

Regulatory brief

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Fiduciary duty proposal: Disruptors at the gate

Overview

With less than 18 months left in office, President Obama has asserted that the Department of Labor's ("DOL") proposed fiduciary standard for retirement account advisors is a major priority. The DOL completed public hearings last week on this proposal, and we believe that the rule will be finalized early next year with the proposal's core framework intact.

The DOL's final rule is set to transform the competitive landscape and disrupt current business models, particularly for financial institutions that are reliant on traditional broker-dealer activities which are currently not covered by the existing Employee Retirement Income Security Act ("ERISA") fiduciary standard.

Common compensation arrangements for retirement advisors (e.g., commissions for products sold) will be prohibited under the new fiduciary standard. However, the proposal grants a number of carve-outs that the DOL does not consider fiduciary in nature,¹ and also grants two major exemptions for fiduciary transactions that would otherwise be prohibited. The first exemption, and in our view most critical, is the Best Interest Contract exemption ("BIC") which would allow financial institutions to continue to receive commissions. The second, the Principal Transaction Exemption, would permit a financial institution to engage in the purchase and sale of certain debt securities (out of the firm's inventory) on behalf of a retirement account.

Whether or not to utilize the BIC represents an important choice for financial institutions. The requirements are strict, complex, and in many cases ambiguous. Businesses relying on this exemption can expect to incur significant costs to maintain their existing commission-based compensation arrangements. Alternatively, companies that choose not to rely on the BIC will need to adopt a fee-based compensation model (e.g., an annual charge to customers based on total invested assets) or a self-directed model.

In addition to these new regulatory requirements, competitive market shifts are underway, as a number of new low cost competitors are emerging to challenge the traditional advisor business model.

This **Regulatory brief** provides (a) key background related to the proposed fiduciary standard, (b) analysis of the two major proposed exemptions for prohibited transactions, (c) strategic considerations for financial institutions, and (d) our view of what's next.

¹ For an analysis of the proposal's carve-outs and other details about the proposal, see PwC's *DOL proposes to redefine fiduciary investment advice, update class exemptions* (April 2015).

Background

On April 14, 2015, the DOL issued the highly anticipated re-proposed regulations that stipulate when a person providing investment advice to an employee benefit plan or an individual retirement account (“IRA”) is considered a fiduciary under ERISA and the Internal Revenue Code.

The DOL’s proposal extends the definition of “fiduciary” to an expanded universe of 401(k) plan advisors and advisors of IRA investors, requiring these advisors to give advice that is in the “best interest” of their clients rather than advice that is merely “suitable.” The stakes are significant as about \$7 trillion is invested in IRAs and more than \$5 trillion is invested in 401(k) plans. Leading industry groups and retirement advisors have therefore raised concerns regarding the proposal’s practical implementation, overall cost of compliance, and potential adverse impacts on investors.

While the concept of expanding the population of advisors subject to a fiduciary standard has been hotly debated for over five years, the White House has made the fiduciary standard a pillar of what President Obama calls “middle-class economics.” Additionally, influential groups such as the American Association of Retired Persons (“AARP”) have come out in favor of the DOL’s proposal as have many Democrats, including the influential Senator Elizabeth Warren.

BIC requirements

The BIC stands out as a key exemption for firms to understand and consider. The DOL developed the exemption to allow firms to continue to receive common forms of commission-based compensation provided they comply with specific requirements.

Disclosure requirements

In our view, one of the most challenging BIC requirements is the point of sale disclosure requirement, which requires financial institutions to disclose to retirement investors the total cost of each new investment over holding periods of one, five, and ten years, prior to the execution of the investment transaction. This disclosure must be provided at the time the customer purchases the new investment, and must include the following:

- The costs of acquiring the asset (e.g., sales charges, commissions, and account opening fees)
- The costs of maintaining the asset (e.g., intermediary fees, and account maintenance fees)
- The costs of selling the asset (e.g., surrender fees, and back-end sales charges)

- Any other costs that reduce the investment’s rate of return

In addition, within 45 days of year-end, financial institutions must provide investors a summary of total annual expenses incurred as a result of an advisor’s investment recommendations. Such expenses must be further broken down by the amount paid to the advisor and the advisor’s firm.

The point of sale disclosure requirement will likely be a significant operational and technological challenge for firms because the proposal suggests that firms will need to delay transactions until obtaining confirmation from the client that the client is comfortable with the projected costs. The delay could result in an outcome not in the client’s best interest, if investment opportunities are missed. Therefore, financial institutions will need to modernize client notification methods (e.g., from mail to e-mail) in order to reduce consent times, which could prove difficult with older investors.

It is likely that the DOL will simplify this requirement, which as currently written may conflict with an existing Financial Industry Regulatory Authority (“FINRA”) rule prohibiting communication with the public that projects performance (such prohibited projections would be needed to estimate and disclose certain costs).

Contract requirements

Prior to providing investment recommendations, the BIC requires the financial advisor and financial institution to enter into a three-way written contract with the investor. The contract must acknowledge fiduciary status, commit the adviser to follow impartial conduct standards, and include warranties to which the financial advisor and financial institution must adhere. The contract also needs to articulate the types of accounts covered and any limitations or conflicts of interest the financial advisor or financial institution may have. Additionally, firms cannot limit liability or preclude investors from enforcing the contract through class actions.

Financial institutions will have to determine the operational implications of these requirements as they will need to re-write (or amend) contracts. For new customers, we expect the DOL to modify the proposal to allow the contract to be applied retroactively to when investment discussions began between the financial advisor and investor (since the advisor may have made investment recommendations during those initial conversations). For existing clients, the DOL is also likely to clarify the proposal in order to permit negative consent – i.e., allowing financial advisors to provide their customers with an updated contract without requiring their signature.

We also expect the DOL to expand the definition of financial advisor to include a group of advisors that routinely work together, rather than a single advisor, or to modify the proposal to only require a two-way contract between the financial institution and investor. This change would ameliorate disruptions resulting from financial advisor turnover and access.

In-scope products and services

The BIC only applies to certain asset types including the most commonly used types of plan investments such as mutual funds, insurance and annuity products, and individual equity securities. Transactions in alternative investment products such as real estate, non-publicly traded securities, hedge funds, or private equity funds are not eligible for the BIC.

Furthermore, the BIC cannot be utilized when advising sponsors of smaller 401(k) plans. Unlike their larger counterparts, these smaller plans (i.e., with 100 or fewer participants or under \$100 million in plan assets) are not carved-out from the proposal's fiduciary standard. Firms will therefore have to determine if they can continue to service these small 401(k) plans due to the likely lower profits, or will have to find lower cost options for doing so.

Principal Transaction Exemption

The Principal Transaction Exemption is the second key exemption. It permits financial institutions to continue to receive markups (amounts in excess of the prevailing market price) when providing retirement investors with access to US debt instruments from their own inventory, including corporate debt, agency debt, and Treasuries.

In order to take this exemption, firms must prepare a pre-transaction statement for the investor that includes price quotes for the same or similar debt security from two non-affiliated market participants (including any markups/markdowns). While this could be difficult to implement, particularly for infrequently traded debt securities, this requirement is likely to remain in the final rule. Similar to the BIC, compliance with this exemption would require the financial institution and advisor to enter into a three-way written contract with the investor (which is likely to be modified, as stated above). Additionally, the exemption requires a financial institution to provide an annual cost disclosure within 45 days of year-end.

Strategic considerations

Given the need to alter business models as a result of the DOL proposal, we are seeing some firms beginning to assess the potential impact of the proposed rule (and exemptions) to their operations. We recommend that firms examine their (a) target operating models, (b) need for new or update existing technology, (c) compensation and human capital, and (d) customers.

Determine the target operating model

Understanding the future competitive landscape under the new regulation will be vital for firms going forward. Financial institutions will need to closely examine their ability to utilize the BIC, or alternatively adopt a new fee-based compensation model or a self-directed model for services (the latter will greatly impact how investors are serviced). Furthermore, it is critical that firms understand and assess new costs associated with maintaining small accounts to determine whether retaining them can continue to be justified under current business models.

Additionally, firms may find that new entrants, such as low-cost (often automated) fee-based service providers, will disrupt their businesses. These new entrants have little (if any) compliance work to do under the proposal, and their business models are suited for thin profit margins. Likewise, we are seeing larger firms begin to examine if automated advice should be incorporated into their operations in order to significantly cut costs for their smaller accounts.

Review technology needs

Technology will play a critical role in managing the increased compliance obligation related to new business processes and procedures. Many proposed disclosure requirements will prove challenging because financial institutions do not have all relevant fee and cost information easily accessible in a centrally located database.

Therefore, we recommend that firms begin to identify gaps in data collection and establish sources to collect fee information, including contracts, amendments, and prospectuses. Financial institutions may consider building a new user interface to include a calculation engine, which financial advisors will need in order to produce appropriate and timely pre- and post-sale customer disclosures. Also, trading systems will need to be enhanced to detect and block certain products that are not allowed under the BIC exemption.

Address compensation and human capital

A major challenge is for firms to consider that a fiduciary advisor's compensation must be "reasonable" (under ERISA and the Internal Revenue Code). Applying this standard will particularly impact commission-based models, as firms will likely need to understand the industry's differing levels of commissions for various products in order to determine "reasonable" compensation.

Furthermore, firms that move to a fee-based model, instead of utilizing the BIC, will have to decide if they should continue to offer complex products that are costly to offer and maintain. While advisors are paid a higher compensation for such products under a commission-based model, that generally will not be the case under a fee-based model.

Finally, staff training will be essential to ensure that advisors are not running afoul of the new rule's complexity.

Understand customer impact

The DOL's proposed changes will also impact how retirement advisors and their customers communicate. As a result, financial institutions will need to provide clear guidance on permissible products and services, and optimize methods to convey such information to customers. This could be onerous and potentially cause confusion, particularly if a retirement investor owns multiple types of accounts (e.g., taxable and non-taxable) to which different rules apply. Firms will need to analyze new costs associated with maintaining such communications and determine if continuing to service smaller accounts makes economic sense.

What's next?

Going forward, we believe the DOL's rulemaking will continue to pressure both the Securities and Exchange Commission ("SEC") and FINRA to propose their own versions of an expanded fiduciary standard, applicable beyond retirement accounts. While the SEC continues to consider its options, we expect FINRA to move forward with its own "best interest" standard for registered broker-dealers (which would still require SEC approval).

Regardless of additional regulatory action, firms must begin to analyze their current business and operating models in light of the DOL's proposal to ensure they remain competitive under the expanded fiduciary definition.

Additional information

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