New Fiduciary Rule Changes the Game for Retirement Plan Management

*Ronald E. Hagan**

On April 6, 2016, a highly anticipated regulation was enacted that changes how retirement plans are managed. The regulation is called the "Conflict of Interest—Investment Advice" rule, but we will refer to it in this article simply as the "Rule." While the Rule is directed primarily at vendors of services like recordkeeping, investment advice, and administration, as well as retirement plans offered by insurance companies, plans qualified under the Employee Retirement Income Security Act ("ERISA") also stand to incur regulatory consequences if their vendors fail to comply with the Rule. This article describes the background against which the Rule was developed, outlines the substance of the Rule itself, and provides guidance to boards of directors and plan sponsor executives on how to effectively navigate a new world of fiduciary responsibility and retirement plan management.

PROGRESSION OF ERISA'S FIDUCIARY STANDARDS OF CARE

Fiduciaries have always been responsible for the prudent oversight of their retirement plans. In the past, this has generally entailed choosing a retirement plan that meets employees' needs and ensuring there is a slate of advisors the plan sponsor trusts to handle the administration of the plan. In recent years, however, employers that offer ERISA qualified plans have come under increased pressure by the U.S. Department of Labor ("DOL") to close an information gap that exists between themselves and the vendors that provide services to their ERISA plans. The DOL has stated that retirement plan vendors have an information advantage over their plan sponsor clients, which enables these vendors to distort pricing and servicing programs for their benefit.

This DOL-dubbed "information advantage" stems from the esoteric nature of many aspects of retirement plan management, including investment oversight, in which most retirement plan

RONALD E. HAGAN is Chairman of the Fiduciary Standards Committee of Roland|Criss, the premier fiduciary manager for retirement plan sponsors, foundations, and endowments. Ron has over 26 years of experience in the fiduciary industry, and has pioneered many of the certification, standards practices, and supply chain management strategies that are preferred by fiduciary leaders today. He can be reached at ronhagan@rolandcriss.com.

sponsor executives are not specifically trained. Over the past decade, this knowledge gap has resulted in many plans being charged excessive fees for services like investment management and recordkeeping, which, in turn, has negatively impacted employees' retirement assets. It has also resulted in an uptick in DOL enforcement actions against plan sponsors, who are the ones ultimately held responsible as stewards of their employees' retirement plans.

For many years before the DOL heightened its scrutiny of vendor transparency and fees, however, the retirement industry flourished as Wall Street and the insurance industry introduced an array of new investment vehicles. Retirement plan vendors added more and more services to their core offerings. They touted "one-stop shopping" as a valid rationale for turning over all of a retirement plan's servicing needs to a single vendor organization. Even if a vendor had no historical expertise in all of these diverse servicing areas, a recognizable corporate brand often helped to build immediate trust with unsuspecting plan sponsors. More vendors began operating in complex structures wherein multiple affiliated entities provided numerous services—making it very difficult for responsible retirement plan fiduciaries to clearly understand vendor fee structures and potential harmful conflicts of interest.

This type of vendor activity became commonplace in the market, undermining the plan sponsor fiduciary role, as well as the best interests of retirement plan participants. The U.S. Department of Labor articulated the state of the retirement plan vendor information advantage as follows:

> Vendors have a strong incentive to use their information advantage for their benefit and are able to distort market outcomes in their own favor. Consequently, vendors can reap excess profit by concealing indirect compensation (and attendant conflicts of interest) from clients, thereby making their prices appear lower and their product quality higher. Current ERISA rules hold plan sponsors rather than vendors accountable for evaluating the cost and quality of plan services.

A TREND TOWARDS ACCOUNTABILITY

In light of this declaration nearly six years ago, the DOL unveiled a proposed change to ERISA for the purpose of helping close the information gap. Initially, it appeared the DOL's new regulation would address needed improvements in the information flow between vendors and clients by requiring vendors to fully disclose their sources and amounts of compensation, and to expose any conflicts of interest that may be embedded in vendors' service offerings.

Shortly before the proposed change to ERISA was made effective, however, several factors contributed to the withdrawal of the conflict of interest portion of the rule. A fee disclosure portion became effective in 2012 as a modification to ERISA Section 408(b)(2), and the Employee Benefits Security Administration ("EBSA"), which is the agency that enforces ERISA, expressed the goals of this new rule as follows:

> EBSA estimates that significant benefits will result from the reduced time and cost for fiduciaries to obtain compensation information needed to fulfill their fiduciary duties, the discouragement of harmful conflicts of interest, reduced information gaps, improved decision-making by fiduciaries about plan services, enhanced value for plan participants, and increased ability to redress abuses committed by service providers.

The DOL, however, was not content with the limited results that were obtained through the issuance of this rule, and concluded that conflicts of interest among vendors still needed to be addressed. A White House Council of Economic Advisers analysis found that these conflicts of interest result in annual losses of about one percentage point for affected retirement plan participants.

So, on April 6, 2016, nearly four years after the introduction of the fee disclosure law in 2012, the DOL announced the "Conflict of Interest—Investment Advice" rule ("the Rule"). The Rule expands the definition of an investment fiduciary to include many classes of retirement plan advisors who previously were exempt from acting as a fiduciary. This transition means that impacted advisors must now act in the best interest of the plan participants they serve—which was not a requirement in their prior non-fiduciary roles. In real-world application, this translates to an investment advisor making investment recommendations to a plan sponsor based on what most helps the plan's participants and their assets—not what maximizes the advisor's own commission or corporate profit. This shift for advisors—from being free to serve their own best interests to being mandated to serve those of plan participants—is a game changer.

The DOL knows this is a sea change for the retirement plan services industry, and is prepared to enforce the new rule. A violation of the Rule falls under the category of a prohibited transaction in ERISA, which not only can cause negative consequences for the offending vendor but can have serious repercussions for the plans that the vendor serves.

IMPACT OF THE RULE ON PLAN SPONSORS' COMPLIANCE DUTIES

While vendors of retirement plan services are the primary targets of the Rule, it will have an important impact on plan sponsors, as well, requiring a change in their vendor vetting and monitoring approaches.

The chart below illustrates the stakeholders that fall under the jurisdiction of the Rule. Under the DOL's definition, any individual receiving compensation for providing advice that is individualized or specifically directed to a particular plan sponsor, plan participant, or IRA owner for consideration in making a retirement investment decision is a **fiduciary**.

STAKEHOLDER ANALYSIS

Conflict of Interest Rule

The DOL is concerned that vendors' persisting information advantage will cause many plan sponsors to merely accept at face value a vendor's assertion of compliance with the Rule. Using prudent methods, however, plan sponsors are encouraged to evaluate carefully such assertions, avoiding reliance on biased references in order to ensure the plan sponsor's compliance with its fiduciary duty. The DOL strongly encourages plan fiduciaries to use the introduction of the Rule as a catalyst for updating their fiduciary training by enrolling in a program that includes vendor management skill development. For plan sponsors who are unsure of where to begin, a program that helps plan sponsors explicitly confirm whether a vendor that services their retirement plans complies with the Rule is now available. The program eliminates the ambiguity inherent in vendors' self-assertions of compliance and makes plan sponsors feel confident about their vendors' status under the new regulation. (A link to the description of the program is provided at the end of this article.)

HOW PLAN SPONSORS CAN PREPARE FOR THE CONFLICT OF INTEREST RULE

The Rule is expected to lead some advisors to replace the revenue sharing arrangements they have in place with fund companies and recordkeeping platform providers (so-called "indirect compensation") with compensation arrangements negotiated directly with ERISA plans ("direct compensation"). Such a shift in affiliations by advisors could bring about the end of "no-cost advice" that was frequently embedded in a vendor's offering to plan participants. This means plan fiduciaries may need to seek out other alternatives to bolster their advice and education programs for plan participants going forward.

One such alternative is a class of personalized one-on-one programs offered by investment firms that are qualified as a "Fiduciary Adviser" under the Pension Protection Act of 2006. These types of firms operate under a contract directly with each participant client and are introduced into a retirement plan's services complex by the plan's sponsor. The participants pay the Fiduciary Adviser's fee. Another alternative is the "Robo-Advisor" category of investment advice that may be considered for enhancing plan participant programs in the new era brought on by the Rule. A Robo-Advisor is an online wealth management service that provides automated, algorithm-based portfolio management advice without the use of human financial planners.

Hiring and managing investment and administration vendors for retirement plans is complex and risky. It's complex due to confusing jargon and conflicts of interest embedded in some vendors' offerings. And it's risky because buyers (retirement plan sponsor executives) are at a major information disadvantage, as referenced previously. Upgrading or installing an ERISA-centric governance, risk management, and compliance system has never been more important. The new Rule will add to the challenge that plan sponsors face in complying with ERISA's fiduciary mandates.

Here are a few questions plan sponsors may use in order to evaluate if their compliance systems are ready for the new Rule:

1. Does our plan have a formal system for evaluating the **reasonableness of our vendors' fees and conflicts of interest**?

2. Is there a **documentation trail** that demonstrates the plan's fiduciaries' evaluation of fees and conflicts?

3. Is our plan's governance, risk management, and compliance system formalized and **does it**

match ERISA's standards?

4. Has our plan's GRC system been **evaluated within the last two years** by an independent firm?

5. Do our retirement plan's fiduciaries know if the plan's vendors provide **services to the plan through affiliates** and **how the affiliates are paid**?

Regardless of the state of sophistication of a retirement plan sponsor's current management process, every plan sponsor should conduct frank conversations with each of its plan vendors to clarify expectations, deliverables, and communications in light of this new era of fiduciary duty. Retirement plan sponsors will ultimately be able to benefit from more shared responsibility and aligned interests on behalf of their plan participants, but there will be growing pains as the industry acclimates to a new climate of accountability and stewardship. The ultimate beneficiaries of the Rule, of course, will be the plan participants themselves. If successful, the Rule will increase the level of safekeeping of retirement plan assets and shift the industry's focus back to where it belongs: the best interests of the employees and retirees who have entrusted their investments to a prudent fiduciary community.

For more information about the program referenced earlier in this article that tests for a vendor's compliance with the Rule on behalf of a plan's primary responsible fiduciary, or for related resources for plan sponsors, visit rolandcriss.com/assurance.