DOL to Advisors: 'Take the Pledge'

By Kerry Pechter *Fri, Apr 17, 2015*

In the much-anticipated revision of its 2010 proposal to curb conflicted sales to retirement account owners, the Department of Labor asserts that rollover IRAs are within its jurisdiction. It also calls on IRA advisers to sign a legally-binding "best interest contract" if they want to receive commissions.

Almost five years after the Department of Labor began work on it, the federal agency's **re-proposal** of its 2010 fiduciary proposal, made public this week, would "allow advisers to continue to receive payments that could create conflicts of interest" as long as they agree contractually to act in the client's "best interest."

The DOL is accepting public comments on the new proposal from now until mid-July. At that point, it will schedule a public hearing on the matter, and then issue a final ruling. Click **here** for FAQs about the proposal.

The most significant regulatory aspect of the re-proposal may be its assertion that individual IRA accounts—collectively, the largest single pool of retirement savings in the U.S. today—are more like ERISA-regulated retirement plans than like other retail accounts, and therefore deserve and require similar government oversight.

If that sticks—and the securities industry is sure to fight it—then financial intermediaries who advise IRA clients, even those who have had nothing to do with workplace retirement plans or with recommending a specific rollover from a plan, would be held to the same high ethical standards as advisers to retirement plans.

The new proposal addresses all "investment advisers," but variable annuity sellers may be forgiven if they feel in the DOL's cross-hairs. At a Labor Department website, the poster children for bad adviser practices are Phil and Carol Ashburn, IRA owners who share an **audio testimonial** about abuse from an adviser who put their $350,000 in a variable annuity.

Poison pill?

Any advisor who makes specific recommendations on the disposition of IRA assets will be affected by the re-proposal, as it is currently written. "More advisors will be held to a fiduciary standard, but they will have considerable flexibility in how they get paid. Our rule is that advisors that are paid to provide advice to qualified plans and IRAs are required to put clients first, but our intent is to provide guard rails, not a strait jacket," said Labor Secretary Tom Perez—who, in an expansive gesture, noted in the press conference that he and his wife rely on an adviser who takes commissions.

At this point, it's difficult to determine from the proposal's legalese how restrictive it might be in pracice. The document is full of exemptions and "carve-outs" that, depending on their interpretation by ERISA lawyers, may allow much of the business of advising 401(k) plan sponsors, educating plan participants, and recommending ways to invest individual IRA assets, to go on as usual.

As a key mechanism for reform, the proposal calls for a "legally-binding," "best-interest contract" between advisers and clients. To accept commissions, revenue-sharing or 12b-1 marketing fees—the non-transparent payments that the government has criticized —advisers would have to sign such a contract.

"People who provide advice tell me that they want to put the client's interests first, Perez told reporters during a phone-in meeting. "This rule will codify what they are already doing. This is a vehicle through which we can install guardrails for consumers while providing flexibility for advisors in carrying out their fiduciary obligations. The proposal doesn't end or bar commissions. It would not apply to brokers who merely take orders and don't provide advice. It will not limit access to education" by call center personnel.

The definition of "best interest" will undoubtedly be a focus of much discussion during the next 10 weeks. At this point, "best interest" is undefined, and so is the exact type of written disclosure that might be required to receive commissions. "Without a clear definition of 'best interest' and a strict protocol for disclosing 'conflicts of interest', it's going to be near impossible to enforce these new standards," said independent fiduciary specialist Chris Carosa, a writer for *Fiduciary News*.

Cynics might wonder if the DOL's insistence on a legally binding contract might be a kind of poison pill—a demand that the DOL knows that advisers can't agree to, perhaps because of the open-ended legal liability it could entail. For its part, the brokerage industry might try to go around the DOL, and work through Congress or the courts to challenge the DOL's assertion that it has jurisdiction over individual IRAs.

Jurisdiction over IRAs

The proposal, if it goes live, would likely have its greatest impact in the individual IRA arena. Americans hold some $7 trillion in tax-deferred savings in IRAs, most of it rolled over at some point from a DOL-regulated employer-based 401(k) plan. Most financial services firms are currently caught up in a "capture more rollovers" gold rush, and, at conferences and privately, they express the belief that rollover money is just like other retail money.

But the government appears to fundamentally disagree with this view. The proposal makes clear that it considers advisers to IRAs to be fiduciaries. "The primary impact of the 'best interest' standard is on the IRA market," the DOL re-proposal says. "IRAs are more like [401(k)] plans than like other retail accounts." Here is some of the pertinent language in the proposal:

> Some commenters additionally suggested that the application of special fiduciary rules in the retail investment market to IRA accounts, but not savings outside of tax-preferred retirement accounts, is inappropriate and could lead to confusion among investors and service providers. The distinction between IRAs and other retail accounts, however, is a direct result of a statutory structure that draws a sensible distinction between tax-favored IRAs and other retail investment accounts. The Code itself treats IRAs differently, bestowing uniquely favorable tax treatment on such accounts and prohibiting self-dealing by persons providing investment advice for a fee. In these respects, and in light of the special public interest in retirement security, IRAs are more like plans than like other retail accounts…
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> The vast majority of IRA assets today are attributable to rollovers from plans. In addition, IRA owners may be at even greater risk from conflicted advice than plan participants. Unlike ERISA plan participants, IRA owners do not have the benefit of an independent plan fiduciary to represent their interests in selecting a menu of investment options or structuring advice arrangements. They cannot sue fiduciary advisers under ERISA for losses arising from fiduciary breaches, nor can the Department sue on their behalf. Compared to participants with ERISA plan accounts, IRA owners often have larger account balances and are more likely to be elderly. Thus, limiting the harms to IRA investors resulting from conflicts of interest of advisers is at least as important as protecting ERISA plans and plan participants from such harms.

Responding to a question during the news conference, Perez said that clients who feel that they've been misused by a broker or advisor will be able to sue them. "If you are in the context of a relationship governed by the best interest contract exemption, the most frequent avenue [of redress] will be private action for breach of contract," he said. The IRS also has authority to levy an excise tax on advisors who engage in prohibited transactions without meeting any of the exemptions.

In addition to the best interest contract exemption, the proposal updates some existing exemptions that govern the provision of investment advice to plan sponsors and participants. In addition, it "carves out" or excludes general investment education, sales pitches to large plan fiduciaries who are financial experts, and appraisals or valuations of the stock held by employee-stock ownership plans, from accountability to a fiduciary standard.

The proposal asks for comment on a new "low-fee exemption" that would allow firms to accept conflicted payments when recommending the lowest-fee products in a given product class, with even fewer requirements than the best interest contract exemption. This could mean that no-load, direct-sold fund firms like Fidelity and Vanguard, or robo-advisers that recommend all ETF-portfolios to IRA owners, might incur relatively light compliance costs.