

The U.S. Department of Labor's ("DOL") proposed rules to address conflicts of interest in retirement investment advice have been the subject of intense debate since publication in April 2015.¹ At present, multiple legislative proposals are being considered that could possibly defer, modify, or derail the release of final rules, and statutorily mandated, though potentially competing, regulations are being drafted by another federal regulator – the Securities and Exchange Commission ("SEC"). No matter the outcome, the industry must take notice that heightened attention is being directed toward retail investment products and services generally, and retirement accounts in particular, and that regulators are keenly focused on customer treatment and customer outcomes, as well as on each firm's efforts to place the best interest of customers at the heart of their business strategies.

In summary: The DOL's proposed rules would **redefine who is a "fiduciary"** of an employee benefit plan under the Employee Retirement Income Security Act ("ERISA") as a result of giving investment advice to a plan or its participants or beneficiaries. The proposals would also apply to the definition of a "fiduciary" of a plan, including an individual retirement account ("IRA"), under Section 4975 of the Internal Revenue Code. As proposed, persons who receive compensation for providing investment advice that is individualized or specifically directed to an employee benefit plan, a plan fiduciary, a plan participant or beneficiary, or an IRA or IRA owner, for consideration in making a retirement investment decision would be deemed a fiduciary. The fiduciary could be a broker, registered investment adviser, insurance agent, or other type of adviser (collectively, "adviser"), and may or may not be subject to the federal securities laws. The adviser would be required to provide impartial advice that is in the best interest of their customer and would be prohibited from accepting any payments creating conflicts of interest unless they qualify for an exemption intended to assure that the customer is adequately protected.

Exemptions provided by the proposals include:

- The **Best Interest Contract Exemption (BICE)**, which would require potential clients to enter into a contract with the company and the individual adviser providing retirement investment advice before any financial topics are discussed. In the contract, the firm and the adviser would be required to:
 - Commit to a best interest standard that requires them to put the client's best interest first and to avoid misleading statements about fees and conflicts of interest.
 - Warrant that the firm has identified material conflicts of interest and compensation structures that could encourage advisers to make recommendations that are not in a client's best interest, and has adopted measures to mitigate harmful impacts from those conflicts of interest.
 - Clearly disclose any conflicts of interest, provide a statement about all fees, and provide information on whether the financial institution offers any proprietary products or receives any third-party payments with respect to any underlying investments.

¹ "Definition of the term 'Fiduciary'; Conflict of Interest Rule – Retirement Investment Advice, Notice of proposed rulemaking," 80 FR 21927 (April 20, 2015). Concurrently, the DOL released proposed rules for two prohibited transactions exemptions ("Best Interest Contract Exemptions; Notice of proposed class exemption," 80 FR 21960 (April 20, 2015) and "Principal Transactions in Certain Debt Securities between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs; Notice of proposed class exemption," 80 FR 21989 (April 20, 2015), as well as additional proposed amendments to several existing class exemptions (80 FR 22004-22042, April 20, 2015).

Certain “common forms of compensation,” such as commissions and revenue sharing, would continue to be permissible under the BICE exemption. Variable annuities (“VAs”), as well as other contracts considered securities under federal law would be prohibited unless the client signs a qualifying BICE contract.

- The **Principal Transactions Exemption**, which would allow advisers to recommend certain fixed-income securities and sell them to an investor directly from the adviser's own inventory (i.e., a “principal transaction”), provided the adviser adheres to the exemption's consumer-protection conditions. The exemption would apply to transactions with investors that are fiduciaries of non-participant-directed ERISA-covered plans, participants or beneficiaries with authority to direct the investments in their accounts, and IRA owners. In addition, the proposed rules include modifications to several existing class exemptions commonly relied on by advisers and financial institutions.

For purposes of the proposed rules, “retirement investment advice” would not include: general education information and/or materials on retirement savings and investments; “order-taking” activities; or, statements or recommendations made to fiduciaries of large plans who themselves are fiduciaries and have control over the management of plan assets.

Potential implications: Critics of the proposed rules have argued that they would limit customer access to quality guidance and guaranteed lifetime income products due to increased costs from investment advice fees that many consumers will be unable or unwilling to bear as well as increased costs for the industry participants providing retirement investment advice. Opponents have also argued that the proposed rules would curtail access to investment advice for investors with modest assets, since these consumers may not be able to afford higher investment advice fees. The industry is concerned the proposals would significantly raise liability risk and regulatory costs for insurance companies as a whole as well as their brokers and agents, making advice more expensive to give and for consumers to receive.

The **insurance industry should anticipate** the DOL proposed rules would impact:

- **Variable annuity writers:** The industry has expressed concern that many VA purchasers might not have sufficient liquidity to buy this product, which is considered a “high-ticket” item, outside of their qualified retirement savings. As such, the proposed rules might result in: 1) lower VA sales industry-wide; 2) manufacturers lowering fees and/or improving guarantees in order to improve the value proposition of the VA product; 3) a restructuring of existing commission structures; and 4) product providers attempting to pivot from VAs to other types of annuities (e.g., indexed products) that appear to be treated differently under the proposals.
- **Retirement plan administrators:** Retirement plan administrators might expect pressures largely related to: 1) potentially increased compliance costs and disclosures; and 2) added difficulty in providing advice to plan participants and soliciting rollover business.
- **Proprietary product offerings:** The process by which insurance companies offer proprietary mutual funds in their retirement plan products through a sales intermediary could be adversely impacted. BICE requires a diversification of offerings so this could potentially prohibit insurance agents from placing retirement plan assets in proprietary funds thus reducing a primary revenue source from the agency distribution channel. This could cause these insurance companies to change/expand how they market and distribute their proprietary products.

All advisers should anticipate that the DOL proposed rules could significantly impact existing IT, compliance, and operations functions:

- **Fragmented system and account architecture, increased IT costs:** The proposed rules only apply to retirement accounts and could therefore result in firms needing to implement separate technology, compliance and accounting solutions for these types of accounts. Furthermore, firms may need to design systems that permit aggregation and

surveillance of products by account in order to ensure that investment professionals provide advice on permissible products only, and that sufficient records are kept.

- **Increased compliance costs and responsibilities for agency transactions:** Because of enhanced requirements applied to discretionary IRA accounts, firms would be required to enhance existing or build new surveillance programs to identify and monitor for impermissible activities within these accounts. Similarly, compliance procedures would need to be designed and performed to ensure pre-trade review of advice and trades in advance of any applicable transaction. Additionally, in order to comply with proposed carve-outs, marketing materials would need to be amended, reviewed, and monitored. And, financial advisers/sales force staff as well as compliance and legal professionals would likely require new and additional training.
- **Disclosure requirements may be unworkable:** BICE would require advisers to make both annual and point-of-sale disclosures which could be difficult to operationalize because of the short time frame under which such disclosures would be required to be provided (e.g., 45 days after year-end). The industry has anticipated issues in sourcing data required to make certain new required disclosures (e.g., calculating and attributing direct/indirect fees earned to individual investors and transactions), which could result in a lack of timeliness, as well as in developing a calculation methodology.
- **Certain customer service and marketing models may prove unworkable:** Call centers staffed by registered employees who provide customers with specific guidance may be unworkable (or, at least, limited to providing generic advice), unless the investment professional, firm, and customer enter into a multi-party agreement prior to any investment advice being provided. Additionally, asset managers who market their funds through third-parties may be unintentionally considered "fiduciaries" under the rule, even for investors with whom they do not transact directly. This may affect how such products are distributed, the manner in which intermediaries are used, and the types of services (e.g., model portfolio and other investment analytics) that would be offered in the future.
- **Compensation structures may require reconfiguration:** Fund distributors may react by: 1) shifting from commission-based to fee-based revenue models; and/or 2) adjusting existing commission structures (e.g., leveling across products) to try to recoup a portion of the lost revenue.
- **In some cases, a moderate impact to asset managers already acting as fiduciaries:** Since asset management divisions of banks and SEC registered investment advisers ("RIAs") are already being held to a "fiduciary" standard through the Investment Advisers Act and regulation 12 CFR 9, the proposed rules are likely to have a moderate impact for these advisers. The principal impact to RIAs who create mutual funds (the primary investment product offerings in the retirement plan space) would fall on the distribution agreements and fee arrangements between fund sponsors and fund distributors of (e.g., broker/dealers, insurance companies, plan administrators). RIAs that are the sponsors of funds offered in retirement plans would need to modify their distribution agreements whereby the broker/dealers move away from loads and commissions and gravitate toward asset-based fee arrangements directly with their retirement plan clients.
- **Short window for compliance:** As proposed, the rules would become effective 60 days after publication in the Federal Register, and the requirements would be applicable eight months after such publication. Advisers may find this to be an aggressive timeframe to complete employee training, enhance existing and/or build new compliance and IT systems, revise policies and procedures, and re-document customer agreements, among other operational tasks.

All advisers should also consider that, to the regulators, compliance with the spirit of the rules, which are focused on **customer protection, will be equally as important as compliance with the specific provisions.** As such, regulators will look broadly to assess advisers' efforts to provide retirement investment advice that is in the best interest of the customer, including areas such as:

- Conducting due diligence on investment options to develop an understanding of the complexity and risks associated with an investment, and ensuring that an investment recommendation is appropriate for a customer based on the customer's investment profile.
- Identifying, mitigating, and disclosing risks associated with conflicts of interest, including compensation structures and/or sales practices that may incentivize recommendations that might not be in the best interest of the customer.
- Assuring disclosures made directly to investors as well as in brochures, sales, and marketing materials are complete and accurate and do not deceive or mislead, including disclosures of conflicts of interest, product risks, and fees.

Congressional response to DOL rulemaking: On October 27, 2015, the House of Representatives passed H.R. 1090, the Retail Investor Protection Act, which would prevent the DOL from finalizing its proposed rules until the SEC issues a final rule governing standards of conduct for brokers and dealers.² The bill has been referred to the Senate though no action has yet been taken, and separately, the Administration has stated its opposition to the bill.³ Two additional and related bills were introduced in the House of Representatives in December 2015, which, as introduced, would prohibit a final version of the DOL's proposed rules from becoming effective until approved by a vote of Congress. If Congress were not to approve the DOL's final rules, the provisions of the two bills would then be enacted. These bills have been referred to committees in the House, though no action has yet been taken.⁴

Corresponding steps to set a uniform fiduciary standard: The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") gave the SEC⁵ authority to promulgate a rule that would require all retail investment advice to be in the best interest of the client (i.e., to establish a fiduciary duty for brokers and dealers consistent with the standard of conduct applicable to an investment adviser under the Investment Advisers Act – generally referred to as a "uniform fiduciary standard".⁶) In the five years since the Dodd-Frank Act was enacted, the SEC has been criticized for not making discernible progress in this area. Speaking at the SIFMA annual meeting on November 10, 2015, SEC Chair Mary Jo White, stated that the agency's staff is focused on writing the rule, noting the SEC is challenged to draft a fiduciary rule that "raises the bar of compliance [but] does not have unintended consequences."⁷ A proposed rule is anticipated to be released in the fourth quarter of 2016⁸ and would be applicable to more than retirement investment advice.

² <https://www.congress.gov/bill/114th-congress/house-bill/1090>.

³ See https://www.whitehouse.gov/sites/default/files/omb/legislative/sap/114/saphr1090r_20151026.pdf

⁴ H.R. 4293, the Affordable Retirement Advice Protection Act, and H.R. 4294, the Strengthening Access to Valuable Education and Retirement Support Act of 2015, were introduced in the House of Representatives on December 18, 2015. The bills would amend ERISA and the Internal Revenue Code, respectively, to ensure that retirement investors receive advice in their best interests, and for other purposes. See <https://www.congress.gov/bill/114th-congress/house-bill/4293/actions> and <https://www.congress.gov/bill/114th-congress/house-bill/4294/actions>

⁵ See Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

⁶ SIFMA and other industry participants have advocated a best-interests of the customer standard for Broker-Dealers which would: (i) apply across all investment recommendations made to individual retail customers in all brokerage accounts (and not just be limited to IRA accounts); serve as a benchmark for, and be consistent with, the SEC uniform fiduciary standard that emerges under the Dodd-Frank Act § 913; (iii) provide interim, strong, substantive, "best interests" protections for retail customers; and (iv) follow the traditional securities regulatory approach of establishing a rules-based standard, including disclosure, coupled with examination, oversight, and enforcement by the SEC, FINRA and state securities regulators (and include a private right of action for investors). See, SIFMA "Proposed Best Interests of the Customer Standard for Broker-Dealers" June 2015.

⁷ "SEC 'Flat-Out Doing' a Fiduciary Rule: Chief White", Think Advisor, November 10, 2015. <http://www.thinkadvisor.com/2015/11/10/sec-flat-out-doing-a-fiduciary-rule-chief-white>

⁸ Agency Rule List as published by the Office of Management and Budget, Fall 2015.

http://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235

In June 2015, the SEC's Office of Compliance Inspections and Examinations ("OCIE") announced the launch of a multi-year Retirement-Targeted Industry Reviews and Examinations ("ReTIRE) initiative. Under ReTIRE, the SEC will conduct examinations of SEC-registered investment advisers and broker-dealers focused on "certain higher-risk areas of [their] sales, investment, and oversight processes, with particular emphasis on select areas where retail investors saving for retirement may be harmed." The examinations will primarily focus on: reasonable basis for recommendations; conflicts of interest; supervision and compliance controls; and marketing and disclosure.⁹ Separately, in August 2015, the Financial Industry Regulatory Authority ("FINRA") announced the launch of a targeted examination of firms' processes to identify, mitigate, and manage conflicts of interest, especially with regard to compensation practices. This review is expected to be completed during 2016; the management of conflicts of interest and its relationship to culture and ethics will be one of FINRA's supervisory focus areas in 2016.¹⁰

Closing Considerations: The financial services industry as a whole is engaged in an effort to rebuild public trust through improvements to culture and conduct. The goal, a "good culture," is marked by specific values - integrity, trust, and respect for the law - carried out in the spirit of a fiduciary-type duty toward customers (placing the best interest of customers at the heart of the business model) and a social responsibility toward maintaining market integrity. The DOL proposed rules and the uniform fiduciary standard authorized by the Dodd-Frank Act are each examples of regulatory standards that would support this goal and, despite the controversy and debate surrounding each of the rules, the consistent theme between the DOL and SEC is customer/investor protection and ensuring that customers: are treated fairly; receive investment advice that is appropriate to their investment profile; are not harmed or disadvantaged by complexities in the investments markets; and, are provided with clear, plain English descriptions of the benefits, risks, and costs of recommended investments.

It is important for advisers not to be distracted by whether the DOL proposed rules will be finalized in their current form, or diminished in some way, or perhaps not finalized at all - but rather to recognize that change is coming to the retail investments industry and, eventually, most advisers will likely be expected to provide advice to their customers subject to a fiduciary standard. In anticipation of this change, advisers are encouraged to review their current practices, including product offerings, commission structures, and policies and procedures to assess compliance with the current guidance (including "suitability standards" for broker/dealers, and fiduciary standards for investment advisers, as appropriate) as well as to identify possible adjustments that might be needed to comply with the DOL rules as proposed. Such a review should consider a reassessment of business line offerings, and product and service strategies.

⁹ See SEC National Exam Program Risk Alert, Volume IV, Issue 6, June 22, 2015. <https://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf>

¹⁰ See FINRA 2016 Regulatory and Examination Priorities, January 5, 2016, http://www.finra.org/sites/default/files/2016-regulatory-and-examination-priorities-letter.pdf?utm_source=MM&utm_medium=email&utm_campaign=NewsRelease%5F010516%5FFINAL

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