Broader "Fiduciary" Definition: Legal Update

by Marcia S. Wagner

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Inside:

- Radical DOL changes to the ERISA Fiduciary definition – detailed legal update.
- Why non-fiduciary advisors may be subject to the Fiduciary Standard for the first time.
- How advisors can adhere to the Fiduciary Standard and grow with technology.

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Introduction

The DOL is on a campaign to expose and minimize conflicts of interest in the retirement plan industry. And they are accomplishing this goal, at least in part, through the new fee disclosure rules (*i.e.*, Section 408(b)(2) and participant-level fee disclosures). But the DOL is also seeking to implement rules that would address the problem of conflicts "head on". Specifically, the DOL is in the process of proposing a new "investment advice fiduciary" definition. If the DOL stays on track with its proposal, many non-fiduciary advisors would become subject to the fiduciary standards under ERISA for the first time. Additionally, any advisors that do not want to become subject to the fiduciary requirements of ERISA would need to fess up to clients and make certain "in your face" disclaimers concerning their non-fiduciary status.

The DOL released its initial proposed regulations to modify the existing regulatory definition of a "fiduciary" on October 21, 2010. However, due to the high volume of comments submitted in connection with this proposal, including comments from members of Congress, the

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Karla Paxton is ByAllAccounts' Business Solutions Manager responsible for strengthening existing relationships and developing new relationships with the firm's key partners. Ms. Paxton has 15 years of experience working with wealth advisory firms servings high net worth clients as Operations Manager, Chief Compliance Officer and Chief Operations Officer. Ms. Paxton has served on the Advent Users Group Board of Directors.

Investors want to know that their financial advisor is focused on helping them meet their long-term goals without any conflicts of interest. That's the promise that fiduciary advisors deliver — they have the legal duty to place their clients' best interests before their own.

DOL announced on September 19, 2011 that it would be re-proposing this definition to take into account further input from the public.[1]

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A. Overview of Existing Regulatory Definition.

ERISA has a functional definition of a fiduciary that focuses on a person's actions. If you provide "investment advice" within the meaning of ERISA, you are automatically deemed to be a fiduciary. Under the current regulation, a person is deemed to provide fiduciary investment advice if:

(1) such person renders advice to the plan as to the value or advisability of making an investment in securities or other property
(2) on a regular basis,
(3) pursuant to a mutual agreement or understanding (written or otherwise)
(4) that such services will serve as a primary basis for investment decisions, and
(5) that such person will render advice based on the particular needs of the plan.

It should be noted that this 5-factor definition of "investment advice" is narrower than the definition under federal securities law. For example, the Investment Advisers Act of 1940 has a rather expansive view of the advisory activity that is subject to regulation as investment advice.

The regular basis and primary basis prongs of this test are particularly important. This was illustrated in the 2007 case of *Ellis v. Rycenga Homes* which applied these factors to a set of facts where periodic meetings between a broker and a plan trustee over the course of a 20-year relationship, resulted in the plan's consistently following the broker's suggestions. This led to the court's holding that the broker was a fiduciary, because of the regularity of the advice and the plan's heavy reliance on the adviser.

B. Two Specific Changes to Existing Regulatory Definition.

If the DOL's re-proposed rule follows its initial proposal, two specific changes would be made to the existing definition of "investment advice." Under the existing rule, advisors are deemed to provide investment advice if, among other requirements:

[1] http://www.dol.gov/opa/media/press/ebsa/EBSA20111382.htm.

- there is a mutual understanding or agreement that the advice will serve as a "primary basis" for plan investment decisions, and

- the advice is provided on a "regular basis."

However, under the DOL's proposed rulemaking, an advisor would be deemed to provide investment advice if there is any understanding or agreement that the advice "may be considered" in connection with a plan investment decision, regardless of whether it is provided on a regular basis. Thus, casual or even one-time advice could trigger fiduciary status. Under both the existing and the initial proposed rules, advice would constitute "investment advice" only if it is individualized advice for the particular plan client.

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C. Safe Harbor "Disclaimer" for Avoiding Fiduciary Status.

In addition to broadening the existing "investment advice" definition, the DOL's initial proposal introduced a safe harbor that advisors would need to follow to avoid fiduciary status. Generally, to avoid being characterized as an investment advice fiduciary, an advisor would have to "demonstrate" that the plan client knows, or reasonably should know, that (a) the advice or recommendations are being made by the advisor in its "capacity as a purchaser or seller" of securities or other property, (b) the interests of the advisor are adverse to those of the client, and (c) the advisor is not undertaking to provide "impartial investment advice." Although the initial proposed rule did not actually require the advisor to provide these disclaimers in writing, it clearly contemplated some type of notice or acknowledgment form for the plan client.

D. Potential Impact on Providers.

If the proposed regulations had been finalized as first issued, non-fiduciary advisors would undoubtedly need to change their service model and re-define their role as plan advisors. To avoid fiduciary status, they would have effectively been forced to furnish written disclaimers to plan clients, stating that they are not providing impartial advice, as contemplated under the proposed DOL guidance. Alternatively, a provider could accept its status as a plan fiduciary. However, as a fiduciary, it would no longer be able to provide investment advice for any variable compensation (*e.g.*, 12b-1 fees) and it would be subject to ERISA and the prohibited transaction rules.

E. Outlook for DOL Proposed Regulations.

Since the DOL announcement that it would be re-proposing its "fiduciary" definition, it has clarified that its re-proposed rule would only impose fiduciary status on those advisors who provide "individualized" advice to plan clients. The DOL has informally indicated that the reproposed rule will be substantially similar in approach to its initial proposal. Its rulemaking the next time around will be coordinated with the U.S. Securities and

Advise on the Entire Financial Picture

By Karla Paxton, Business Solutions Manager, ByAllAccounts

The SEC, DOL, FINRA, Congress, and many more regulatory organizations have made statements on the fiduciary standard – and changes are on the horizon, pushing for all advisors to act as fiduciaries.

Investors want to know that their financial advisor is focused on helping them meet their long-term goals without any conflicts of interest. That's the promise that fiduciary advisors deliver — they have the legal duty to place their clients' best interests before their own.

In addition, by truly placing the interests of clients first, and ensuring there is a reasonable basis for investment advice, you create an opportunity to attract high net worth clients looking for a broader relationship, enabling you to grow assets under management.

But what does "best interest" really mean? It calls for taking a holistic look at what a client owns and providing advice that reflects their total financial picture. Only then will you have their "best interest" in mind when making your recommendations.

As your client's financial quarterback, you should be able to:

- Report and advise on all of their assets. This includes assets held outside your firm's primary custodian, such as a 529 account, separately managed accounts, real estate holdings, trusts and off-shore accounts as well as mutual funds, hedge funds and other alternative investments held directly with the fund manager.
- Act as your client's trusted retirement planning advisor, providing advice on reallocating tax-deferred assets such as a 401(k) or 403(b) plan based on their total investment portfolio.
- Understand their estate plan and how their financial affairs should be best managed to help them achieve their objectives.
- Effectively collaborate with their other advisors, including accountants, attorneys and insurance agents to ensure you are all on the same page when it comes to making recommendations that affect their financial situation.

With today's account aggregation technology this task can be easily automated to enable you to receive reconciliation-ready data each day that covers all of your clients' assets, even those that are held away. Most importantly, data for positions, balances, transactions and securities are loaded directly into your portfolio management software of choice to support comprehensive performance reporting so you can provide the best advice possible.

Adopting the fiduciary standard as a way of doing business reinforces your role as a trusted advisor and sets you apart from the competition. It also enables you to move your business to the next level — from an "asset manager" providing advice on a portion of your client's assets to a "wealth manager" where you can develop a broader and deeper relationship.

ByAllAccounts provides account aggregation to over 1500 firms, supporting their efforts to adhere to the fiduciary standard and build deeper relationships with HNW clients. We'd love to speak with you about taking your client service to the next level with daily automated account data from over 4,100 sources.

Exchange Commission (the "SEC"), which is working on its own proposal to impose fiduciary status on broker-dealers as authorized under the Dodd-Frank Act.[2] The DOL's re-proposed rule is expected in the second part of 2013.

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F. Practical Implications of Broader "Fiduciary" Definition.

The DOL's pending proposal to broaden its "investment advice fiduciary" definition is likely to "shake up" the retirement plan industry, pressuring many retirement plan advisors to provide their services in a fiduciary capacity for a level fee. If the DOL's re-proposed rule is similar to its initial proposal, any advisor that is unwilling to advise plan clients on these terms may, as a practical matter, be forced out of the retirement plan business. Given the significance of this anticipated change, financial advisors should evaluate and re-consider their business model for ERISA plan clients, especially those who do not currently hold themselves out as plan fiduciaries.

Recordkeepers are constantly adapting and developing new types of arrangements, and they may be able to offer assistance with the problems associated with variable compensation (which is prohibited under ERISA's prohibited transaction rules in the case of a fiduciary advisor). For example, working with recordkeeping platforms that are able to offer level payouts may be one possible approach. Advisors can also explore the use of ERISA budget accounts (also known as ERISA fee recapture accounts) as a means for leveling the compensation payable to the advisor. Advisory firms that currently receive variable compensation may also wish to consider providing investment advice to ERISA plans as a dual-registered RIA, which would enable the firm to charge a level asset-based fee. There are no "one size fits all" solutions for all firms, especially since every advisor's service model will need to be fully compliant with both ERISA and securities law. However, financial advisors and advisory firms should strongly consider the potential impact of the DOL's proposal in the near future, and investigate potential and possible solutions in the days ahead.

[2] Under the powers conferred by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the SEC is authorized to issue regulations that will impose on broker-dealers the same fiduciary standard that applies to investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). As required under the Dodd-Frank Act, on January 21, 2011, the SEC's staff published its study on the different standards of conduct that currently apply to broker-dealers and investment advisers. In sum, the SEC staff's report recommended that the SEC create a uniform fiduciary standard that would apply to both brokers and investment advisers when they provide personalized investment advice to retail customers. Of the 5 commissioners serving on the SEC, the 2 Republican appointees released a separate statement, criticizing the report and making the following points: (i) the SEC staff's report does not reflect the views of the SEC or its individual commissioners, (ii) the report failed to properly evaluate the existing standards of care applicable to broker-dealers and investment advisers as required by the Dodd-Frank Act, and (iii) additional study, rooted in economics and data, is required to support any recommendation for a uniform fiduciary standard.

About The Wagner Law Group

The Wagner Law Group, a professional corporation, is a nationally recognized ERISA and employee benefits; estate planning; employment, labor and human resources practice. The firm helps clients with tax and corporate matters, litigation, succession planning and real estate. We take pride in counseling our clients in all areas of their businesses. Established in 1996, The Wagner Law Group has 22 attorneys, five of whom are AV rated by Martindale-Hubbell as having very high to preeminent legal abilities and ethical standards. The firm has one of the largest ERISA groups in the country.

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About ByAllAccounts

ByAllAccounts is the only provider of intelligent data aggregation for financial services companies and the platforms on which their businesses depend. Their patented, intelligent data aggregation system implements a knowledge-based process that uses artificial intelligence to gather and transform financial account data and deliver it to portfolio management, reconciliation, compliance, trust accounting and performance systems. The financial industry's most reputable advisory firms, financial institutions, and financial technology vendors rely on ByAllAccounts as their primary connector to structured and unstructured financial account data, enabling them to streamline their third-party relationships and to empower their applications and services. For more information, visit www.byallaccounts.com.

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