

FIVE TRAPS FOR THE UNWARY

Due Diligence and the DOL Fiduciary Rule

By Duane R. Thompson, AIFA®

On June 9, 2017, the U.S. Department of Labor (DOL) interim fiduciary rule¹ went into effect after years of intense opposition. Its principal opponents were financial services firms previously exempt from the section 3(21) definition of a fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA).²

Surveys of industry preparedness suggest many wealth managers and financial planners who have operated successfully under a fiduciary standard in the past were prepared for the new interim rule. For example, an Investments & Wealth Institute™ survey in the fall of 2016 indicated 57 percent of member respondents were only marginally impacted by the rule, and 48 percent said they were fully prepared for compliance.³

However, anecdotal reports from pension attorneys and other compliance professionals suggest that appreciation of the rule's impact, even on experienced financial advisors already working in a fiduciary environment, may be spotty. The purpose of this article is twofold: (1) to focus on conflicts that fee-based advisors should be aware of; and (2) to suggest that the best way to harmonize compliance across various regulatory jurisdictions is through a thorough review and adaptation of due diligence processes.

It should be noted that although the final rule is still scheduled to take effect

January 1, 2018, with all its prohibited transaction exemptions, since February President Donald Trump's administration has undertaken an intensive review of those requirements. On June 29, 2017, DOL announced a new request for comments on extending the January 1 deadline and soliciting additional feedback on changes to the exemptions.⁴

IMPACT OF THE RULE ON WEALTH MANAGERS AND FINANCIAL PLANNERS

The DOL interim rule imposes twin fiduciary duties of loyalty and care with which experienced investment advisors are well-acquainted. These basic duties are integrated into the DOL Impartial Conduct Standards, which require conformance to the ERISA basic fiduciary duties of loyalty and prudence, where prudence is a requirement that generally is equivalent to the suitability obligations of an investment advisor or broker. The Impartial Conduct Standards include two additional requirements that prohibit misleading statements and receipt of excessive compensation. Combined, the Impartial Conduct Standards mirror the fiduciary duty of investment advisors under securities law but are more prohibitive.

As such, fiduciary advisors should not assume that, if they are fiduciaries under one law and make a good-faith effort to act in the client's best interest under ERISA, they will be in compliance. Some may be surprised to learn upon closer

examination of the DOL fiduciary rule that certain conflicts under the Investment Advisers Act of 1940 (Advisers Act) that are managed through disclosure would be prohibited under ERISA absent a safe harbor.

For example, advisory fees under the Advisers Act generally are unregulated, except that an advisor must disclose all forms of material compensation in Form ADV or in other documents.⁵ Advisors whose fees substantially exceed those of others may violate the antifraud provisions of the Advisers Act, which serve as the basis for the U.S. Securities and Exchange Commission (SEC) regulation of fiduciary conduct. SEC staff over the years has issued a number of no-action letters expressing the view that an advisory fee greater than 2 percent of the total assets under management (AUM) would be excessive; and the fact that an advisory fee is higher than the industry average must be disclosed (assuming the same or similar services as other advisors).⁶

In contrast, under its interim and final fiduciary rules, DOL has rejected disclosure as a principal means of managing conflicts. Instead, it concedes in the preamble to the Best Interest Contract Exemption (BICE),

It is true that the final exemption does not chiefly rely on disclosure as a means of [investor] protection, but rather on the imposition of fiduciary

*standards of conduct ... and the prohibition of misaligned incentive structures.*⁷

As a consequence, conflicts faced by wealth managers and financial planners as investment fiduciaries must be managed differently depending upon the jurisdiction. Under the Advisers Act, conflicts often are successfully managed through informed disclosure. Under ERISA, the same conflict frequently must be avoided or managed under more stringent conditions. Fees that can be merely disclosed under the Advisers Act must, under the DOL interim rule, be reasonable and paid directly by the advice-recipient to avoid a prohibited transaction. The interim rule allows receipt of variable compensation, i.e., commissions or third-party revenue, but fees for conflicted advice must meet the conditions of the Impartial Conduct Standards.

Given the legal differences between the two statutes, we examine five relatively common activities of fiduciary advisors; how each may result in a conflict; and the regulatory treatment of each under the Advisers Act and ERISA (see table 1). Wealth managers and financial planners are likely to encounter the first two activities (rollover advice and tiered fees) on a fairly routine basis; depending on the business model and other regulatory affiliations, the remaining activities may be encountered on an intermittent basis.

ROLLOVER ADVICE

Beginning in 2013, securities regulators began focusing considerable attention during surprise inspections on rollover advice by brokers and investment

advisors. Their attention was prompted by a report of the Government Accountability Office citing problems with biased advice.⁸ In 2014, the Financial Industry Regulatory Authority (FINRA) and the SEC made rollover advice an examination priority.⁹ In subsequent years, both regulators have included rollover advice as part of a broader focus on protection of seniors and other retirement investors.

The SEC examination arm, the Office of Compliance Inspections and Examinations (OCIE), explained in 2014 that advisors and broker-dealers may have incentives to encourage the rollover of client assets from an ERISA plan to an individual retirement account (IRA) or other account managed by the firm. The SEC stated that it would examine in particular the transfer of a client's 401(k) plan assets into higher-cost investments of an IRA and the use of misleading retirement credentials or statements regarding the benefits of an IRA.

Similarly, the DOL final fiduciary rule adopted in 2016 made rollover advice, including transfers, distributions, and account switches from brokerage to advisory accounts, a fiduciary act.

Under the Advisers Act, advisors have a duty to make only suitable investment recommendations. In 2014, OCIE de facto expanded the suitability obligations of an investment adviser to include cost comparisons by stating that it would examine whether participants' 401(k) accounts are rolled over into higher-cost investments in an IRA. Under the DOL interim rule, ERISA fiduciaries are subject to the Impartial

Conduct Standards in providing rollover advice. As such, they have roughly similar fiduciary duties to the Advisers Act standard because the Impartial Conduct Standards impose duties of loyalty and prudence on the fiduciary, as well as requirements to charge only reasonable fees and make no misleading statements. As noted above, the SEC does not mandate a "reasonable fee" for rollover advice but only requires disclosure. The net result, however, is that the SEC has joined DOL with an increasing focus on investment expenses.

The DOL level-fee exemption, however, along with a host of other exemptions, goes much further than SEC regulation by requiring fiduciaries to undertake a specific due diligence process in formulating rollover recommendations. The level-fee exemption requires fiduciaries to assess whether the plan pays any of the administrative expenses, to compare the difference in fees and expenses along with the scope of services and investments available under each option, and to document why the final recommendation is in the client's best interest.

With the exception of taking into account any administrative support by the plan sponsor in a plan-to-plan or plan-to-IRA scenario, the same due diligence process is required for other transfers, such as an IRA-to-IRA transfer, or switching from a brokerage to an advisory account.

It should be noted that ERISA fiduciaries do not always need an exemption when providing rollover advice. For example, advisors who already are managing a

Table 1

FIVE COMMON ACTIVITIES OF FIDUCIARY ADVISORS, CONFLICT, AND REGULATORY TREATMENT

Activity	Advisers Act	ERISA
Rollover advice	Best Interest Standard	Exemption may be needed
Tiered fees	Form ADV disclosure	Exemption may be needed
Referral fee	Solicitor's Rule	Exemption needed
Entertainment/educational expenses	Disclosure and internal policy restrictions	\$250 ceiling with limited exceptions
Other compensation	Form ADV disclosure	Exemption needed

participant's 401(k) account for a fee, whether they charge a flat fee or include the account in an overall management fee, would not have a conflict because their compensation remains unchanged no matter the final recommendation.

However, if the client is new, or the account is not presently managed for compensation, a recommendation to roll over represents an aggregate increase in compensation for the firm, whether it charges a level fee or not. DOL regards this as a "clear and substantial conflict of interest" that requires using either BICE or the level-fee exemption.¹⁰ Under the interim rule, ERISA fiduciaries providing conflicted advice on rollovers are subject only to the Impartial Conduct Standards.

TIERED FEES

Advisors sometimes will discount their advisory fees, for a number of reasons. Their motivations may include rewarding longtime clients for loyalty, providing incentive to attract new business, or, more commonly, to offer tiered discounts based on the amount of assets under management. Regulators are okay with these compensation arrangements, as long as the fee structures are disclosed.¹¹

Some advisors also provide tiered discounts based on the asset class or other investment strategy. For example, some advisors may not charge an AUM fee for the cash portion of the portfolio, or they may charge a lower AUM fee for the fixed-income portion. DOL appears to have given its blessing to this kind of arrangement in the BICE preamble, by stating that

*Different payments for different classes of investments may be appropriate based on differences in the time and expertise necessary to recommend them.*¹²

A note of caution: Although charging fees based on the amount of work required is laudable, the above DOL statement conflicts with extensive other

commentary that fees should not vary with the assets recommended or invested.¹³ Otherwise, a financial incentive exists to overweight the portion of the portfolio that carries higher fees. To avoid any problems, advisors should carefully document the process used in developing the investment strategy. Documentation could be in the form of an investment policy statement, a risk tolerance questionnaire, or written client communications that suggest an appropriate weighting of equities in the portfolio.

The Advisers Act does not expressly prohibit gifts and gratuities, but the SEC noted in a 2015 enforcement settlement that the defendant advisor had ignored its own gifts and entertainment policy limiting such gifts to a value of \$250 or less.

REFERRAL FEE

The new definition of a fiduciary under ERISA makes referrals to an investment professional for a fee, direct or indirect, a fiduciary act. Advisors registered with the SEC may be aware of the longstanding "cash payments for client solicitations" rule, or for short, the "Solicitor's Rule," that covers the same situation.¹⁴ The SEC holds, and rightly so, that someone paid a fee to recommend a particular advisor is providing conflicted advice. Consistent with the Advisers Act approach to managing conflicts through disclosure, under the Solicitor's Rule, the solicitor must, among other things, furnish the prospective client with a copy of the solicitor's agreement with the advisor, a copy of the current Form ADV brochure of the advisor, and a separate disclosure document with details on the terms of the referral arrangement.

Under the DOL interim rule, the solicitor would need to rely on BICE because the referral results in variable compensation and therefore is a conflict under ERISA. Moreover, because some states require the solicitor to be registered as an investment adviser representative of the advisor, the firm is also required to use BICE. Under the interim rule, then, the advisory firm in this particular scenario would be subject to the Impartial Conduct Standards.

Advisory firms receiving finder's fees from other unaffiliated firms for making a referral that involves an ERISA or IRA account also would need to rely on BICE to avoid a prohibited transaction.

ENTERTAINMENT AND EDUCATIONAL EXPENSES

Neither the SEC or DOL has clear ground rules regarding receipt of gifts or other payments made to an investment fiduciary by a third party that stands to benefit from transacting business with the advisor. The Advisers Act does not expressly prohibit gifts and gratuities, but the SEC noted in a 2015 enforcement settlement that the defendant advisor had ignored its own gifts and entertainment policy limiting such gifts to a value of \$250 or less. According to the enforcement settlement, certain employees of the advisory firm received benefits from a client including a significant personal loan and numerous trips on clients' private planes. In exchange, certain clients received favorable investment treatment, according to the settlement. The SEC did not opine on the \$250 limit, other than to say that the advisor had failed to enforce its own written code of ethics "under the principle that an adviser's employees owe a fiduciary duty to clients."¹⁵

Since 2008, the DOL enforcement manual for investigators reviewing potential fiduciary violations has maintained a ceiling for "gifts and gratuities" of no more than \$250 for plan fiduciaries

accepting meals, gifts, entertainment, or expenses associated with an educational conference from a third party doing business with the plan.¹⁶ However, the enforcement manual goes on to explain that if the educational conference meets certain conditions, including a reasonable relationship to the duties of the plan representative, such expenses may be permissible.

In either instance, advisors should consider adopting policies designed to avoid or prohibit extravagant gifts or events that could lead the fiduciary to feeling obligated to use the products or services of the third party. A ceiling of \$250 per event seems to be a reasonable standard accepted by both regulators.

OTHER COMPENSATION

Advisors acting as fiduciaries under the interim rule also may be recipients of trails that they continue to receive as the broker of record. For the most part, many advisors who consider themselves fee-based—but not fee-only—may have a few important clients who insist on maintaining a limited number of legacy brokerage accounts through the advisor. Disclosure of their broker-dealer or insurance company affiliation in Form ADV generally will allow these fee-based advisors to manage the conflict under the Advisers Act, but if the trails are from an ERISA account or IRA—even if it's just a single account—then they will need BICE or another DOL exemption to avoid committing a prohibited transaction.

Anecdotally there have been reports of registered representatives considering dropping their brokerage licenses and becoming registered investment advisers (RIAs) in response to the DOL fiduciary rule. Michael Kitces, a well-known industry speaker and blogger, wrote recently how RIAs actually can be paid commissions for fixed insurance and annuity products via a brokerage general agency instead of simply referring the client to insurance specialists.¹⁷ This approach, of course, creates

conflicts that must be disclosed in Form ADV, and requires compliance with the Impartial Conduct Standards if the transaction occurs in a retirement account.

Grandfathering is available under BICE for receipt of ongoing trails from pre-rule transactions, but the conditions are very restrictive. For example, transactions executed before the June 9, 2017, compliance deadline do not cover advice on new contributions to those investment products, although a rebalancing protocol established before June 9, and limited to exchanges between securities in the same variable annuity contract, or within the same fund family, are permissible. Grandfathering also applies to trails received from buy-and-hold recommendations made before June 9, 2017. However, the usefulness of the grandfathering provision is limited, given the dynamics of an investor's evolving retirement goals over time, or market conditions that require periodic review of the client's investments if the scope of engagement includes monitoring. Indeed, advisors who want to retain the "hold" positions solely to avoid BICE compliance would breach their duties of loyalty and care.

The limitations of the safe harbor for pre-existing transactions were no accident. In the preamble to BICE, DOL stated that its intent was to "permit orderly transition from past arrangements, not to exempt future advice and investments from the important protections of the Regulation."

DUE DILIGENCE PROCESSES: KEY TO REGULATORY HARMONIZATION

Thoughtful advisors already have examined the question of how to best harmonize a firm's compliance obligations across multiple regulatory jurisdictions. There are no easy solutions or shortcuts available. The best solution is to follow the highest standard "known to law,"¹⁸ that is, trust law as articulated under ERISA, to apply across accounts, clients, and other regulatory jurisdictions.

Of course this is no easy proposition, and it may be impossible for advisors working in large firms. Moreover, regulators tend to act in silos when promulgating new rules. At times they make good-faith efforts to ensure that their rules do not conflict with other laws, but frequently their hands are tied by statutory restraints or politics if they want to go further with harmonizing their rules. It is true that both the SEC and DOL have announced their intent to collaborate on an effort to harmonize the fiduciary standard applicable under securities laws and ERISA. But as noted throughout this article, the laws may limit their ability to fully harmonize the rules that flow from the fiduciary concepts underlying the statutes.

For example, much of the detailed disclosure information required under BICE goes far beyond the more general disclosure requirements of Form ADV Part 2A. Even within the same agency, other related rules may not serve as a substitute. DOL noted in its preamble to the fiduciary rule that disclosures under its 408(b)(2) rule would not be adequate to meet the specific disclosure requirements of its prohibited transaction exemptions.

On the positive side, DOL notes that under its principal transactions exemption, a registered representative can satisfy the best execution requirements for principal transactions if it complies with FINRA rules 2121 and 5310 for best execution. Conversely, DOL also notes that an investment recommendation that is not suitable under the securities laws would not meet the Best Interest Standard under its own fiduciary rule. As a simple matter of recordkeeping, advisors under the Advisers Act are required to maintain business records for five years, but FINRA and the DOL prohibited transaction rules require six years. The simple rule of thumb is to keep all records for six years. However, these regulatory concessions are for the most part uncommon and of limited value to the advisor.

To a certain extent, advisors can take the lemons from this protracted debate over the appropriate standard for investment advice and convert their compliance policies into fiduciary lemonade. They can accomplish this in a number of ways, such as taking inventory of all accounts, categorizing them by fiduciary or non-fiduciary (including “grades of fiduciary” such as ERISA and Advisers Act accounts), comparing the disclosure and other requirements used to manage conflicts of interest, and developing due diligence processes that cover the regulatory waterfront.

Although easier said than done, avoiding conflicts entirely resolves a whole host of compliance issues. The majority of other options for harmonizing compliance require a deeper analysis. For example, duty of care and suitability factors that an advisor must consider under ERISA, securities laws, and insurance laws have a lot in common (see table 2).

As part of the holistic process used in providing wealth management or financial planning services, many advisors already address these suitability factors—and many others—as part of their overall inquiry into the client’s financial situation. Being able to check off all of the applicable suitability factors at once would obviate the need to research the specific requirements under each regulatory jurisdiction.

One area of potential harmonization is rollover advice. The DOL level-fee exemption provides an explicit due diligence process of analyzing comparisons, largely between fees, services, and available investment products. FINRA, the SEC, and state insurance regulations do not, although FINRA offers helpful guidance in Notice to Members 13-45 and in a 2014 investor alert. Following the DOL process under the level-fee exemption makes good sense as a best practice and as a higher standard that, combined with addressing any explicit suitability factors under

Table 2

DUTY OF CARE—DETAIL

ERISA	Advisers Act	Broker-Dealer/Insurance
Investment objectives	Investment objectives	Investment objectives
Financial circumstances	Financial situation	Financial situation and needs
Risk tolerance	Investment experience	Investment experience
Needs of investor		Risk tolerance
<ul style="list-style-type: none"> Prudent Investor Rule, “...acts with care, skill, prudence and diligence under circumstances then prevailing ...” 	<ul style="list-style-type: none"> Advice is suitable in context of overall portfolio Suitability rule (proposed but never adopted by the SEC) notes similarity to ERISA’s prudence standard and trust law 	<ul style="list-style-type: none"> Age Other investments Tax status Time horizon Liquidity needs Annual income* Intended use of annuity* Existing assets (including investment and life insurance holdings)*

Source: “Harmonizing the DOL Rule with Other Laws,” Investments & Wealth Institute Fiduciary Best Practices Online Course

securities or insurance law, would ensure compliance across the board.

Due diligence processes, which may include checklists, could be developed in a number of ways. These can be applied in the form of benchmarking investment expenses to address ERISA’s exclusive purpose requirement that a fiduciary defray reasonable expenses. With respect to trusts, foundations, and endowments, be aware of the duty under the Restatement (Third) of Trusts that requires a trustee to “incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.”¹⁹ Benchmarking is one way of satisfying, at least in part, the reasonable fee requirement across various laws.

Finally, building a master list of conflicts of interest is another way to avoid or manage them as part of a due diligence process. Lists could be organized by product or service, and they could include specific items such as rollover advice, proprietary products, principal transactions, third-party compensation, tiered fees, gifts, entertainment, educational conference policies, and referrals.

In summary, it’s easy to conclude that being a fiduciary is hard work. George Washington, who in addition to his more prominent public roles, also may be deservedly called one of America’s first

and foremost fiduciaries. According to one biographer, in his capacity as legal guardian to his stepchildren, he was vested with a “weighty, time-consuming task that required Washington to satisfy the court with annual reports on his fiduciary action.” Like every other task that Washington assumed, he was reported to have tackled his fiduciary responsibilities with utmost vigor, claiming that a stewardship demanded even more care from a stepparent than from “a natural parent, who is only accountable to his own conscience.”²⁰

The fiduciary standard for advisors is constantly evolving, as evidenced by the significant transformation of the standards applicable to advice-givers in recent years. Yet, over time, the underlying duties of a fiduciary have remained constant, including the necessity for due diligence processes to fulfill this timeless duty. ●

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Note: The content in this article addressing potential compliance solutions is not a substitute for legal advice. Each advisory firm must tailor its own due diligence and other compliance procedures to the firm’s unique operations, business model and clients’ needs.

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ENDNOTES

1. The term “interim fiduciary rule” refers to the Impartial Conduct Standards element of the DOL fiduciary rule that went into effect on June 9, 2017. DOL has proposed the remainder of the rule that is scheduled to be applicable on January 1, 2018, to be extended by another 18 months.
2. Definition of the Term “Fiduciary,” Retirement Investment Advice, U.S. Department of Labor, 81 Fed. Reg. 20946 (April 8, 2016). An ERISA 3(21) fiduciary is typically an advisor that advises a plan sponsor on various aspects of administering a plan, with its primary role defined as assisting the plan sponsor in selecting designated investment options for the plan. A 3(38) fiduciary is an advisor with discretionary authority over managing plan assets. Delegation of this authority by the plan sponsor removes much of the plan sponsor’s fiduciary liability for the prudent selection and monitoring of investments.
3. See Duane Thompson, “To BIC or Not to BIC? That Is the Question as Fiduciary Deadline Approaches,” *Investments & Wealth Monitor* 31, no. 6 (November/December 2016): 51–52.
4. See “Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions,” Department of Labor (June 29, 2017), <https://www.dol.gov/sites/>

- [default/files/ebsa/temporary-postings/definition-of-the-term-fiduciary-request-for-information.pdf](https://www.dol.gov/sites/default/files/ebsa/temporary-postings/definition-of-the-term-fiduciary-request-for-information.pdf).
5. “Adviser” and “advisor” have two different meanings in this article. “Registered investment adviser” is a statutory reference to advisory firms registered with the SEC under the Investment Advisers Act of 1940 or, alternatively, with a state securities administrator. “Advisor” is a term used by *Investments & Wealth Monitor* to refer generically to an individual advising clients on securities investments and other property.
 6. See Robert Plaze, “Regulation of Investment Advisers,” U.S. Securities and Exchange Commission, at 50 (March 2013), https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.
 7. See “Best Interest Contract Exemption,” U.S. Department of Labor, 81 Fed. Reg. 21049 (April 8, 2016).
 8. See “Labor and IRS Could Improve the Rollover Process for Participants,” Government Accountability Office report 13-30 (April 3, 2013), <http://www.gao.gov/products/GAO-13-30>.
 9. See “FINRA and SEC to Focus on IRA Rollover Practices in 2014,” Morgan & Lewis law firm blog (February 6, 2014), https://www.morganlewis.com/pubs/eb_im_lf_finraandsecfocusonirarolloverpractices_06feb14#_ftn1.
 10. See “Best Interest Contract Exemption,” supra note 7, at 21011.
 11. “Conflict of Interest FAQs (Part-1 Exemptions),” at 9, Department of Labor, 10 (Oct. 27, 2016), <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf>.
 12. See “Best Interest Contact Exemption,” supra note 7, at 21035.
 13. Conflict of Interest FAQs, supra note 11, at 4.
 14. See “Cash Payments for Client Solicitations,” SEC rule 206(4)-3, [https://www.law.cornell.edu/cfr/text/17/275.206\(4\)-3](https://www.law.cornell.edu/cfr/text/17/275.206(4)-3).
 15. See, e.g., “Guggenheim Partners Investment Management, LLC,” SEC administrative proceeding (August 10, 2015), <https://www.sec.gov/litigation/admin/2015/ia-4163.pdf>.
 16. See the Enforcement Manual, Employee Benefits Security Administration, chapter 48, section 13, <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement/oe-manual/chapter-48>.
 17. See Michael Kitces, “How Some RIAs Sell Life Insurance Through a BGA Without a B/D,” Kitces.com (June 29, 2017), https://www.kitces.com/blog/annuity-ltc-life-insurance-license-fee-only-ria-bga-hybrid-broker-dealer/?utm_source=rss&utm_medium=rss&utm_campaign=annuity-ltc-life-insurance-license-fee-only-ria-bga-hybrid-broker-dealer&utm_source=Nerd%E2%80%99s+Eye+View+%7C+Kitces.com&utm_campaign=6048452df8-NEV_MAIL_CHIMP_LIST&utm_medium=email&utm_term=0_4c81298299-6048452df8-5703794.1.
 18. *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982).
 19. Restatement (Third) of Trusts, Section 90(c)(3).
 20. Ron Chernow, *Washington: A Life* (New York: Penguin Press, 2010), 100.