6 Steps to Compliance with the DOL Fiduciary Rule or a Uniform Fiduciary Standard

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Second Edition - July 2017

This treatise is designed to provide all financial advisers with practical guidance to achieving compliance with a fiduciary standard of care regardless of their specialty within the financial services industry. It explores six essential elements required to meet a fiduciary standard of care including the Department of Labor Fiduciary Rule (the DOL Rule). In addition, it can serve as "buyers guide" for the public consumer of financial services.

Part 1 was originally written in early 2017 prior to the effective date of the DOL Rule which was initially April 10th. Since the publication of Part 1 in February, there have been significant developments in the rollout of the DOL Rule worth reviewing – here's a quick recap to bring us up to present.

As you know, the implementation date of the Rule was slated for April 10, 2017. An executive order from President Trump, in February, directed the DOL to review the rule prior to implementation. On April 5th, just 5 days before the implementation date, the DOL announced a 60-day delay, moving the date to June 9, 2017. Many predicted there would be further extensions, perhaps through the balance of 2017. That did not happen. On May 22nd, Department of Labor Secretary Alexander Acosta announced that the 60 - day delay on the Conflict of Interests Rule would not be extended beyond June 9th.

For the convenience of the reader, this second edition combines Parts 1 and 2.

Part 1 – The First Three Elements

Whether an insurance agent, securities broker, financial planner or investment adviser, the practitioners that will survive the evolution of standards in the industry will need to embrace a business model that is **procedurally prudent** in all respects. Furthermore, they will need to demonstrate that they have done so with more than rhetoric – it will require a method which follows a template and is supported with good documentation.

It may seem ridiculous to public investors that persons holding themselves out as trusted financial advisers would challenge the notion of being a fiduciary and resist accepting the duties and responsibilities that are attendant that position. It should come as no surprise that the industry feels differently. The fact is, many factions within the industry have raised arguments and presented substantial legal challenges aimed at defeating the imposition of a Fiduciary Standard on financial advisers.

While it may appear counterintuitive, spokespersons of many industry associations, special interest groups and politicians argue, that forcing financial advisers to accept fiduciary duties and status may be detrimental to the customer. The rationale being that increased cost of compliance, recordkeeping and reporting will prompt advisors to walk away from smaller investors for lack of economic feasibility. Indeed, a compelling argument emerges that suggests that it may take advice away from those investors that need it the most.

Regardless of whether the DOL Rule stands or is defeated, financial advisers should prove to their customers that they mean it when they say "**we always act in our customer's best interest**". To do so, they will need to move from the classic business model that maximizes profit and minimizes risk (profit motivated) to one that has a thinner profit margin and higher personal risk (client centric).

Firms and advisers that oppose a fiduciary standard risk sending an unmistakable message to their clients and reaffirming the misconception of most regulators which is; financial advisers are repurposed salesman that are motivated by personal gain and are averse to accountability and transparency.

Either the adviser has the courage to accept the duty of being a fiduciary and all the liability that goes along with violating that duty or they don't!

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If you are an investor, you should ask yourself if your adviser has the chops.
If you are an adviser, you should ask if your firm does.

Firms and advisers that truly embrace stewardship principles are not playing the wait and see game. Instead they are embracing the movement to higher standards and distinguishing themselves within the industry. They are in fact positioning themselves at a competitive advantage. Simply put, whether imposed by law or dictated by best practices, trusted advisers will need to do the following.

1. <u>Acknowledge a Fiduciary Status</u>

This is the first step and it is simple. **<u>Customer Agreements</u>** will need to include an affirmative acknowledgement of fiduciary status by the individual or institution providing advice. It must be unambiguous, so there is no confusion and it should articulate those specific duties and the remedies available to a customer, in the event of a breach of those duties. The agreement should be signed by both the customer and the adviser. **<u>The institution's website</u>** should also include the same acknowledgment and present it prominently.

If the DOL Rule does proceed, acknowledgement of fiduciary status will be included in the **<u>Best Interest Contract (BIC)</u>** which is expected to be broadly employed as an exemption for those who choose to continue providing product solutions or managed services that involve potential conflicts. If the rule is defeated, the acknowledgement will remain an essential piece of any advisory agreement that involves discretion.

2. <u>Disclose Fees, Charges and Deductions</u>

An adequate disclosure must be a good faith effort to disclose everything that is reasonably possible by the advisor. A typical independent adviser has a practice including the sales of insurance and annuities, the sales of securities, financial planning and fee based managed accounts. Considerable detail will be required to achieve full disclosure. For example:

- **Life Insurance** - disclose cost of insurance, administrative charges, sales and distribution expense and any other costs that are deducted from the premium payments being made by the customer.
- **Mutual Funds** – summarize all the expenses and fees that are included in the prospectus in addition to transactional, custodial and administrative expenses.
- **Annuities** – disclose Mortality and Expense (M&E) charges, distribution expense, administration expenses and all other fees that are deducted from the premiums paid by the customer.
- **Fee Based Accounts** – disclose management expenses, custodial fees, internal investment expense ratios, administrative expenses, sales and marketing expenses.
- **Financial Planning** - disclose the full menu of packaged plans available and the "all in" cost of each. Detail the services and components included in each. When charging an hourly fee, disclose the breakdown of the rates if it is variable. For example – Senior Planner $100/hour, administrative $60/hour, data input $36/hour, etc.

It may not be possible to capture and detail every expense incurred by a customer in exact dollar amounts in which case a statement should be made to that effect. For example, **"We have disclosed all known expenses, fees and deductions that we are able to quantify in dollars and cents. To the extent that there are others that we are unable to quantify we will, upon your request, secure that information from the institution or issuer of the instrument in question and provide it to you as received."**

Adequate Disclosure = Full Disclosure = Transparency

3. Disclose Conflicts of Interest and Compensation

Needless to say, this is a very controversial issue. The fact is that almost all financial advisors are in some way conflicted. Here are few examples:

Selling a product and receiving a commission – they need to disclose it at all levels. For example, when selling life insurance, a disclosure may read something to the effect of "Total compensation being paid to those involved in the sale and distribution of this type of product may be as high as 140% of the first year's premium depending on the place the sale occurs. We have disclosed the total compensation to the extent we are able.

Compensation will be paid to the agent, in his/her role as a selling agent, along with other entities that may be involved in supporting this transaction. The agent will receive compensation derived from commissions paid by the insurer. The compensation is dependent upon several variables and may vary by company, type of product, volume of business an agent provides to an insurer, total premium, and other factors.

You, as the owner, may, upon request, obtain additional information concerning the compensation expected to be received because of this transaction as well as compensation as would have been expected on any alternative quotes presented by the agent."

With a broad universe of investments to choose from - they must disclose that the compensation may vary from product to product and may create an incentive to not act in a customer's best interest by choosing the higher commission. Compensation ranges should be disclosed for all the product categories the institution is authorized to sell.

With a limited universe of options - they must disclose that they have an incentive to recommend something that may not be in the customer's best interest because it's all they are able provide.

If they are a fee based adviser with different platforms or managers to choose from - they must disclose that there is a difference in compensation available from one to another which presents an incentive to choose one that is not in the customer's best interest.

Any and all conflicts must be disclosed and you must explain how they are being managed

The degree to which an institution is motivated by profit, social responsibility or moral obligation is important to understand and can be seen by examining an institution's values and vision. More importantly, it is revealed by their behavior!

There is a growing element, within the industry, that recognizes a generational opportunity presented by Dodd-Frank and the DOL to examine the question - what is acceptable corporate behavior. It is beyond argument that a board of directors owes a fiduciary duty to their shareholders. Can it be argued that they owe a fiduciary duty to the public as well?

The public investor will scrutinize our actions more closely than in the past as every firm faces the decision of voluntarily adopting a fiduciary model or opposing it. Whether altruistic or strategic, Merrill Lynch was one of the first to announce its embrace of a fiduciary standard by announcing their cessation of brokerage sales and movement to all fee based managed accounts. Other firms like LifeMark Securities Corp[1]., embraced stewardship standards years ago, and adopted ongoing fiduciary training for all advisers. In addition, they published public statements affirming their position and detailing their prudent process business model.

In the final analysis, firms, advisers and politicians will be judged in the court of public opinion. A growing number of firms are demonstrating moral and ethical courage by embracing a uniform fiduciary standard. Conversely there are those who strongly oppose the standard and present compelling arguments to support their position. Although they send a very different message, I respect their conviction. Lastly, there are those that lack the fortitude to even take a position.

[1] www.lifemark.com

Part 2 – The Last Three Elements

4. Charge Reasonable Fees

Fiduciaries are obliged to act in their client's best interest and the DOL Rule specifically discusses the reasonableness of fees associated with advising retirement investors.

Despite considerable argument and concern around this point, this element is easily satisfied provided the adviser charges fees and receives compensation that are deemed reasonable for the services being provided when compared to professional standards and norms.

The fiduciary must rely on valid data and apply an expert analytic method in determining whether the fees fall within an acceptable range

Because of the vastly diverse universe of financial products and solutions available to advisor's, the greater challenge for the fiduciary is demonstrating that the services provided were appropriate and necessary. The debate concerning the selection of commissionable product solutions vs fee based managed accounts remains and is not expected to be resolved anytime soon. The insurance industry is arguably the largest and most innovative provider of financial solutions to retirement investors and have a strong influence on legislation. It is doubtful that commissionable product sales will go away anytime soon. More likely, insurance products will continue to evolve and improve in a manner that better serves the investor and secures their prominence as solution providers.

The fiduciary cannot assume that fee based managed approach is necessarily better for the investor.

Even though a conflict of interest may be present, a product solution may produce a lower net cost and more appropriate situation for the investor.

If recommending a commissionable product solution, the advisor must demonstrate, through a valid analytic method, that the cost and benefit over the anticipated hold period is justified and reasonable.

Similarly, a fee based advisor will need to demonstrate that an asset based fee is justified. Despite the absence of a commission, there is an argument to be made that this too is a form of "variable compensation" which would require an exemption under the rule. The advisor must rationalize an ongoing fee that varies with the value of the assets under management (AUM). This will be difficult, if not impossible, where a buy and hold strategy is indicated.

5. Document the Basis of Recommendations

There are numerous financial solutions and options available to investors today and that number is ever increasing due to product innovation and improving technologies. There are four dominant categories of solutions that may be recommended to investors. The following is a cursory description of those categories:

1. **Commission Based Product Solutions** including annuities, mutual funds and alternatives all of which are commission bearing. Because they are prohibited transactions under the Rule, the advisor must rely on an exemption like the Best Interest Contract Exemption (BICE) to affect the transaction.

2. **Fee Based Managed Accounts** are directly managed by the advisor or utilize Third Party Managers (TPM). These accounts charge the customer a fee that is applied as a negotiated percentage of assets under management (AUM). When the Rule was initially announced, it was widely believed that this approach would automatically qualify for a "Level Fee Exemption" under the Rule. Almost immediately, experts began to disagree on whether this approach qualifies for the exemption under the Rule. The DOL subsequently published several rounds of guidance and clarified the definition of a level fee.

   "As defined in the exemption, a "level fee" is a fee or compensation that is provided based on a fixed percentage of the value of the assets or a set fee that does not vary with the particular investment recommended. Level fees do not include commissions or other transaction-based fees. "[2]

[2] Taken from the first round of guidance from the DOL in 2016 – answer to question 13.

Because of the presence of potential conflicts of interest, managed accounts may also require the use of a BIC.

3. **Fee Based Advice** may be provided in a manner that is free of conflicts of interest. An advisor may provide financial analysis and planning to a retirement investor that is purely fee based. If the advice is generic and does not involve remuneration for the sale of a product or a fee for management of assets, it is likely conflict free and the advisor does not need to rely on an exemption.

4. **Combined or Hybrid Advice** Many financial advisors have the option of choosing between managed account and product based solutions. These advisors are hybrids as they are typically licensed to sell securities and insurance and are also Investment Advisory Representatives (IAR) of a Registered Investment Advisor. The DOL specifically recognizes this status and the potential value of the advisor having access to a broad portfolio of solutions.

Whether the advisor is a "level fee" fiduciary, a fiduciary complying with a BIC or a fee only financial planner, the advisor is obliged to document the reasons why the advice was in the best interest of the retirement investor. The documentation should always recognize and consider the fact that many options are available.

This is particularly important for advisors and firms who have chosen a compliance strategy involving the eventual conversion of all brokerage accounts to managed accounts. Shortly after publication of the Rule, Merrill Lynch made a dramatic announcement that they would adopt that strategy and eliminate brokerage sales. Whether you believe that was a brilliant marketing move or a genuine attempt to eliminate conflicts of interest, it important to note that they subsequently backed off that position.

The documentation should acknowledge the existence of myriad solutions. It should also acknowledge the advisor's limitations, if any, to access solutions due to licensing restrictions or portfolio limitations of the financial institution with which he or she is associated.

Fiduciaries confined to such limitations, like “fixed insurance only” may find this particularly challenging or even unworkable depending on their product array. Not surprisingly, the insurance industry has been a strong opponent of the Rule as it has been a dominant purveyor of retirement services and annuities for the longest time. The insurance companies that remain in the retirement markets with fixed products will likely provide their agents with substantiation support.

Substantiation should be comprehensive and specifically responsive to the client’s goals, requirements and preferences. The advisor should consider providing a copy to the client and securing an acknowledgement of receipt.

6. Adhere to a Prudent Process

Although there are numerous articulations of the professional standards of a fiduciary they all, in one form or another, require a fiduciary to demonstrate **procedural prudence**. Doubtless, the most essential ingredient of an effective compliance approach is the adoption of a prudent process in the advisor’s interactions with a plan and participants or IRA owners. Equally important is the documentation of the process. The primacy of this element is beyond argument!

When challenged, the fiduciary should be able to answer a skilled litigator’s question; **“What fiduciary protocols did you employ in your engagement with the investor”?** Being able to answer that question achieves two things very important to the fiduciary.

The implementation and documentation of a prudent process provides solid support of the fiduciary’s decisions and limits their personal liability[3]

[3] “Meeting your Fiduciary Responsibilities” the Department of Labor publication available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/meetingyourfiduciaryresponsibilities.pdf

The importance of “prudent process” is further emphasized by the DOL where the agency makes it clear that a fiduciary’s duties under ERISA are related to “the process used to carry out the plan functions rather than simply the end results.”[4] In other words, an investment does not have to be a winner, rather it needs to be part of an overall prudently diversified portfolio.

The fiduciary, whether an institution or individual, has considerable latitude on how they develop and deploy their “**prudent process**”. The DOL does not prescribe hard elements of such a process, instead, they define the obligation and leave it to the fiduciary to create and deploy.

A good analogy would be FINRA Rule 3110 relating to Supervision which states the following about supervisory systems:

> ***“Each member shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. <u>Final responsibility for proper supervision shall rest with the member”.</u>***

Rule of Thumb
Procedural Prudence = Compliance

An Example of a Prudent Process

As Chief Compliance Officer of my firm, LifeMark Securities, I was charged with the development and adoption of a training curriculum specifically focused on the practical application of fiduciary principles. In addition to our own primary training modules, we added a certification program called Global Financial Steward (GFS), created by Don Trone of 3ethos[5]. We deployed the training, firm wide in 2013 and have continually customized the application of the “template” to the specific disciplines within which we are involved – insurance, securities, managed accounts and financial planning.

[4] “Profit Sharing Plans for Small Businesses,” the Department of Labor, available at https://www.dol.gov/ebsa/publications/profitsharing.html.
[5] http://3ethos.com/#training

The GFS model involves 5 discreet steps that define the 3ethos decision making framework:

ANALYZE – STRATEGIZE – FORMALIZE – IMPLEMENT – MONITOR

Within these 5 steps are 17 dimensions that clarify the specific actions required to fulfill a step. For example: **Step 1 = Analyze**

1.1 State goals and objectives

1.2 Define the roles and responsibilities of decision makers

1.3 Brief decision makers of objectives, standards, policies and regulations

As a broker/dealer/ RIA that specializes in supporting independent financial advisors, this model is particularly relevant as it considers fiduciary duties from multiple sources including Dodd-Frank, DOL 408(b)(2) and 404(a)(5) and the Internal Revenue Code section 4975. The 3ethos decision making framework is fully substantiated by legislation, regulations, regulatory opinion, letters and case law.

As noted earlier in this paper, it is my strong belief and that of many professional colleagues, that a uniform fiduciary standard for the financial services industry is imminent. Fortunately, the case law supporting fiduciary standards is old and well settled.

As the industry evolves toward a uniform standard, it will be increasingly more difficult for Institutions and advisors to rely on traditional "suitability" or "reasonableness" standards. They will need to demonstrate the presence and application of a **prudent process**. By doing so, they will not only best serve their clientele but also dramatically reduce the regulatory and litigation risk associated with providing investment advice.

In summary, the fiduciary relationship between an advisor and retirement investor has been confirmed by the DOL Rule. Although defeat or significant modification may occur before the full implementation deadline of January 1, 2018, the movement toward a uniform fiduciary standard is accelerating.

When challenged, whether a fiduciary met the required professional standard of care will be determined by examining the prudence and process employed to support the decisions and advice provided as opposed to the performance of the challenged investment.