To BIC or Not to BIC? That is the Question as Fiduciary Deadline Approaches

By Duane R. Thompson, AIFA®

In April 6, 2016, the Department of Labor (DOL or Department) released the final conflict of interest rule, better known to advisors as the fiduciary rule. The rule’s core provisions—the greatly expanded definition of a sec. 3(21) fiduciary and its related exemptions such as the Best Interest Contract Exemption (BICE or BIC Exemption)—go into effect April 10, 2017. For thousands of securities brokers and insurance producers, April 10, 2017, marks the first time they will operate under a professional standard of conduct often referred to by the courts as “the highest known to law.”

This article provides a snapshot of the current state of affairs as the financial services industry prepares for the April 10, 2017, compliance date. The author reviews industry preparation, estimates of market impact at this stage of the implementation process, advisor attitudes, recent DOL guidance, and ongoing efforts by trade groups to derail the pending rule in Congress and the courts.

Background

Advisors registered under the Investment Advisers Act of 1940 or state law generally are permitted to rely on disclosure as the primary mechanism to manage conflicts of interest, so long as the client is able to make an informed decision following notification. In contrast, the Employee Retirement Income Security Act of 1974 (ERISA) requires fiduciaries to avoid conflicts unless a prohibited transaction exemption (PTE) is available for a specific activity. Under the law, ERISA fiduciaries are tasked with acting solely in the interest of the plan participants and their beneficiaries, and with the exclusive purpose of providing them with benefits. Notwithstanding the more prophylactic restrictions under ERISA, the DOL is authorized by law to create limited exemptions for service providers, including financial advisors, so providers may receive reasonable compensation for their services.

Over the intervening decades since ERISA was enacted, many observers have noted the much higher duty of loyalty required of ERISA fiduciaries, but it wasn’t until 2010 that the Department determined to streamline the decades-old, five-part definition of an investment fiduciary in order to capture thousands of previously exempt brokers and insurance producers. The DOL said the update was needed given the shift in the retirement market from professionally managed pension plans to participant-directed plans. The result of that trend, according to industry participants, many veteran observers say it is one of the most controversial changes to the DOL’s fiduciary rule.

The rulemaking process was lengthy and the resulting debate extended over a six-year period. Given the significant financial stakes for industry participants, many veteran observers say it is one of the most controversial rules ever promulgated under ERISA. The industry responded with heavy lobbying of Congress that pressured the DOL to withdraw the proposal in 2011 before a revised proposal was re-introduced in 2015. The new version was even less palatable to industry critics than the original. In apparent response to defections within his own party, President Barack Obama personally announced his support for the rule in a televised news conference at the Washington headquarters of AARP, one of the most powerful lobbying groups for seniors. After that message got through, Democrats stopped defecting in committee or floor votes, ultimately leaving the GOP without a majority to override a presidential veto.

The final version of the fiduciary rule retains the core features of the 2015 proposal, but it eliminates some of the more onerous recordkeeping requirements and a prohibition on the use of riskier investment products in retirement accounts. It also adds almost a year of additional time for full compliance with the revised definition and the existing PTEs, including the level-fee exemption. An additional eight months on top of that are added for full compliance with the BICE and the principal transaction exemption. Both exemptions are the newest and most complex of the rule’s safe harbors for prohibited transactions. One other important and controversial change was moving indexed annuities from the PTE 84-24 safe harbor to BICE.

Industry Preparation Underway

Seven months into the transition period, firms report spending millions of dollars in fiduciary training, legal costs, and new tools to adapt to the new rule. A handful of the largest firms also have announced plans of how they will comply.

Who’s In, Who’s Out

Even before the final rule was released, two major firms announced they were leaving the brokerage industry as a result. In late January 2016, AIG announced the sale of its broker–dealer unit to a private equity firm, citing the DOL rule as part of its decision to sell. In February, MetLife...
announced it was selling its brokerage subsidiary of 4,000 financial advisors to Mass Mutual. However, both also had been designated as systemically important financial institutions (SIFI) by the Financial Stability Oversight Council and were divesting subsidiaries in an effort to be rid of the SIFI designation.

LPL was the first of the large broker–dealers to announce changes in response to the DOL rule. LPL said it was lowering its account minimums from $15,000 to $10,000 and introducing a more streamlined individual retirement account (IRA) menu.

An industry research firm reinforced concerns over the safe harbors for commissions and other variable compensation by declaring that broker–dealers owned by insurance companies were at the “greatest risk” of running afoul of the rule because brokerage houses often were used as distribution outlets for proprietary products. With the exception of State Farm, however, insurance companies have not yet revealed their plans. In a related development, independent marketing organizations (IMOs), which serve as a major distribution channel for insurance companies selling equity indexed annuities, are seeking status under the rule as financial institutions. This would enable them to provide fiduciary investment advice under BICE and clear up any questions over IMO regulatory status.

More recently a number of conventional brokerage firms have diverged significantly in their decisions to either rely on the BIC Exemption or avoid it entirely.

In mid-August, Edward Jones was reported to be planning to curtail mutual fund access within brokerage accounts due to the complicated share structures. It also will require $100,000 account minimums, the Wall Street Journal reported. Account holders will be able to buy stocks, bonds, variable annuities, and certificates of deposit, but not mutual funds or exchange-traded funds, according to the Journal.

Several weeks later, State Farm announced that next year it will sell mutual funds and variable products only through a self-directed call center, and not through its 12,000 agents who currently are licensed to do so.

Even bigger news followed in early October when Merrill Lynch became the first major Wall Street firm to announce its plans. Merrill’s 14,000 brokers, it said, no longer would open commission-based retirement accounts after next April, although they could service pre-existing accounts under a special grandfathering provision in the rule. Independent broker–dealer Commonwealth Financial followed suit a few weeks later.

However, Morgan Stanley, Ameriprise, Raymond James, and several others opted for BICE a few weeks later when the companies said they would continue to offer a choice of retirement accounts to their customers.

“We believe our advisers can most effectively uphold a fiduciary standard of care and work in clients’ best interests by continuing to offer choice,” stated a news release from Morgan Stanley.

In an October 26 conference call with investors, Ameriprise Chief Executive Officer and Chairman Jim Cracchiolo stressed the need to support its advisors. “Implementing and executing against the BICE does require the firm to put more resources to ensure there is a greater level of support, compliance, changes to products and platforms for the advisers and their training,” Cracchiolo said.

Market Impact
In the meantime, Morningstar analysts predict that discount brokerages such as Schwab and TD Ameritrade, along with robo-advisors, would grab a larger share of the low-balance individual retirement accounts (IRAs) that critics of the rule said would be abandoned due to the rule’s higher costs.

More actively managed investment products also would suffer, according to Morningstar. Morningstar said exchange-traded fund product sponsors such as BlackRock, State Street, and Vanguard would gain market share. Upwards of $1 trillion, or one-third of IRA assets, could move into passive investments, according to Morningstar’s analysis. Conversely, outflows would increase from complex products and annuity sales would decrease.

Another research firm, Cerulli Associates, predicts that up to one-half of future IRA rollovers may stay in-plan because rollover and distribution advice would be a fiduciary act under the rule. However, the firm added that the lack of draw-down strategies in plans “will assure a continued migration of some retirement savings to IRAs.”

Morningstar itself is planning to roll out an automated 401(k) plan advisory tool that provides so-called “3(38) services” to small plan sponsors—industry jargon for the plan sponsor outsourcing investment management of plan menus. However, a spokesperson for Morningstar noted that many wealth managers advising small plans will be reluctant to drop them. These firms believe that although the plans aren’t profit drivers, they are worth retaining to retain the plan sponsors, who typically are also high-net-worth retail clients of these advisors.

Advisor Attitudes
A survey in late September 2016, of a limited pool of IMCA members about the fiduciary rule suggests a wide range of opinions over how it will impact their business models. Not surprisingly, a majority believe it will increase the time they allocate to compliance and new due diligence procedures. Twenty-three percent of the 31 respondents said their qualified plan business would grow over the next five years and another 23 percent said their business would shrink (see figure 1). Another 29 percent said it would not affect their plan business. Thirteen percent had no opinion and another 13 percent said the rule was not applicable to their business model.

Fifty-seven percent said they were only marginally impacted by the rule, presumably because they will not rely heavily on the BICE; another 48 percent in primarily
fee-based advisory firms said they were fully prepared for compliance.

Which exemption is best? The majority (58 percent) of respondents expect to use the level-fee exemption available under the rule, followed by the BIC Exemption at 42 percent (see figure 2). Only a handful expect to rely on BICE for the sale of proprietary products and one expects to use the principal transactions exemption for the sale of fixed-income products held in the firm’s own inventory. Not surprisingly, most expect the new compliance requirements to increase their workload, with nearly two-thirds estimating additional time spent on rule compliance of 6 percent to 20 percent in a typical work week. Sixty-one percent said their due diligence procedures for rollover advice will increase significantly. IMCA is expanding the survey to include all members and will post results on its website.

Are advisors too optimistic? Another recent survey of registered investment advisors—this one by the Massachusetts state securities regulator of 300 registered investment advisors—suggests that although most advisors oversee retirement accounts of their clients, they are ill-prepared to comply with the new rule. According to the survey, 61 percent believe the rule will have little or no impact on their practices; one-fifth of respondents were unsure and 17 percent predicted a modest or significant impact. In contrast, the Massachusetts Securities Division has stated that it believes the majority of registrants will need to take several steps to become compliant even if they are already fiduciaries under securities laws. Massachusetts’ Secretary of the Commonwealth William Galvin said that “the survey results demonstrate a need for training, which this office will be providing for free to investment advisers providing retirement advice.”

DOL Rule Guidance
The first of three FAQs on the rule was released October 27, 2016, by the DOL. Widely anticipated by industry participants, the 34 questions-and-answers fill in some of the gray areas that the initial thousand-page release did not cover. The other two FAQs are expected to be released before the end of 2016.

In particular, the first FAQ addresses the impact of the rule on broker–dealer pay grids for registered representatives as well as the payment of recruitment bonuses executed prior to the October 2016 guidance. In its most basic form, the Department reiterated the BICE requirements to avoid incentivizing advisors to make recommendations that are in conflict with the investors’ best interests and encouraged firms to “carefully consider the amounts used as the basis for calculating adviser compensation.”

Figure 1: IMCA DOL Fiduciary Rule Preparedness Survey—Question 5

Q5: As a result of the DOL Rule (and excluding market conditions), do you anticipate the plan side of your business will grow or shrink over the next five years?

Grow 22.58% 7 Responses
Shrink 22.58% 7 Responses
DOL will not affect my plan business 29.03% 9 Responses
No opinion 12.90% 4 Responses
Not applicable to my practice 12.90% 4 Responses

Figure 2: IMCA DOL Fiduciary Rule Preparedness Survey—Question 7

Q7: Select as many ERISA exemptions below that you believe you may rely on when the DOL Rule goes into effect next year

Best interest contract exemption 41.94% 13 Responses
Best interest contract exemption for proprietary product transactions 16.13% 5 Responses
Level-fee exemption 58.06% 18 Responses
Principal transactions exemption 3.23% 1 Response
Unsure 29.03% 9 Responses
None 9.68% 3 Responses
The FAQ also clarifies that advisors holding discretion over a client’s account before and after a rollover transaction are not prohibited from using the level-fee exemption unless they hold discretion over the actual rollover.19 Most advisors do not, so the vast majority are unlikely to be prevented from using the streamlined exemption. Moreover, the Department will not automatically exclude advisors from the level-fee safe harbor in making a rollover recommendation if they are not able to obtain plan expenses and other information directly from the plan as part of their due diligence. However, if the firm is unable to obtain the necessary information or the participant is unwilling to provide it, firms and their advisors are permitted to rely on alternative sources such as the most recent Form 5500 or reliable benchmarks.20

Regulators nonetheless continue to express concerns about whether the pension-advice industry is ready for April 10, 2017. In addition to the previously mentioned concerns by Massachusetts Secretary Galvin, the DOL repeatedly has invited industry groups to submit their compliance questions.

“Our main goal in the near term is going to be to help people get to compliance,” said Timothy Hauser, DOL deputy assistant secretary of program operations, at an industry conference in September 2016. “Honestly, we think by April 2017, the industry should be in a position where it can be prudent, loyal, not charge more than reasonable compensation, and be honest. We don’t think that’s a huge ask.”21

**Roadblocks to DOL Implementation**

After its release in April 2016, the fiduciary rule survived an override vote of a presidential veto of legislation that would have killed the initiative. Although legislation was introduced in the Republican-controlled House this fall to repeal the rule as well as most of the Dodd-Frank Wall Street Reform and Consumer Protection Act, it would face the same veto threat. A fiscal year 2017 appropriation for the DOL also is pending, and a legislative amendment to the appropriation would block funding for implementation of the rule. However, like a similar effort last year, the amendment is expected to fail when Congress reconvenes after the 2016 election to consider a final budget.

A half-dozen lawsuits filed by industry groups to overturn the rule or portions of it are pending in federal courts around the country. Several hearings already had been held as of press time, and another is scheduled on November 17, 2016. One of the lawsuits, filed in the D.C. district court, was dismissed November 4.22 Most observers believe these lawsuits are unlikely to succeed.

Success in court by opponents, however, would create dilemmas for major firms in the midst of planning for April 10, 2017. Merrill Lynch and Commonwealth are making significant moves away from commission-based retirement accounts in the new fiduciary environment. Do they continue to press forward and risk losing an important account option for their customers? Similarly, do the firms such as Morgan Stanley and Raymond James that plan to use the BICE continue to move forward anyway with the new compliance systems if the rule is overturned, or put everything on hold until a final court decision?

**What’s Next?**

Barring any judicial surprises, the bulk of the rule goes into effect on April 10, 2017, with the BICE and principal transactions exemption fully in effect on January 1, 2018.

The rule has received little attention during the presidential campaign and Wall Street was conspicuously absent during the three presidential debates. Former Secretary of State Hillary Clinton, the Democratic nominee, is on record supporting the DOL rule.23 She likely would continue the same implementation schedule as the Obama administration. Similarly, Wall Street foes Sen. Elizabeth Warren (D-MA) and Sen. Bernie Sanders (I-VT) will monitor Clinton’s political appointments if she wins, and would object strongly to any slowdown or new exemptions under the DOL rule that would dilute investor protection.

Although the Republican nominee, Donald Trump, has not taken a formal position on the rule, a campaign aide said the fiduciary rule should be overturned.24 Trump has said that in general he would “cut regulations massively” and put a moratorium on new agency rules.

In the meantime, many of the service providers to the firms impacted by the rule are scrambling to see where the chips may fall in terms of changes to business models and investment products. Some service vendors, for example, are expected to come out with new benchmarks measuring the cost of investment advice and other services to IRA accounts; investment and annuity product vendors are reviewing ways to simplify and perhaps reduce the share classes and assortment of other revenue-sharing costs that could create compliance problems under the new rule.

Duane Thompson, AIFA®, is president of Potomac Strategies, LLC, a public policy consulting firm in Kensington, Maryland; he previously was managing director of the Financial Planning Association’s Washington office. He earned a BA in history and studio art from Principia College and a master’s degree in journalism from the University of Missouri. Contact him at dthompson@potomacstrategiesllc.com.

**Endnotes**

1. A section 3(21) ERISA fiduciary is an advisor who does not hold discretion over plan assets.
2. See, e.g., “The fiduciary obligations of the trustees to the participants and beneficiaries of the plan are those

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of trustees of an express trust—the highest known to the law.” Restatement of Trusts 2d § 2, (1959). See also Donovan v. Blenworth, 680 F.2d 263, 272 (2d Cir. 1982).

3. The instructions to Form ADV, the primary disclosure document used by registered investment advisors, state that “[a]s a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest … that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest … and can give informed consent to such conflicts or practices or reject them.” General Instructions for Part 2 of Form ADV, at 2, https://www.sec.gov/about/forms/form_adv-part2.pdf.


5. See, e.g., Cyril Tuohy, “6 IMOs Apply for ‘Financial


18. Id., at 7.


28. Id., at 7.

29. Id., at 6.


31. Mark Schoeff, Jr., “‘DOL official downplays advisors’ lawsuit fears stemming from fiduciary rule,” InvestmentNews (September 16, 2016), http://www.investmentnews.com/article/20160916/


34. Id., at 7.

35. Id., at 6.