Proposed New Fiduciary Rule for 401(k) Advisers

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The U.S. Department of Labor (DOL) has proposed its long-awaited fiduciary rule addressing conflicts of interest in retirement advice. Consistent with White House announcements, the new proposal broadens the range of retirement advisers who would become subject to ERISA fiduciary standards. It also includes proposed exemptions that would give brokers and insurance agents (and their firms) the ability to continue to earn transaction-based compensation, such as commissions, when advising retirement clients, subject to certain significant restrictions.

"Best Interest" Fiduciary Standard. As proposed, all fiduciary advisers would have a duty to provide impartial advice in their client's best interest. Furthermore, they cannot accept any payments creating conflicts of interest, unless they qualify for an exemption intended to ensure that the customer is adequately protected, such as the newly proposed "Best Interest Contract Exemption."

Broad Coverage of Retirement Advisers. Under the DOL proposal, any individual receiving compensation for providing advice that is specifically directed to a particular plan sponsor, participant, beneficiary, or IRA owner would be deemed a "fiduciary" automatically. For example, fiduciary status would be triggered by recommending what assets to purchase, sell, or hold and whether to roll over assets from a plan to an IRA. The DOL proposal to broaden its "fiduciary" definition potentially would apply to brokers, registered investment advisers (RIAs), insurance agents, administrative

service providers, and salespeople. However, the following individuals would be excluded from the fiduciary definition:

- Brokers acting strictly as order-takers for customers who are telling them exactly what to buy or sell without asking for advice,
- Financial institutions (intending to act as counterparties) making a "sales pitch" to fiduciaries of large plans with financial expertise,
- Providers of nonfiduciary "investment education" who do not identify specific investment products, and
- Providers of valuation services for ESOP stock.

Large Plan-Small Plan Dichotomy. The exception for advisers selling to large plans would be conditioned on a plan's having 100 or more participants and the adviser's reasonable belief that a plan independent fiduciary possesses sufficient expertise to evaluate a transaction and determine what is in the best interest of the plan. An alternative way to qualify for the seller's exception would be to determine that the plan's independent fiduciary has responsibility for managing at least $100 million of plan assets which could be accomplished by reviewing the plan's Form 5500. The limitation of the seller's exception to large plans reflects the proposal's disparate treatment of those advisers rendering advice to large plans and those who advise the so-called retail market consisting of plans with fewer than 100 participants, plan participants and beneficiaries, and IRA owners. Advisers to the latter group will be required to meet the terms of the new Best Interest Contract Exemption if they wish to receive variable compensation.

Best Interest Contract Exemption. The DOL proposal's "Best Interest Contract Exemption" gives fiduciary advisers the ability to set their own compensation practices and earn variable compensation, such as commissions.

Written Contract. To qualify for this exemption, the firm would need to enter into a written contract with the client that provides for the following:

- The firm commits to following the "best interest" fiduciary standard,
- The firm represents and warrants that it has adopted compliance policies designed to mitigate conflicts (and there are no differential compensation or other incentives that would tend to encourage individual advisers to make improper recommendations),
- Any conflicts have been identified and disclosed (and the contract must direct the customer to a web page with additional compensation disclosures), and
- The customer has a private right of action against the firm for contractual breaches (and arbitration clauses are permitted so long as the client has the right to bring class action lawsuits).

A failure to adopt appropriate compliance policies would not result necessarily in the loss of the exemption, but it may give rise to a private right of action by the customer for the contractual breach.

Customer Disclosures. In addition to the written contract requirement, the Best Interest Contract Exemption also would require various disclosures to be provided to the customer including:

- A point-of-sale disclosure to the customer that includes the total and ongoing costs of the recommended investment,
- Annual compensation disclosures that also list the investments purchased or sold during the year,
- A Web page with disclosures of all direct and indirect compensation, and
- Notice and other related disclosures if the adviser is unable to recommend a sufficiently broad range of investments due to platform-related or other limitations.

DOL Notice. The adviser also would need to notify the DOL of its intent to utilize the Best Interest Contract Exemption. It is contemplated that such notice would be sent electronically or by mail.

Principal Transactions Exemption. The DOL proposal also includes a new "Principal Transactions Exemption" that would give a financial institution the ability to recommend certain fixed income securities and sell them from the firm's own inventory.

Potential Low-Fee Exemption. In connection with its proposal, the DOL is asking for comments on whether it should establish a "Low-Fee Exemption" with fewer requirements than the Best Interest Contract Exemption, permitting advisers to earn variable compensation when recommending the lowest-fee product in a given product class.

Anticipated Impact on Retirement Industry. The DOL proposal would create a uniform fiduciary standard for all retirement advisers, including brokers and insurance agents. It would impose on substantially all retirement advisers the same type of disclosure and compliance policy requirements that already are imposed on RIAs under securities law.

Impact on Brokers and Insurance Agents. Under the existing 408(b)(2) fee disclosure rules, there is no obligation requiring advisers to disclose their conflicts of interest. However, the DOL proposal would require conflicts-related disclosures from many advisers who are not currently subject to this requirement, and it also would put pressure on broker-dealers and insurance firms to monitor more closely and limit the levels of variable compensation earned by their registered representatives and agents. If adopted, the DOL proposal may increase compliance costs for these firms and their retirement businesses significantly.