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Understanding the Fiduciary Rules

January 31, 2017

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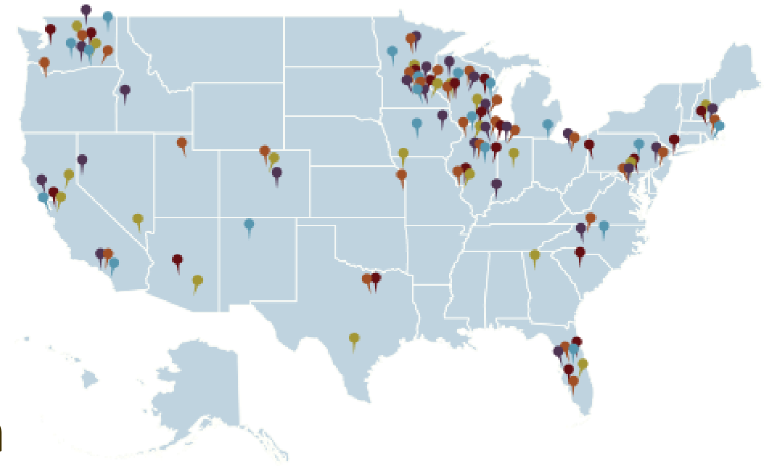
- A professional services firm with three distinct business lines
  - Wealth Advisory
  - Outsourcing
  - Audit, Tax, and Consulting



- More than 5,000 employees
- Offices coast to coast
- Providing employee benefit plan audit, tax compliance, and consulting services for more than 60 years.
- Our 50 principals and 300 professionals audit more than 2,500 plans across the country and provide compliance and consulting services for hundreds more.

Speaker Introduction

John C. Stiglich, CPA, CFP®,PFS, AIF®, CPFA,

- Managing Principal of Retirement Services, CliftonLarsonAllen Wealth Advisors, LLC
- Over 37 years of experience in working with qualified retirement plans.
- Manages the third-party administration (TPA) services team in the Joliet, IL office.
- Assists wealth advisors across the firm in selling and servicing qualified retirement plans.

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Learning Objectives

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At the end of this session, you will be able to:

- Describe and understand the principals of the new fiduciary rules
- Recognize the new risks associated with the changed fiduciary rules
- Examine examples of how the standard might be applied to your organization

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History of the new Fiduciary Rules

- Around 2010 or so, Congress, the Obama administration and other leaders in Washington D.C. came to the realization that defined contribution plans were the predominant retirement plans covering most U.S. workers

- The majority of the defined contributions plans were either 401(k) or 403(b) plans.

- The leaders in Washington also realized that the ultimate benefit received at retirement by participants in defined contribution plans was based upon the amount the plan participant saved, the amount contributed by the employer and earnings on those amounts over time.

- The leaders in Washington determined that most employees were not saving enough and unlike defined benefit plans, an employee could easily out-live his or her retirement benefit.

History of the new Fiduciary Rules

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- Fearful of having a large number of retired U.S. citizens financially insolvent in the future, Congress passed laws allowing for auto-enrollment and auto-escalate options in defined contribution plans as a means to get employees actively saving for retirement.

- The Department of Labor(DOL) with the encouragement of the Obama administration focused on the impact that “fees” have on a plan participant’s account balance over time.

- The DOL determined that the impact could be significant . So, in 2012, the DOL issued regulations requiring those companies providing services to 401(k) and 403(b) plans and being paid from plan assets, provide plan trustees and plan participants with disclosures about the amount of those fees.

- It is the obligation of the plan trustees to then determine if the fees being charged are “reasonable”.

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History of the new Fiduciary Rules

- A recent survey by NEPC LLC, a large independent investment advisory firm, indicates that asset-weighted expenses charged by service providers to 401(k) and 403(b) plans are at their lowest level in a decade and that there is trend toward fixed-fee arrangements.

- Encouraged by these types of results, the Department of Labor(DOL) with the support of the Obama administration focused on the impact that "fees" have on all retirement account balances, especially small IRA's, SIMPLE IRA's and SEP IRA's.

- The current balance of all retirement plan accounts in the United States is somewhere between $17 and $23 trillion.
- As "baby-boomers" continue to age, the expectation is that most of their wealth will transfer from qualified retirement plans to Individual Retirement Accounts(IRA's).

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History of the new Fiduciary Rules

- The DOL and the Obama administration saw a broadening of the regulations affecting the behavior of financial advisors who serve retirement plans as the best means of trying to control the costs these advisors charge and the standards to which they must adhere. The ultimate goal was to protect the “small and unsophisticated” investor.

- As a result, on April 10, 2016, the DOL published in the Federal Register the final rules pertaining to the status and conduct of investment firms and investment advisors when working with any retirement account. For the first time, the DOL has extended its authority beyond just retirement plans covered by Employee Retirement Income Security Act(ERISA) to now include all retirement plans and all types of Individual Retirement Accounts(IRA’s).

- The new Fiduciary Rules are scheduled to become applicable on April 10, 2017.

Current Rules Governing Financial Advisors

- Broker/Registered Rep:
  - Not fiduciaries under ERISA.
  - Not subject to fiduciary standard of care.
  - Usually, need only to comply with the FINRA and SEC's "suitability" standard.
  - Allowed to receive variable compensation.

FIDUCIARY ADVISORS:

- ERISA 3(21) Advisor:
  - A co-fiduciary under ERISA.
  - Advisor makes recommendations.
  - Plan sponsor is <u>not</u> fully relieved of fiduciary responsibility.
  - Normally compensated on a percentage of assets basis.
- ERISA 3(38) Investment Manager:
  - Represents the <u>highest</u> level of investment liability transfer possible under ERISA.
  - Plan sponsor delegates responsibility for the investments to the 3(38) fiduciary.
  - Normally compensated on a percentage of assets basis.

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What do the new Fiduciary Rules require?

- Financial advisors must give advice that is in the “best interest” of the retirement investor. This best interest standard has two chief components: prudence and loyalty.
- Under the prudence standard, the advice must meet a professional standard of care as specified in the terms of the Best Interest Contract Exemption(BICE).
- Under the loyalty standard, the advice must be based on the interests of the customer, rather than the competing financial interest of the adviser or firm.
- The Investment Firm and financial advisor can not charge more than reasonable compensation.
- The financial advisor can not make any misleading statements about investment transactions, compensation, and conflicts of interest.

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What do the new Fiduciary Rules require?

- Variable compensation such as sales commissions on securities and variable annuities are only allowed upon the execution of a Best Interest Contract Exemption (BICE). This contract is signed by the investment firm, the financial advisor and client. The BICE discloses and documents to the client why the proposed investment is in his or her "best interest." If the transaction is later determined not to have been in the client's best interest, the client has a right to sue the parties in state court under a fiduciary standard.

- Certain acts, such as advising a plan participant whether to roll a balance into or out of a retirement plan, is deemed a fiduciary act if the person providing the advice received any direct or indirect compensation. A detailed analysis of all costs associated with each option needs to be prepared and documented.

- Conversion of accounts from commission-based to fee-based require the same analysis.

What do the new Fiduciary Rules require?

There are many other operational items covered in the over 1,000 pages of regulations.

These include:

- The definition of "education" versus advice to plan participants.
- The definition of a "referral" versus advice.
- The definition of "indirect" compensation and its restrictions.
- Many more complicated rules and explanations

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How will these new Fiduciary rules affect you?

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- **For Qualified Retirement Plans**, if the plan is not on an advisory platform, many are being moved to an advisory platform.
- **For Individual Retirement Accounts** – many large accounts(>$ 1million) are being moved to an investment advisory account, some small (>$100,000), active accounts are being moved to advisory platforms as well. Many inactive(no additional contributions) IRA accounts will remain where they are and the investment firms will follow the grandfathering rules for these.
- **For SEP's and SIMPLE IRA Accounts** – many active(regular contributions and withdrawals) plans are being moved to investment management accounts, non-active accounts are remaining where they are at and investment firms are following the grandfathering rules for them.
- **What is grandfathering?** – the new rules allow accounts established prior to April 10, 2017 which are subject to commissions and variable fees the ability to remain on the current platform so long as no new deposit or trading activity takes place in the accounts.
- **Small Retirement Accounts** – some small retirement accounts will be established on computer-based, "Robo advisor" type platforms in order to make them cost-effective for the investment firm. Unfortunately, many small accounts may receive no assistance from a financial advisor.

How will the Fiduciary Rules change the current Service Model for Investment Firms?

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- Several large investment firms have already announced that they are requiring all of their brokers to obtain proper licensing as an Investment Advisor.

- These firms are then requiring the financial advisors to move all commission-based retirement plans, IRA’s, SIMPLE IRA’s and SEP IRA accounts to “managed account” solutions with a pre-selected line-up of investment options

- Many small brokerage firms which can not afford the costs of this new regulation are merging with larger investment firms.

- A few large investment firms have announced that they will continue to use a commission-based model for various retirement accounts but will rely on the BICE for compliance purposes.

- Some small advisory firms which have a small block of retirement accounts have made decisions to no longer serve these accounts and will just focus on individual accounts.

How will the Fiduciary Rules change the current Service Model for Investment Firms?

- Some investment firms are considering a multi-service level model. Clients would receive differing offerings of services and features at different fee levels. For example, Bronze, Silver and Gold.
- Some investment firms are considering having less-experienced advisors work with their clients who have the smallest retirement account balances.
- Many clients with small account balances will be forced to use computer-based “Robo “ advisor solutions.
- Many small retirement accounts will go un-serviced.

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Current status of the new Fiduciary Rules

- While scheduled to take effect, April 10, 2017 there are several lawsuits related to these new rules which are still pending.

- A couple of weeks ago, Rep. Joe Wilson, R-S.C., introduced legislation which would delay the implementation of the new rules by two years. Congressman Wilson's goal is to allow the Trump administration adequate time to re-evaluate the rules and delete or modify them.

- The Securities and Exchange Commission(SEC) is working on its own version of a fiduciary-type rule which would govern advisors regulated by the SEC. Many industry experts believe a delay in the effective date of the current rules would allow time for the SEC to complete its version of a fiduciary rule and the two rules could be merged into one.

- Finally, most industry experts believe that an outright repeal of the new Fiduciary rules is improbable.

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Next Steps – What should you do?

- Inventory your current retirement accounts.
- Determine the type of the account, the nature of the current service model and the costs associated with them.
- Call your financial advisor for a meeting to discuss your options.
- Keep an eye on the news in order to determine the likelihood of the new Fiduciary Rules being delayed or repealed.
- Implement the most cost-effective option for your retirement accounts.

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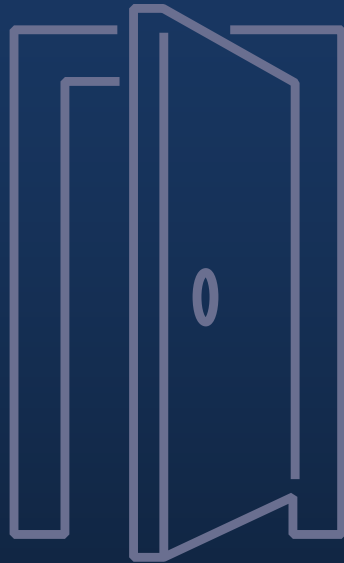

Questions?

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