THE EXCELLENT FIDUCIARY

Six Steps to Complying with the New Conflict of Interest Rule

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OBJECTIVE OF THE CONFLICT OF INTEREST RULE

ERISA safeguards retirement plan participants by imposing legal standards of care on plan fiduciaries, and by holding fiduciaries accountable when they breach those obligations. In addition, fiduciaries to plans and IRAs are not permitted to engage in "prohibited transactions," which pose special dangers to the security of retirement, health, and other benefit plans because of fiduciaries' conflicts of interest with respect to those transactions. Under this regulatory structure, fiduciary status and responsibilities are central to protecting the public interest in the integrity of retirement and other important benefits, many of which are tax-favored.

In order to protect the interests of the plan participants and beneficiaries, IRA owners, and plan fiduciaries, there is a specific provision in the new Conflict of Interest Rule (the "Rule") named the "Best Interest Contract Exemption." It requires a service provider that delivers investment advice to acknowledge fiduciary status for itself and any of its representatives that provide such advice. The provider and its advisor representatives must adhere to basic standards of impartial conduct. That translates to advice that:

1. Is **prudent**, meaning serving the client's best interest,
2. Is **devoid of misleading statements**, and
3. Carries a **reasonable fee** (we'll address fee reasonableness a bit later in the article).

In addition, the Rule requires that investment advice vendors:

1. Adopt procedures that **reduce possible negative effects** of their conflicts of interest,
2. Fully disclose information about their **conflicts of interest**, and
3. Provide transparent information about the **cost of their advice**.

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PLAN SPONSORS GET A TOUGH ASSIGNMENT

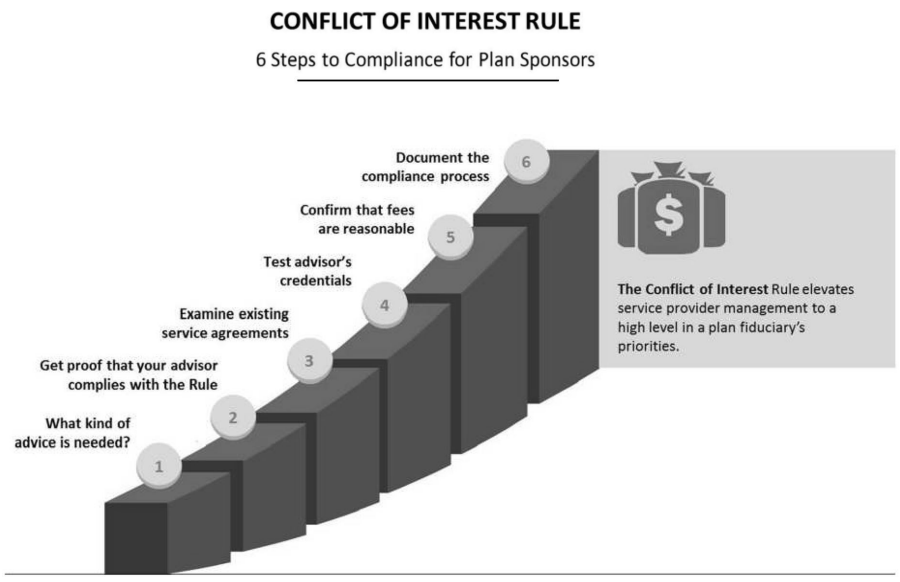
Retirement plans qualified under ERISA stand to incur negative consequences if their plans' service providers fail to comply with the Rule. For that reason, plan fiduciaries have a tough assignment, as the relationship between plan fiduciaries (i.e., the buyers) and service providers (i.e., the sellers) historically has been dominated by the providers. Many plan fiduciaries are not accustomed to testing the regulatory compliance status of their vendors. But that is about to change.

The proliferation of certification and accreditation programs available to vendors, most of which fail to comment on vendors' regulatory status, add a veil of authenticity to a service provider's claims that may not be relevant to the Rule's requirements. Although the responsibility to verify a vendor's regulatory status is a challenge for plan fiduciaries, a six-step approach can eliminate the guesswork and streamline the work involved.

SIX STEPS TO COMPLIANCE WITH THE CONFLICT OF INTEREST RULE

As retirement plan fiduciaries move into the next generation of ERISA's vendor management mandates, organizations will increasingly turn to the use of procurement methods that their organizations have traditionally applied to the selection of vendors of raw materials and core business services. With the U.S. Department of Labor's ("DOL") intent to elevate service provider management to a high level in a plan fiduciary's priorities, the skills needed to adequately perform that task will grow with more and more retirement plans maximizing their outcomes.

In order to ensure a smooth transition into the compliance environment as dictated by the Rule, plan fiduciaries must appropriately assess their vendors and evaluate the degree to which they add to their plans' regulatory risk. The basic principles of vendor assessment apply to vendors of services to ERISA plans, but the emphasis must be placed on understanding where sensitivities under the Rule exist and on how each vendor aligns with their obligations under the Rule.



The steps outlined in the image above map a plan sponsor's pathway to compliance:

1. **Determine the investment advice needs of the plan's fiduciaries, participants, and beneficiaries.** Each of these groups requires different types of investment advice, so the plan and related service provider agreements should outline strategies for accommodating each audience. Participants' and beneficiaries' needs are based primarily on outcomes—determined by the thousands of mutual fund options comprised in a retirement plan. Investment advice and communications, then, should be structured in a way that allows beneficiaries to easily evaluate a large universe of options. Fiduciaries, on the other hand, need investment advice that is clearly generated through an ERISA-qualified approach. In this case, prudence (rather than performance alone) is central to the investment advice needed for fiduciaries to oversee and execute their plans in accordance with ERISA. The key takeaway of this step is the importance of selecting money managers not necessarily based on highest performance history, but because they conduct themselves in in a demonstrable, prudent manner that aligns with the new ERISA rule and the various needs of the plan's stakeholders.

2. **Evaluate which of the plan's current vendors are investment advice providers as defined by the Rule.** According to the new Rule, investment advice providers must satisfy a list of requirements in order to ensure they are not in breach of the regulation. While investment advice providers have an obligation to meet certain requirements under the Rule, there is currently no standard by which vendors can prove their adherence to these requirements. Hence, this evaluation burden is placed on the plan sponsor. The consequence of dealing with a provider that does not meet these requirements is a prohibited transaction that is associated with serious penalties. Seeking an independent third party experienced in vetting vendors against ERISA standards may be a worthwhile investment for plan sponsors who are concerned about their vendors' status under the Rule.

3. **Examine the vendors' service agreements with the plan.** Every retirement plan should have a written service agreement with each of its vendors to help clarify (for both the vendor and plan sponsor) the vendor's role, responsibilities, and expectations. The new Rule now all but requires that all vendor relationships have a service agreement. Plan sponsors should ensure that the representations, warranties, and commitments to service that appear in this document align with the vendor's stated service offerings and approach.

4. **Test whether vendors' credentials verify their compliance with the Rule.** Unlike professions such as medicine and law, investment advisors do not have stated education or training prerequisites they must complete in order to become practitioners. There is no uniform knowledge base that all investment advisors must obtain prior to serving clients in this field, and there is no association that vets the investment advisor denomination as a whole. As a

result, investment advisors may brandish a logo and a website, and gain trust with plan sponsors without the necessary experience to qualify them as a trusted fiduciary partner. Plan sponsors must be wary of advisors touting credentials that speak to their qualifications in this field, as there currently is not an established institution that issues certifications for this type of advisor. It is important for plan sponsors to create a methodology for assessing advisors' competence that does not rely solely on the presentation of such credentials. If investment advisors are, in fact, not qualified to serve in this role and are in violation of the Rule, plan sponsors are ultimately held liable for their vendors' missteps.

5. **Determine if each vendor's compensation is reasonable.** In 2012, the DOL released a rule mandating that plan sponsors evaluate each of their advisor's fees not just based on general benchmarking against the industry, but specifically based on the individual vendor's services rendered in order to determine whether the fees are "reasonable." The new Conflict of Interest Rule takes this fee vetting to the next level, as it requires that investment advisors themselves determine whether their fees are reasonable. When a plan sponsor is looking to evaluate fee reasonableness with their vendors, the key is to evaluate the quality of an individual vendor's services against their fee. Tools like the Vendor Value Index can be helpful to plan sponsors who want to make this process more quantitative.

6. **Document the steps taken in the compliance process.** Currently, there is no statutory compliance process that plan sponsors are required to follow under the new Rule. However, based on the DOL's history in breach of fiduciary duty cases, documentation is critical to have for plan sponsors accused of mishandling their fiduciary responsibilities. Documentation of how the plan sponsor attempted to comply with the Rule, including how they evaluated and made decisions on each vendor, will help to attest that the plan sponsor followed a prudent process that aligns with Rule's requirements.

Compliance is an ever-evolving challenge for organizations that sponsor ERISA-qualified retirement plans. Most plan sponsor fiduciaries juggle a plethora of executive responsibilities on behalf of their organization, in addition to carrying the burden of acting as a steward of their employees' retirement plan assets. The investment advisor can be a significant ally to the plan sponsor in the retirement plan management process, if carefully selected and monitored. The six steps outlined herein can serve as an accountability tool for plan sponsors and their vendors—to ensure that all partners aiding the fiduciary role comply with ERISA and its newest requirements.

For specific questions regarding how to update your corporation's policies to comply with the new Rule, contact Roland|Criss at 800-440-3457 or admin@rolandcriss.com.