 2018. While there are many more layers to the new rule and it will take time to understand them fully, we are committed to providing insight on the impact to your plan.

If you have questions, please contact your Lockton Retirement Services team.

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