A Practical Application of the NEW Fiduciary Definition

Presented by:
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Description

The OMB has released the DOL’s new fiduciary definition along with the promised exemptions. The applicability of the new fiduciary definition goes into effect April 10, 2017 with full BICE compliance by 1-1-18.

Without question this new rule will affect every financial institution and adviser that sells and services retirement plans, IRAs and HSAs. The practical application of the new rule and corresponding exemptions is still being digested but the impact of the rules is something that must be considered in preparation for compliance by plan sponsors, IRA holders, financial institutions and advisers alike.

This session will focus on specific sections of the new rules and the impact I anticipate they will have on the industry and plan sponsors.
# Settlements

<table>
<thead>
<tr>
<th>Defendant</th>
<th>Settlement</th>
<th>Attorney Fee</th>
<th>% of Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ameriprise Financial</td>
<td>$36.5 M</td>
<td>$9.0 M</td>
<td>24.7%</td>
</tr>
<tr>
<td>Bechtel</td>
<td>$26.2 M</td>
<td>$7.7 M</td>
<td>29.4%</td>
</tr>
<tr>
<td>Boeing</td>
<td>$57 M</td>
<td>$20.8 M</td>
<td>36.5%</td>
</tr>
<tr>
<td>Caterpillar</td>
<td>$22.3 M</td>
<td>$5.83 M</td>
<td>26.1%</td>
</tr>
<tr>
<td>Cigna</td>
<td>$47.8 M</td>
<td>$12.8 M</td>
<td>26.8%</td>
</tr>
<tr>
<td>General Dynamics</td>
<td>$20.9 M</td>
<td>$5.7 M</td>
<td>27.3%</td>
</tr>
<tr>
<td>International Paper</td>
<td>$41.5 M</td>
<td>$11.5 M</td>
<td>27.7%</td>
</tr>
<tr>
<td>Kraft</td>
<td>$14.2 M</td>
<td>$4.7 M</td>
<td>33.1%</td>
</tr>
<tr>
<td>Lockheed Martin Corp</td>
<td>$84.3 M</td>
<td>$22.3 M</td>
<td>26.5%</td>
</tr>
<tr>
<td>Mass Mutual</td>
<td>$9.8 M</td>
<td>$315k</td>
<td>3.2%</td>
</tr>
<tr>
<td>Nationwide</td>
<td>$190 M</td>
<td>$50 M</td>
<td>26.3%</td>
</tr>
<tr>
<td>Novant Health</td>
<td>$32 M</td>
<td>$10.8 M</td>
<td>33.8%</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td><strong>$582.5 M</strong></td>
<td><strong>$161.45 M</strong></td>
<td><strong>27.72%</strong></td>
</tr>
</tbody>
</table>

Source: Multnomah Group; percentages derived
# 408(b)(2) Requirements – Old vs New

<table>
<thead>
<tr>
<th>Rules</th>
<th>Old Rule</th>
<th>New Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Document must permit fees to be paid from plan assets</td>
<td>Yes</td>
<td>Applies</td>
</tr>
<tr>
<td>Services must be necessary for plan establishment or operation</td>
<td>Yes</td>
<td>Applies</td>
</tr>
<tr>
<td>Fees must be paid for services rendered, not promised</td>
<td>Yes</td>
<td>Applies</td>
</tr>
<tr>
<td>Fees must be determined to be reasonable</td>
<td>Yes</td>
<td>Applies</td>
</tr>
<tr>
<td>Contract must be terminable on short notice without penalty</td>
<td>Yes</td>
<td>Applies</td>
</tr>
<tr>
<td>Covered Service Provider must meet new disclosure rules</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Disclosures must be delivered timely</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Disclosures must be complete</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>A fiduciary must determine disclosures are complete</td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>
Determining Completeness – A Requirement

According to the 408(b)(2) Preamble,

“The Department does not believe that responsible plan fiduciaries should be entitled to relief provided by the class exemption absent a reasonable belief that disclosures required to be provided to the covered plan are complete. To this end, responsible plan fiduciaries should appropriately review the disclosures made by covered service providers. Fiduciaries should be able to, at a minimum, compare the disclosures they receive from a covered service provider to the requirements of the regulation and form a reasonable belief that the required disclosures have been made.” [77 FR 5647-48 (2-3-12)]

No Relief Absent a Reasonable Belief Disclosures are Complete
A Reasonable Belief is Dependent on a Comparative Assessment

See Fall 2014 – Silver Lining in ERISA 408(b)(2)
ERISA § 408(b)(2) Compliance Checklist

5 Step Process to evaluate an 408(b)(2) Compliance

Step 1 - Confirm Disclosure is Compliant with § 2550.408b-2(c)
  - Step 1.1 - Timing [§ 2550.408b-2(c)(1)(v)]
  - Step 1.2 - Services [§ 2550.408b-2(c)(1)(vi)(A)]
  - Step 1.3 - Fiduciary Status [§ 2550.408b-2(c)(1)(vi)(B)]
  - Step 1.4 - Compensation [§ 2550.408b-2(c)(1)(vi)(C)(i)-(iii)]
  - Step 1.5 - Investment Related Disclosures [§ 2550.408b-2(c)(1)(vi)(E)&(F)]
  - Step 1.6 - Termination of Contract or Arrangement [§ 2550.408b-2(c)(1)(vi)(C)(iv)]
  - Step 1.7 - Disclosure Errors

Step 2 - Confirm Services are Necessary [§ 2550.408b-2(b)]

Step 3 - Confirm Compensation is Reasonable [§ 2550.408b-2(d)]

Step 4 - Confirm No Conflicts on Interest [§ 2550.408b-2(e)]

Step 5 - Exemption Analysis [§ 2550.408b-2(c)(1)(ix)]
How do You Define REASONABLE?

By Process and Opinion

1. Procedural prudence dictates a documented comparative process such as:
   a. Benchmarking,
   b. Informal Request for Information (RFI) and/or
   c. Formal Request for Proposal (RFP)

2. Comparative assessment should be engaged periodically
   a. Historically, every 3-5 years unless material changes occur,
   b. Kraft Foods – Judge suggests every 3 years, or
   c. Best practices – material changes or changes you know would impact fees
   d. Statute of Limitations – let 3 years be your guide not 6 years

3. General rule of thumb for your clients…25th and 75th percentile

4. Consider complexity of plan design and operational issues (i.e. multiple payrolls, directed brokerage, abnormal number of investment options).

5. Give thoughtful consideration to quantity and quality of services

6. Leverage the RPF’s trump card – their “SUBJECTIVE” opinion
Time to Prepare for Change

169 Days
A Revised Fiduciary Definition Applies to

Covered advice/recommendation/suggestion for the following types of Plans:

1. ERISA-covered retirement plans including ERISA 403(b)s,
2. IRAs (includes SIMPLE-IRA and SEPs),
3. Health Savings Accounts,
4. Archer Medical Savings Accounts, and
5. Coverdell Education Savings Accounts
What Changes on April 10, 2017

Advisers become fiduciaries under ERISA § 3(21)(A)(ii) on
1. Retirement accounts
2. IRA accounts

IF YOU RECOMMEND
1. Buy, hold, sell, or exchange an investment
2. Rollover, transfer, or distribute retirement proceeds
3. The amount, form, or destination of retirement proceeds
4. Investment policies or strategies
5. A 3rd party money manager or advice provider
6. An investment account arrangement e.g., brokerage vs. advisory
7. A move from commission to advisory or visa versa

YOU ARE A FIDUCIARY
## Comparing Old to New

<table>
<thead>
<tr>
<th>ERISA § 3(21)(A)(ii)</th>
<th>Current Rules</th>
<th>Effective April 10, 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applies to ERISA Plans</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Applies to IRAs</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Recommendations</td>
<td>As to Securities</td>
<td>Any</td>
</tr>
<tr>
<td>Regular Basis</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Understanding*</td>
<td>Yes-“Mutual”</td>
<td>Yes-“An”</td>
</tr>
<tr>
<td>Primary Basis</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Advice</td>
<td>Individualized</td>
<td>Or Specifically Directed</td>
</tr>
<tr>
<td>Consideration</td>
<td>Yes-Direct or Indirect</td>
<td>Yes-Direct or Indirect</td>
</tr>
</tbody>
</table>

*agreement, arrangement or understanding, written or otherwise
What Constitutes a “Recommendation”

Defined:
A "recommendation" means a communication that, based on its content, context and presentation, would be reasonably viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action.

Applies to:
1. Products
2. Services
3. Decisions
What Constitutes a “Recommendation”

A “recommendation” becomes fiduciary advice if:

1. Compensation is explicitly received for that advice
2. The compensation paid would not have been paid but for the advice given
3. Compensation is based in whole or in part on the advice
4. If it can be shown the recommendation was purely an extra for which no fee was received, the recommendation should be non-fiduciary in nature
5. If the recommendation is deemed to be a part of its regular services, for which it earns a fee, the recommendation could potentially be viewed as a fiduciary advise
New Compliance Requires

Financial Institution and the adviser will contractually agree to adhere to certain Impartial Conduct Standards including

1. Serve as a fiduciary,
2. Adhere to the best interest standard of care,
3. Disclose fees, compensation, and material conflicts of interest,
4. Represent that none of its statements are misleading,
5. Receive no more than reasonable compensation,
6. Adopt policies and procedures designed to ensure best interest advice,
New Compliance Requires - 2

7. Retain records demonstrating compliance,
8. Disclosure and contract must be signed NO LATER than the point of sale,
9. Clients requests for information must be honored,
10. All information must be clearly and conspicuously provided,
11. Financial institution must maintain a website with required information
Impartial Conduct Standards

1. Must offer advice in the best interest of client, for example
   1. Is it based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor?
   2. Is it provided without regard to the financial or other interests of the advisor, financial institution, affiliate, or any related entity

2. Standard mirrors ERISA prudent man rule under 404(a)(1)(B)
   a. Therefore it must reflect the care, skill, prudence, and diligence under the circumstances that a prudent person would exercise under the circumstances then prevailing

3. **Compensation must be reasonable** for services rendered

4. No materially misleading statements about assets, fees, conflicts of interest, or any other matters relevant to investment decisions
### Comparing the Difference

<table>
<thead>
<tr>
<th></th>
<th>408(b)(2)</th>
<th>Fiduciary Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Effective Date</strong></td>
<td>July 1, 2012</td>
<td>April 10, 2017</td>
</tr>
<tr>
<td><strong>Purpose</strong></td>
<td>Fee Disclosure</td>
<td>Best Interest Standard</td>
</tr>
<tr>
<td><strong>Reasonableness</strong></td>
<td>RPF determines</td>
<td>• Adviser Assertion</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• All encompassing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Documentation Necessary</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Investor Agreement</td>
</tr>
<tr>
<td><strong>Approach</strong></td>
<td>• Components</td>
<td>Components &amp; Aggregate</td>
</tr>
<tr>
<td></td>
<td>• Aggregate Optional</td>
<td></td>
</tr>
<tr>
<td><strong>Applies When</strong></td>
<td>Fees from Plan Assets</td>
<td>Fees from Anywhere</td>
</tr>
</tbody>
</table>
Preparation is Key

1. Training
2. Benchmarking
3. Monitoring

Before anything else, preparation is the key to success.

Alexander Graham Bell
In particular, Financial Institutions **must ensure** that Advisers are provided with information and **training** to **fully understand** all investment products being sold, and must similarly ensure that customers are **fully advised of the risks**. Additionally, when recommending such products, the Financial Institution and Adviser should take special care to **prudently document** the bases for their recommendation and for their conclusions that their recommendations satisfy the Impartial Conduct Standards. **FR 21016**
Benchmarking a Process to Reasonableness

1. To determine **reasonableness, benchmarking** data is needed
2. Failure to obtain data on legacy products and commissions will result in an arbitrarily low benchmark
3. Benchmarking the adviser’s comp cannot be de-linked from the recommendations e.g., investments, custody, recordkeeping, etc.
4. To determine market rates - data on products, clients, and advisers is needed
5. Product data includes cost of riders, surrender charges, indirect comp, investments, etc.
6. Client data includes duration of product, by adviser relationship etc.
7. Advisor data includes fees and commissions by retirement, IRA, and wealth management clients, the services rendered to each, etc.
The Degree of Complexity Affects Monitoring

• For example, in many circumstances, it may require more time to explain the features of a complex annuity product than a relatively simpler mutual fund investment. Based on such neutral considerations, the Financial Institution’s policies and procedures could permit the payment of greater commissions in connection with annuity sales, subject to appropriate controls and oversights as described below, including that the neutral factors be neutral in operation as well as selection. Differential compensation between categories of investments could be permissible as long as the compensation...were not tied to the Financial Institution’s own conflicts of interest, such as the time or complexity of the advisory work, rather than on promoting sales of the most lucrative products. FR 21037

• The Department also expects that Advisers and Financial Institutions providing advice will exercise special care when assets are hard to value, illiquid, complex, or particularly risky. FR 21037
Monitoring

Further, when determining the extent of the monitoring to be provided, as disclosed in the contract pursuant to Section II(e) of the exemption, such Financial Institutions should carefully *consider whether certain investments can be prudently recommended to the individual Retirement Investor, in the first place, without a mechanism in place for the ongoing monitoring of the investment*. This is particularly a concern with respect to investments that possess unusual complexity and risk, and that are likely to require further guidance to protect the investor’s interests. *Without an accompanying agreement to monitor* certain recommended investments, or at least a recommendation that the Retirement Investor arrange for ongoing monitoring, the Adviser may be unable to satisfy the exemption’s Best Interest obligation with respect to such investments. Similarly, the added cost of monitoring such investments should be considered by the Adviser and Financial Institution in determining whether the recommended investments are in the Retirement Investors’ Best Interest.  

FR 21016
Financial Institution Challenges

1. Re-write contracts tied to each business model – est. 44 different versions
2. Review marketing materials for recommendations
3. Review website for updates
4. Assess product complexity for targeted education and monitoring obligations
5. Assess adviser knowledge for targeted ERISA education
6. Establish procedures for proposals that declare best interest
7. Establish policies addressing misleading statements and conflicts of interest
8. Determine process for declaring reasonableness
9. Review E&O contracts - $1 million is not enough
10. Populate 3rd party benchmarking with product, adviser, and client data
How Should a Plan Sponsor Prepare?

1. Review communication & education materials – focus on advice

2. Review service agreements and contractual relationships
   a. Is a non-fiduciary CSP now a fiduciary service provider
   b. Does the CSP have fiduciary insurance
   c. Has the CSP provided an assessment of reasonableness
   d. Counseling terminated participants on rollovers may now be a fiduciary act requiring they acknowledge their fiduciary status in writing

3. Compare communication between CSPs for consistency

4. Confirm compensation structures are not prohibited to avoid co-fiduciary liability

5. Confirm all compensation paid from plan assets is reasonable

6. Retain ERISA legal counsel for guidance
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Questions?

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