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DEPARTMENT OF LABOR'S RE-PROPOSED DEFINITION OF A FIDUCIARY WIDELY PROHIBITS PERSONALIZED INVESTMENT ASSISTANCE EVEN IF THE ASSISTANCE IS IN THE CUSTOMER'S BEST INTEREST

On April 14, the Department of Labor ("DOL") issued a re-proposed definition of a fiduciary applicable to retirement plans and IRAs, along with a set of proposed prohibited transaction exemptions. The new guidance, together with the economic analysis, is nearly 700 pages long. Accordingly, our full analysis of the broad changes and the potential effects on retirement savers, small businesses, and retirees is ongoing. However, certain points are already clear. On behalf of an extensive group of clients, set forth below are (1) our overall thoughts on the re-proposal, (2) a very brief overview of the re-proposal, and (3) key specific concerns with the re-proposal.

OVERALL THOUGHTS

- **Widespread unintended adverse results**. The framework set up by the DOL could work conceptually, but ***in its current form, it would have the same effects as the original 2010 proposal – cutting off the option for low and middle-income individuals and small businesses to receive personalized investment assistance.***
- **Re-proposal effectively prohibits substantial assistance that is in the best interest of the customer**. The conceptual framework of the re-proposal applies a best interest standard. As noted many times over the last several years, most of the industry is fine with a best interest standard. The problem is the many other rules described below that effectively prohibit a vast amount of assistance that is in the recipient's best interest.
- **DOL's exemption approach does not work, thus effectively creating the same result as 2010**. Under the original 2010 proposal, the problem was that almost all financial professionals providing investment assistance would become fiduciaries and thus subject to the "prohibited transaction rules." The prohibited transaction rules would make the means by which small accounts and small businesses generally receive personalized investment assistance illegal. The re-proposal attempts to address this issue by including an exemption from the prohibited transaction rules that could, if it worked correctly, preserve access to investment assistance. But ***the exemption does not work: it is extremely narrow, is not principle-based, and includes such impractical conditions that it is unusable***.
    - **Rollover and distribution assistance would be illegal because it is not covered by the exemption.** As explained below, financial institutions would be prohibited from providing any specific assistance to individuals seeking help with the rollover and distribution process, which is not covered by the exemption.
    - **Assistance to small businesses would be illegal because it is not covered by the exemption.** As explained below, financial institutions selling retirement plans would be prohibited from providing any material assistance to small businesses in selecting investment options to offer their employees, a critical element in setting up a plan, but which is also not covered by the exemption.

- **Effective prohibition on assistance to individual investors with smaller accounts.** There is a proposed exemption that is intended to permit the provision of investment assistance to individuals with smaller accounts. The problem is that the exemption is not usable. A principle-based exemption could work, but the proposed exemption is not principle-based. Instead, the exemption requires the production of an unprecedented amount of very specific data. ***As explained below, far more data and additional disclosures are required with respect to, for example, a $3,000 IRA than are required to be provided by a service provider to a retirement plan with tens or hundreds of thousands of participants. For example, under the re-proposal, financial institutions are required to disclose – and update at least quarterly -- all direct and indirect compensation received with respect to all assets of all retirement customers of the financial institution and all affiliates for the past 365 days as well as the same information with respect to all assets that a retirement customer could possibly purchase (other than certain assets not commonly purchased).*** Unfortunately, the unprecedented requirements render the exemption unusable in its current form.

- **Re-proposal falls far short of its own goals.** DOL's states that its goals are "to preserve beneficial business models for delivery of investment advice. . . . Rather than create a highly prescriptive set of transaction-specific exemptions, the Department instead is proposing a set of exemptions that flexibly accommodate a wide range of current business practices . . ." We agree with these goals. And those goals could certainly be achieved with very extensive changes to the re-proposal. Unfortunately, the re-proposal in its current form does not achieve these goals, but rather would have very adverse effects on retirement savers.

OVERVIEW OF RE-PROPOSAL

This is a very general overview of an extremely long and complicated set of proposals.

Fiduciary definition. A person is a fiduciary if he:

- provides advice regarding investments, distributions, rollovers, other fiduciaries, or certain asset valuations, and
- the advice is individualized – or specifically directed to the advice recipient -- and is provided pursuant to an understanding that such advice is for the advice recipient's consideration in making decisions.

The application of the definition to distributions and rollovers is new, but not unexpected. As described further below, however, the implementation of this expanded application is highly problematic.

- **Seller's exception**. In some cases, it is hard to tell the difference between selling (e.g., "our investment products can help you achieve a secure retirement") and advice (e.g., "we advise you to invest in these products"). To ensure that financial institutions can still promote their own products, the original DOL proposal provided a rule under which a seller who makes it clear that he is selling and not advising is not a fiduciary. The re-

proposal also has a seller's exception, but, unlike the original proposal, makes it inapplicable in the case of selling to individuals or small plans.

- **Selling to small businesses.** Small businesses need material help from their retirement plan vendor in choosing investment options (or managed account services) to offer to their employees. Under the proposal, almost no such help is permitted; almost any helpful information will create a risk of fiduciary status and a corresponding prohibited transaction with severe penalties.

- **Education.** Under current law, an employer or service provider may provide investment education without becoming a fiduciary. The re-proposal generally codifies those existing rules, but cuts those rules back in one material way. Current law permits employers and service providers to provide (1) guidance on the extent to which an individual should invest in different asset classes (such as large and small cap equity funds, and long and short-term bond funds) based on her age and other factors, and (2) examples of investments that fit within such asset classes. Under the re-proposal, providing such examples would be fiduciary advice, not education.

Prohibited transaction exemptions. In addition to modifying a number of prohibited transaction exemptions, DOL proposes two new exemptions, a best interest exemption and a principal trading exemption. This summary deals with the best interest exemption, which is the main one.

- **Application.** The exemption applies to advice that:
    - is provided to participants, IRA owners, and sponsors of plans that have less than 100 participants and ***that do not allow participants to control the investment of their own account (an atypical type of plan)***, and
    - relates to the purchase, sale, or holding of certain assets. ***This asset-based approach means that the exemption does not apply to distribution or rollover advice.*** It also means that the exemption does not apply to advice or marketing regarding which company to use to provide investment services, such as managed account or IRA services.
- **Exemption conditions.** Except as noted, ***all of the conditions below*** must be fulfilled ***prior to*** the advice.
    - The adviser and his company must contractually agree to adhere to "Impartial Conduct Standards" in providing advice, and must comply with those standards. This requires a contractual agreement to provide advice that is in the "Best Interest" of the customer, which is defined by reference to the ERISA fiduciary standard.
    - The contract must state that the adviser is a fiduciary.
    - The adviser's company must warrant that it has policies and procedures designed to mitigate the dangers of conflicted advice. For example, the adviser's company cannot have bonuses, special awards, or other incentives that would encourage advisers to make recommendations that are not in the best interest of the customer.

- The contract must disclose all conflicts of interest and make information about direct and indirect fees available.
- *The contract cannot have a provision under which the customer "waives or qualifies its right to bring or participate in a class action or other representative action in court."*
- The adviser must provide a chart to the customer with the "Total Cost" of the asset over 1, 5, and 10 year periods, as a dollar amount, making reasonable assumptions about ***future*** investment performance. "Total cost" includes the expense ratio with respect to a mutual fund, for example.
- Every year, the adviser must provide information to the customer about that year's transactions, including the total dollar amount of all indirect compensation received by the adviser and his company during the year attributable to the customer. We understand that systems do not exist that could produce this data. Also, this data is very different from existing DOL requirements about disclosing indirect compensation.
- The adviser's company must maintain a webpage with detailed information – updated at least quarterly -- about all direct and indirect compensation payable to the adviser, his company, and all company affiliates with respect to ***every single asset*** purchased, sold, or held by a retirement customer during the last 365 days (excluding only certain assets not commonly purchased). In addition, the webpage must include the same information about ***all assets that a retirement customer could possibly purchase (subject to the same exclusion).*** It is hard to imagine that almost anyone would be able to process this staggering amount of data, which would be extremely costly to provide.
- It is permissible to limit advice to a range of proprietary funds or funds that pay forms of revenue sharing, subject to certain conditions.
- The adviser may provide advice, but all investment decisions must be made by the customer. Thus, "discretionary" accounts where the adviser has discretionary authority over the assets, pursuant to guidelines from the customer, are not covered by the exemption.
- The exemption only applies to certain assets that are "commonly purchased" by retirement customers.

Effective date. The final rule would be "effective" 60 days after finalization, but would not be "applicable" (i.e., enforceable) until eight months after finalization.

- **Transition rule**. An exemption also applies to compensation received after the applicability date attributable to pre-applicability transactions.

Comment period. There is a 75-day comment period, compared to a 104-day period in 2010-2011. As in 2011, there will be a public hearing within 30 days of the close of the comment period. Again like 2010, there will also be an opportunity to comment after the publication of the hearing transcript.

KEY CONCERNS

- **Small business issue not addressed.** As noted, the re-proposal does not address the small business problem that existed under the original proposal: financial institutions selling retirement plans would be prohibited from providing meaningful assistance to small business owners in selecting investment options for the small businesses to offer their employees. This issue was addressed very powerfully in a 2014 survey by Greenwald & Associates. That survey showed that unless this issue is addressed (which, as noted, it has not been), the following results would flow:
    - **Close to 50% of small businesses without a plan state that the regulation would reduce the likelihood of them offering a plan, with 36% saying it would reduce the likelihood greatly.**
    - **Almost 30% of small businesses with a plan indicate that it is at least somewhat likely that they would drop their plan if this regulation were to go into effect.**
- **Small accounts cut off from investment assistance**. Under the re-proposal, as noted, any individualized advice that is intended to be "considered" *in any way* is fiduciary advice. That means that, in order to be paid, a broker/dealer serving a customer with a $3,000 IRA, for example, will need to assume broad liability and fit within the unworkable prohibited transaction exemption described above, which is ***not principle-based***.
    - ***Under the exemption, the broker/dealer would need to provide an unprecedented level of detailed data about future costs and past costs, far more data than has ever been required with respect to service providers providing services to retirement plans with tens or hundreds of thousands of participants. For example, financial institutions are required to disclose -- and update on at least a quarterly basis -- all direct and indirect compensation received with respect to all assets of all retirement customers of the financial institution and all affiliates for the past 365 days as well as the same information with respect to every asset that a retirement customer could possibly purchase (excluding only certain assets that are not commonly purchased). Recent well publicized DOL fee disclosure rules require far less data.***
    - For the above reasons, there is simply no way to practically make this exemption work for small accounts, setting us up for a repeat of what happened in the U.K. where advisers left the small account market in droves. Moreover, the effect on IRAs of such departures are well documented by a 2011 Oliver Wyman study that remains completely applicable in the absence of a workable prohibited transaction exemption:
        - **Just within the study sample (40% of the IRA market), over 7 million IRAs would lose access to an investment professional.**
        - **As many as 360,000 fewer IRAs could be opened every year.**
- **Leakage/rollovers.** Even if the exemption were otherwise workable, ***it does not apply to rollover and distribution advice. As a result, financial institutions could not provide assistance to participants with respect to rollover or distribution issues, unless the assistance related solely to other financial institutions' products and services.*** This means that employees terminating employment will find themselves cut off from their normal sources of information on distributions and rollovers. As reflected in an in-depth 2014 study by Quantria Strategies, this will result in far more individuals cashing out

their retirement savings. **In fact, Quantria estimated the lost retirement savings to be $20 billion to $32 billion annually.**

- **Prohibition on promoting your own products, services, or yourself.** With respect to individuals and small businesses, there is no seller's exception. DOL's rationale for this is the following: "Most retail investors and many small plan sponsors are not financial experts, are unaware of the magnitude and impact of conflicts of interest, and are unable effectively to assess the quality of the advice they receive." This position is directly contrary to the structure of ERISA and to DOL enforcement positions which place a fiduciary duty on small employers to make prudent fiduciary decisions. It is also cutting off marketing to individuals. The DOL's view seems to be that individuals are unable to process advice. But if individuals are unable to process marketing, how are they expected to make decisions?
- **Effect of absence of seller's exception.** Let's translate the lack of a seller's exception into real terms with a few examples. One could argue that these results were not intended, but after a four and a half year debate about the need for a seller's exception, and the nature of any such exception, concern levels are high.
    - **Prohibition on promoting a company's own products or services**. A company should be permitted to market its own products and services if it is made completely clear that the company is not providing advice but is selling a product or a service. Unfortunately, such promotion is prohibited with respect to individuals and small plans. Almost any discussion of a company's own products or services with any individual or small business plan is a fiduciary discussion. The result is that companies would be prohibited from, for example, promoting their own services, such as rollover services or managed account services.
    - **Interviews to be hired.** Assume that a broker is interviewing with a prospective customer and asking that she be hired to help with the customer's IRA. She talks about her firm and her hard work and her dedication to her customers. She does not make any investment recommendations. Under the re-proposal, the broker is acting as a fiduciary. In fact, the individual would actually be committing a prohibited transaction by recommending that she be chosen. Obviously, that is an absurd result, but the fact that this result is inherent in the structure of the re-proposal says a lot about how the re-proposal is structured far too broadly.
    - **How do we know the difference between the absurd results that are not intended and the very strange results that may be intended?** It is not enough to say that the above examples were not intended and cannot be the law. There is no hint in the re-proposal regarding what promotion by a financial services provider is permissible and what promotion is prohibited, leaving all of us to make guesses. Unfortunately, this lack of clarity is built into the structure of the re-proposal.
- **Education.** Instead of expanding education for participants, the re-proposal eliminated a valuable educational tool that has worked well for many years. Educators could no longer provide examples of funds that fit within recommended asset classes, likely leaving less informed participants lost as to how to use the education and correspondingly lost as to how to invest their 401(k) account.

- **Effective date.** The regulations provide eight months to analyze and understand lengthy final regulations and exemptions that we have not yet seen, make business decisions that affect the entire retirement business, restructure that business, revise compensation packages and structures for advisers, renegotiate fee arrangements, design and implement company policies and procedures, create and modify systems to produce an unprecedented amount of new data, draft contracts for IRA owners across the country, and enter into contracts with tens of millions of existing customers. That will take a minimum of two years; eight months is simply not realistic.
    - **Feasibility of entering into contracts with all existing customers.** A financial institution has no way to compel existing customers who are not actively using their services to enter into any contract. So not only is the effective date unrealistic, the entire contract requirement is problematic as a transition matter.
- **Comment period.** In 2010, a far shorter, simpler proposal with no exemptions and far less analysis had a 104-day comment period. It is hard to understand the rationale for a much shorter comment period for this much more complicated re-proposal.
- **None of the above problems, which have been raised for four and a half years, received the attention they deserved at OMB.** OMB's 50-day review of the re-proposal was startlingly brief:
    - **The review period was almost a month shorter than the next shortest review period for any significant retirement regulatory proposal in the last 10 years.**
    - **It was less than half the average review period of other significant retirement regulatory proposals in the last 10 years (which was 109 days).**
    - **Equally startling is that the review period after OMB received significant public input was actually just a few days.**

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