April 8, 2016

First take
A publication of PwC's financial services regulatory practice

Ten key points from the DOL's fiduciary duty rule

On April 6th, the Department of Labor (DOL) released the long-awaited fiduciary regulatory package[1] which sets a new standard for advice given to retirement investors. Under this final package, investment advice given to an employee benefit plan or an individual retirement account (IRA) is considered fiduciary advice and therefore must be in the "best interest" of the investor. As a result, financial advisors (FAs) who provide investment advice will face limits on receiving commission-based compensation. With up to 50% of US retail financial assets in retirement accounts, the impact of the rule will be widespread across asset managers, broker dealers, and insurance companies.

In response to over 3,000 public comments, the DOL has made a number of accommodating modifications to the regulatory package. In particular, the Best Interest Contract (BIC) exemption, which would allow advisors to continue to receive commissions under a contract with a retirement investor, is considerably less challenging to implement. The changes will be particularly beneficial to institutions with a largely commission-based business model. However, the DOL has preserved the core requirements from the proposal,[2] and the final version will still require strategic and operational changes by affected firms.

1. **The commission-based compensation model is under less jeopardy.** The ability of FAs to utilize the BIC exemption has been eased, as many of the anticipated costly compliance requirements are no longer included. Therefore, we expect many firms to now utilize the exemption by establishing contracts with clients in order to continue to receive commissions. However, the BIC exemption requires that investors retain the right to join class action lawsuits, so we still expect part of the industry to consider a fee-based compensation approach (i.e., receiving a flat or scaled fee for services instead of a commission). Even when utilizing the BIC exemption, FAs will need to reassess their product portfolio and policies in order to ensure that any commission-based advice is in the investor's best interest.
2. **The DOL has more clearly distinguished between investment advice (which would trigger the "best interest" standard) and investor education (which would not).** The proposed rule raised concerns that investors would no longer have access to education from an FA. To address this, the DOL has provided examples of investor education materials which would *not* constitute investment advice as long as they do not include recommendations of specific investment strategies. Specifically, the final rule includes four general categories of investment education that will not be treated as recommendations.[3] As a result, FAs will be able to promote their services through various types of media advertisements and public commentary such as speeches, newsletters, and reports. Additionally, asset allocation models and other online tools can identify specific products and their impact on returns for plans, without it being deemed investment advice. However, identifying specific products in this way for an IRA would be considered investment advice because there is no independent plan fiduciary to oversee the product selection.

3. **Contracts needed to utilize the BIC exemption are more flexible and simpler to initiate.** The DOL removed the FA from the proposal's original call for a three-party contract to be signed between the FA, firm, and investor in order to utilize the BIC exemption. This change to a two-party contract without the FA eases concerns with respect to (a) transitioning client accounts from one FA to another in the event that an FA leaves the firm and (b) cases where multiple FAs within one firm give advice to a particular client. This latter point is particularly significant for firms that have call centers with multiple advisors, any of whom could speak to each client. Secondly, the final exemption allows FAs to initiate conversations with prospective clients without having a contract in place beforehand. Instead, the contract can be signed when the investor decides to open an account, and the contract will retroactively apply to prior communications. Finally, the DOL has further eased the process by clarifying that new contracts can be signed electronically, rather than only in writing, but maintains that consent via telephone is not permitted.

4. **Simplified updates to existing contracts will likely ease BIC implementation.** To reduce the effort of repapering contracts with existing clients, the DOL will allow FAs to provide their existing customers with a contract amendment that does not require a signature. The amendment can be provided electronically, and customers will have 30 days to "opt out" if they do not want to continue receiving advice. To further minimize the impact on pre-existing arrangements, the BIC exemption allows FAs to continue to receive commission-based compensation for assets acquired by the investor before April 10, 2017 (i.e., grandfathering).

5. **Proposed disclosure and document retention requirements for utilizing the BIC exemption have been softened.** The DOL has eliminated two major disclosure requirements that were expected to be particularly challenging: (a) the one-, five-, and ten-year cost projections for each new investment at the point of sale, and (b) the annual disclosure of expenses incurred as a result of an FA's recommendations. Instead, firms will need to provide a single written document for each new transaction[4] that describes any material conflicts of interest and offers the investor the option to request cost, fee, and other compensation data. Firms will still need the capability to collect and retain such data, but will not need to provide this information unless the client requests it. The requirement to post certain model disclosures on the web (and update it on at least a quarterly basis) has been retained, but it has been streamlined to no longer require individual FA compensation figures. Finally, instead of needing to retain detailed information related to retirement investments, firms will only need to retain enough documentation to show that they have complied with the law (e.g., contracts outlining the FA's fiduciary responsibility).

6. **Most investment products will be allowed under the BIC exemption.** Under the proposed BIC exemption, FAs could only recommend "plain-vanilla" products (e.g., mutual funds and exchange traded securities). In response to industry feedback, the DOL has removed the list of products which would have been permitted under the exemption. Instead, investors will be able to continue to invest IRA assets in complex products, including options, non-traded REITs and hedge funds if they are deemed to be in the investor's "best interest" (which may only be true for more sophisticated investors). Firms can also continue to recommend proprietary products, provided that they comply with certain provisions, such as monitoring the incentive structure and clearly explaining that the products are recommended from a limited menu of options.

7. **Variable and indexed insurance products are both now covered under the BIC exemption.** FAs selling insurance products will need to rely on the BIC exemption for recommendations of both variable and indexed annuities.[5] Because most of these products currently generate commissions, we expect this change to lead to the development of products that can both satisfy the "best interest" requirements and generate a profit. In addition, new disclosure requirements may lead to changes in revenue sharing and other fee arrangements due to increased transparency of previously undisclosed compensation information.

8. **A new "level fee fiduciary" concept is introduced, with eased conditions to utilize the BIC exemption.** When an FA recommends a rollover or a switch from a brokerage to a managed retirement account, this would qualify as investment advice under the final rule. FAs who receive a fixed dollar fee or a fee based on a percentage of client assets for their services (i.e., level fee fiduciaries) can utilize the BIC exemption to avoid a potential fiduciary conflict for such rollover advice, without having a contract in place. Certain "robo-advice" providers, which are growing in popularity, may also be eligible to take advantage of the level fee concept.

9. **FAs can provide advice to more plans and IRAs without being deemed a fiduciary.** The proposal included a carveout allowing FAs to provide advice to employee benefit plans which have at least $100 million in assets and are represented by certain fiduciaries[6] without it constituting investment advice. The final rule expands this provision by lowering the asset threshold to $50 million for plans and also extends it to IRAs which meet the $50 million threshold (i.e., very few high-net worth individuals).

10. **Implementation timeline is extended.** In response to industry concerns over the proposed eight month implementation period, the DOL has incorporated a longer two-phased implementation approach. The new fiduciary standard for investment advice will apply on April 10, 2017, and firms will be required to comply with several conditions by this date in order to utilize the BIC exemption (i.e., adhere to the best interest standard, acknowledge their fiduciary status, and make basic disclosures to investors). Full compliance with the BIC and other exemptions is delayed until January 1, 2018. Although the rule and exemptions will not come into effect as quickly as was proposed, firms should still begin preparation as soon as possible due to the significant structural and operational changes needed.

What's next?

Although many of the changes to the fiduciary regulatory package make implementation less challenging, we still expect to see significant structural and operational changes across affected firms. In fact, many firms have already undertaken significant evaluations of their business and operating models, including customer segmentation analysis and consideration of different channels for fiduciary and non-fiduciary advice. In particular, the industry will likely see a significant uptick in the use of digital and online channels, including an increased appetite for less costly robo-advice due to pricing pressure on commissions. Furthermore, we have already seen some insurance firms moving to divest their broker-dealers, and expect to see consolidations among smaller insurance broker-dealers, independent broker-dealers, and regional brokerages over the next three years.

Finally, the SEC is expected to issue a similar proposal to cover non-retirement accounts given the mandate for a federal uniform fiduciary standard under the Dodd-Frank Act. As a result, some FAs may consider extending the DOL standard to an increased scope of accounts in order to avoid potentially awkward double standards for investors who hold both retirement and non-retirement accounts. Regardless, the DOL's opening move to increase transparency and eliminate conflicts of interest will lead to convergence of regulation across the wealth management industry towards a broad fiduciary standard.

Endnotes

1. The regulatory package includes the regulation, which defines who is a fiduciary as a result of providing investment advice, and the associated exemptions which allow firms to continue to receive commission-based compensation provided they adhere to certain standards.
2. See PwC's *Regulatory brief, Fiduciary duty proposal: Disruptors at the gate* (August 2015).
3. This educational information includes: (a) plan information; (b) general financial, investment and retirement information; (c) asset allocation models; and (d) interactive investment materials.
4. If there is an additional recommendation of the same investment product within a year of the original disclosure, the disclosure will not need to be repeated.
5. Indexed annuities were not covered in the proposal. For details see PwC's *Regulatory brief, Insurers: Retirement plans look less golden* (December 2015).
6. These fiduciaries include banks or similar institutions, insurance carriers, registered investment advisers, broker-dealers, or any persons acting as independent fiduciaries.

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Advisory Leader
646 471 8488
daniel.ryan@pwc.com
@DanRyanWallSt

Mike Alix
Financial Services Advisory Risk Leader
646 471 3724
michael.alix@pwc.com

Adam Gilbert
Financial Services Global Regulatory Leader
646 471 5806
adam.gilbert@pwc.com

Armen Meyer
Director of Regulatory Strategy
646 531 4519
armen.meyer@pwc.com

Contributing authors: Michael Spellacy, Chris Joline, Arjun Saxena, Debbie Packer, Lisa Herrnson, and Edward Hirsh.

To learn more about financial services regulation from your iPad or iPhone, click here to download PwC's Regulatory Navigator App from the Apple App Store.

Follow us on Twitter @PwC_US_FinSrvcs