CLS Advisor IQ Series

THE DOL'S FIDUCIARY RULE AND HOW IT WILL IMPACT FINANCIAL ADVISORS

What the new rule says, and the expected impact to advisors and investors

CLS INVESTMENTS

advisor IQ
By CLS Investments

TABLE OF CONTENTS

Introduction

CLS's Advisor IQ series is a library of industry-related content, designed specifically to help advisors succeed. Following the release of a potentially highly-impactful new fiduciary rule from the DOL, CLS's Chief Compliance Officer, Mike Forker, has written this white paper to help advisors better understand the rule. The United States Department of Labor (DOL) has finalized the rule that will impose a fiduciary standard on all investment advice to retirement accounts. In order to impose a uniform fiduciary standard, the rule will broaden the definition of investment advice under the Employment Retirement Income Security Act (ERISA) of 1974. This white paper will discuss how the rule impacts financial advisors, review the current fiduciary landscape, discuss the new definition of fiduciary investment advice, analyze how conflicts of interest will be handled under the new rule, cover the implementation period, and reveal how existing business is impacted by the rule. This white paper also includes data that CLS has gathered concerning the perceived fiduciary meaning as understood by financial advisors. An appendix of commonly asked questions and their answers can be found at the end of the paper. We invite you to learn more about the many practice and business management resources our Advisor IQ program offers by visiting www.clsinvest.com/advisoriq

The Current Fiduciary Landscape

For retirement accounts governed under ERISA, section 3(21) of ERISA determines whether a financial advisor is held to the fiduciary standard. This section states that anyone who renders "investment advice for a fee or other compensation" is considered a fiduciary with respect to the retirement plan account. When ERISA was enacted in 1975, 401(k) plans didn't exist and other individual retirement accounts had just been approved by the IRS. At the time, professionally managed defined benefit plans dominated the retirement landscape.

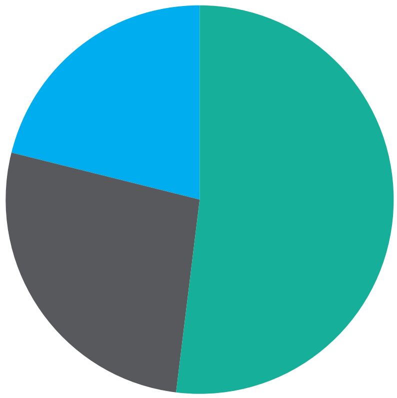
At this time, the DOL issued a five-part definition (otherwise known as the "five-part test") of what constitutes "investment advice for a fee." Under that definition, in order for investment advice to be held to the fiduciary standard, the advice had to be provided "on a regular basis." As a result of that requirement, commissions based transactions have typically fallen outside of the DOL's definition of investment advice. Thus, the individual providing the advice has not been considered a fiduciary and has not been obligated to act in the best interest of his or her client.

Over the last 40 years, there has been a shift from professionally managed accounts to defined contribution plans, which are primarily participant directed. As retirement plans have shifted, participants have turned to financial advisors more frequently, providing advisors with more opportunities to help clients manage their retirement accounts. However, as a result of this transition to participant directed accounts, the DOL argues that the narrowness of the five-part test has hurt investors because, in certain circumstances, it allows financial professionals to avoid the fiduciary standard and permits them to provide conflicted advice.

After the final ruling was announced, CLS conducted a survey among investment advisors. The survey found that 52% of respondents expect the rule to have about the same impact on their business as they had initially thought. On the other hand, 27% feel it will be less impactful, and 21% think it will be more impactful. These results indicate that advisors were well informed on the ruling prior to its finalization and announcement.

ERISA section 3(21) states that anyone who renders "investment advice for a fee or other compensation" is considered a fiduciary with respect to the retirement plan account.

DO YOU THINK THE DOL FIDUCIARY RULING WILL BE MORE OR LESS IMPACTFUL ON YOUR BUSINESS THAN YOU HAD ORIGINALLY THOUGHT?



- About the same as I expected
- Less impactful than I expected
- More impactful than I expected

A Uniform Fiduciary Standard

To address the limitations of the five-part test, the DOL has issued a new definition of "investment advice." In the preamble to the rule, the DOL argues that Congress always intended for the fiduciary standard to apply to all advice provided to retirement plans, plan participants, and beneficiaries. To ensure all financial advisors are held to the fiduciary standard, the rule abandons the five-part test and has broadened the definition of investment advice to include all individualized investment advice, even if it is a one-time event. Under the new definition, an advisor is considered a fiduciary if he or she:

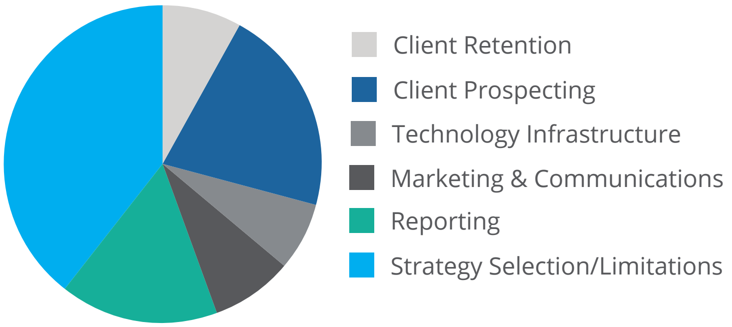
- Makes a recommendation:
    - to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner.
    - for a fee or other compensation (directly or indirectly).
- Acknowledges his or her fiduciary status, or the advice provided is based on the particular needs of the recipient.

Under this new definition, the term "recommendation" is written broadly to include more than just the recommendation of securities. Recommendations on the type of account to use, whether to rollover an IRA, or the decision to utilize a third party money manger would be considered a recommendation and therefore, these actions will be subject to the fiduciary standard.

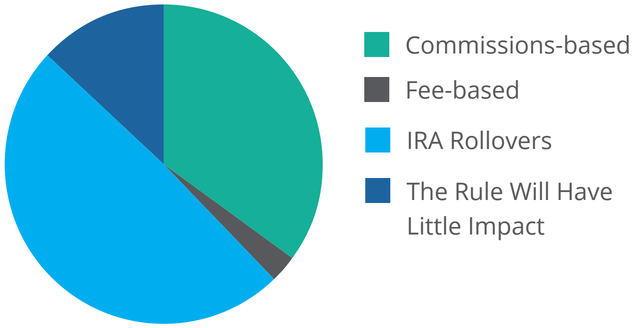
Additionally, the rule states that whether or not an advisor is a fiduciary will be determined based upon the services provided and not what the contract with the client states. In other words, advisors will not be able to provide tailored investment advice, but state in their contract that they are not a fiduciary.

Along with this new rule comes uncertainty of how advisors' businesses will be impacted. In the survey previously mentioned, advisors were asked, "Aside from compliance regulations, which area of your business do you think will see the biggest impact as a result of the DOL's fiduciary rule?" Of the choices listed, "strategy selection/ limitations" was the highest concern for advisors. This survey also found that 49% of advisors believe their IRA rollover business will be most affected by the new rule. The commission-based area of their businesses was the next highest, with 35% of advisors expecting it to be the most impacted.

ASIDE FROM COMPLIANCE REGULATIONS, WHICH AREA OF YOUR BUSINESS DO YOU THINK WILL SEE THE BIGGEST IMPACT AS A RESULT OF THE DOL'S FIDUCIARY RULE?



WHICH PART OF YOUR BUSINESS WILL BE MOST IMPACTED BY THE DOL'S FIDUCIARY RULE?



Under ERISA, if an advisor is acting as a fiduciary, the compensation cannot vary based on the recommendations, and the advisor cannot receive compensation from the investments he or she recommends. These types of transactions are considered "self-dealing," which is prohibited. In limited instances, the DOL has created exemptions from the self-dealing prohibition that allow for advisors to receive compensation from the investments they recommend. For example, under an existing DOL exemption, advisors are allowed to use affiliated mutual funds that pay the advisor or his/her affiliates a fee, provided the advisor complies with the conditions specified in the DOL's exemption.

For fiduciary advisors with conflicts as a result of the expanded definition of investment advice, the DOL has included a new exemption, called the Best Interest Contract (BIC) Exemption. Advisors would need to comply with the BIC Exemption if they are receiving indirect compensation. They would also need to comply with the BIC Exemption when making recommendations on an IRA rollover or a transition from a commission-based account to a fee-based account. The DOL considers these types of transactions to be prohibited transactions, which require exemptive relief because the advisor has a strong financial incentive to recommend the client follow one path over the other.

When recommending an IRA rollover, the advisor will typically only get paid if the client goes through with the rollover. If the client does not undergo the rollover, then the advisor does not earn a fee. In the case of converting a commissions-based account to a fee-based account, the advisor is likely to charge a higher fee for the fee-based account. Therefore, in both of these instances, the advisor will be providing conflicted advice and will need to comply with the BIC Exemption. In order to rely on the BIC Exemption, an advisor must satisfy the following conditions:

ERISA section 3(21) states that anyone who renders "investment advice for a fee or other compensation" is considered a fiduciary with respect to the retirement plan account.

1. Acknowledge in writing:
    - that he or she is acting as a fiduciary, and
    - will adhere to "Impartial Conduct Standards," which means acting in the best interest of the client.
2. Disclose the services provided, any conflicts of interest the advisor has, and all fees and compensation that will be received.
3. Warrant that the advisor has adopted policies and procedures designed to ensure that advice is provided in the best interest of the client and that the advisor has a process in place for reviewing and disclosing material conflicts of interest.
4. The compensation received by the advisor and his or her financial institution must be reasonable.
5. The advisor must provide the client with a link to his or her website where the client can access a copy of model contract disclosures and access information on how the client can obtain a copy of the advisor's policies and procedures for conflicts of interest.

If the advisor is providing advice to an IRA, then the information list above must be part of a written contract with the client. If the client is a 401(k) or other plan that is subject to Title 1 of ERISA, then the disclosures need to be provided in writing, but the advisor does not have to enter into a contract with the client. If an advisor recommends only proprietary products, then he or she will need to comply with additional disclosure requirements. Alternatively, in certain situations, advisors will not be required to comply with all of these requirements. For example, if the advisor is required to comply with the BIC Exemption, but is charging a level asset-based fee, then he or she can comply with the "Level Fee" BIC Exemption, which requires less disclosure.

Where Do We Go From Here?

The new definition of investment advice will be effective on April 10, 2017 and advisors will need to begin complying with the BIC Exemption on January 1, 2018. Prior to the effective date of the rule, we anticipate that the DOL will release additional guidance on how to comply with the rule in the form of an FAQ. Existing business will be exempt from compliance with the new rule and the BIC Exemption. This grandfathering will extend to recommendations to hold existing securities, the continuation of an existing systematic purchase plan, rebalancing of an account, or changing the allocation among existing holdings within a mutual fund family. However, the grandfathering provision does not extend to the deposit of additional money (except as discussed above). Additionally, advisors will not be able to rely on the grandfathering provision if their contracts with the client expires or if their existing contracts renew. In these situations, the advisor will need to comply with the new rule. If advisors are required to comply with the rule for an existing account, any additional required disclosures can be delivered via a negative consent process.

A joint survey conducted by CLS and Market Counsel brings to light advisors' misunderstanding of what the term "fiduciary" means and just who is considered a fiduciary. The misunderstanding can dramatically affect advisor behavior and client relationships. Given the new DOL rule, clarifying a fiduciary is more important than ever. The following data collected from the survey highlights the need for clarifying the definition.

80% of advisors surveyed considered themselves to be a fiduciary; however, nearly 37% of overall respondents deemed the term "meaningless" given a lack of understanding of the function, and 39% felt that regulatory language, definitions, and standards are not clearly defined.

83% of respondents who identify as fiduciaries completely or partly disagree with the statement "fiduciary oversight is applied consistently throughout my organization."

Nearly 70% of all respondents said being a fiduciary is not determined by how you are compensated, or how the standard of care is disclosed; 75% of overall respondents say acting solely in a client's best interest defines a fiduciary.

20% of respondents who consider themselves a fiduciary do not use the term to describe their services.

Prior to the ruling, 50% of all respondents, and 80% of those who consider themselves fiduciaries, say the standard of care is not regulated well.

Prior to the ruling, the reasons that advisors feel the term fiduciary isn't regulated well include standards aren't clear (39%), enforcement is inconsistent (46%), and lack of understanding of the fiduciary function (37%) renders it meaningless.

Appendix:
Common Questions and Their Answers

Q. WILL THE NEW RULE REDUCE THE NUMBER OF IRA ROLLOVERS?

A. Potentially. When conducting an IRA rollover, an advisor will need to comply with the BIC Exemption. Compliance with this exemption requires the advisor to document in writing why the client is better off rolling over his or her IRA versus leaving the funds in a retirement plan. In some instances, going through this exercise may result in the advisor and client deciding against a rollover.

Q. HOW DOES THE NEW RULE IMPACT THE RECEIPT OF 12B-1 FEES?

A. In order to receive 12b-1 fees, an advisor will need to comply with the BIC Exemption.

Q. HOW WILL ANNUITIES BE IMPACTED?

A. In 1984, the DOL established an exemption for the sale of annuities to ERISA covered plans (PTE 84-24). Going forward, this exemption will only be available for fixed annuities. Advisors will need to comply with the Best Interest Contract (BIC) Exemption when selling variable and equity-indexed annuities.

Q. WHAT IS THE LIKELIHOOD THAT THE RULE WILL BE CHANGED BY THE NEW ADMINISTRATION BEFORE IMPLEMENTATION?

A. In our opinion, it is very unlikely that the next administration will change the rule. Repealing a rule that requires "advisors to act in their clients' best interest" is not something many politicians would be willing to take on. Although this has been such an unusual election cycle, who knows?

Q. IS THE INFORMATION IN AN ADVISOR'S MARKETING MATERIALS HELD TO THE FIDUCIARY STANDARD?

A. The DOL has clarified that an advisor recommending him or herself to provide advisory services is not subject to the fiduciary standard, nor is the general information contained in the advisor's marketing materials. However, if specific recommendations are included and then implemented, that would be fiduciary advice.

Q. ARE ADVISORS REQUIRED TO USE THE LOWEST COST PRODUCTS (I.E., INDEX FUNDS)?

A. No. The DOL had considered including an exemption for "low-fee" investment options, but declined to include this in the final rule. The DOL clarified that when providing fiduciary investment advice, suitability is more important than using the lowest cost product. The fact that the DOL declined to include this exemption in the final rule signifies that the DOL recognizes the value that active management can add to client portfolios.

The information contained herein is based on current interpretations of the law and is not guaranteed. The materials contained herein should not be relied upon as legal or tax advice. Neither CLS Investments nor its employees provide legal or tax advice. You should consult with an attorney or tax professional prior to acting on any information contained in this report.

Contact Us Today

17605 Wright Street | Omaha, NE 68130

888.455.4244 | CLSinvest.com

1040-CLS-8/15/2019