CORE COMPLIANCE & LEGAL SERVICES, INC.

Risk Management Update
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THE IMPORTANCE OF REVIEWING FEES ASSESSED TO RETIREMENT PLANS

The U.S. Department of Labor ("DOL"), Securities & Exchange Commission ("SEC"), and the Financial Industry Regulatory Authority ("FINRA") have all published rule proposals or guidance on sales practices involving retirement plans. Clearly, protecting retirement investors is a top regulatory priority. Although the guidance has invoked terms such as "fiduciary," "conflicts-of-interest" and "best interest," the common theme underlying this trend is a focus on commissions and advisory fees charged for providing sales and services to retirement investors. In this Risk Management Update we will review the regulators' focus on services and fees and offer some compliance considerations to get ahead of the trend.

The DOL Proposal and Comments by President Obama

On April 20, 2015, the DOL published a proposed rule entitled "*Definition of the Term 'Fiduciary'; Conflict of Interest Rule – Retirement Investment Advice*[1]." Many articles have addressed the proposal in depth which truly is a "game changer" for broker-dealers and insurance agents but the guise of fiduciary and conflicts of interest is a straw man. This is really about fees and it is being driven by President Obama. Here is a quote from the President's speech delivered to AARP on February 23, 2015:

"There are a lot of very fine financial advisors out there, but there are also financial advisors who receive backdoor payments or hidden fees for steering people into bad retirement investments that have high fees and low returns. So what happens is these payments, these inducements incentivize the broker to make recommendations that generate the best returns for them, but not necessarily the best returns for you."

The President's comments were a prelude to the DOL proposal and much of the 120 page proposal addresses the negative effects of high fees.

"Some studies suggest that the underperformance of broker-sold mutual funds may be even higher than 100 basis points, possibly due to loads that are taken off the top and/or poor timing of broker sold investments."

The IRS piggy-backs on DOL rulemaking under Internal Revenue Code Section 4975[2]. IRC 4975 mirrors the prohibited transaction rules under ERISA, and governs non-ERISA plans, such as IRAs, solo-participant employer-sponsored plans, Coverdell education savings accounts[3], and Medical Savings Accounts.

The SEC and FINRA

The DOL and IRS are not alone in their crusade, as the SEC and FINRA have been very vocal on this subject as well. Specifically, the sales practices and fees structures utilized by broker-dealers and investment advisers pertaining to retirement accounts made the 2015 list of examination priorities for both regulators[4].

[1] *See* U.S. Department of Labor proposed rule: Definition of the Term 'Fiduciary'; Conflict of Interest Rule – Retirement Investment Advice at http://www.dol.gov/ebsa/regs/conflictsofinterest.html.
[2] *See* 26 U.S. Code §4975 – Tax on Prohibited Transactions at https://www.law.cornell.edu/uscode/text/26/4975.
[3] *See* IRS Topic 310 – Coverdell Education Savings Accounts at http://www.irs.gov/taxtopics/tc310.html.
[4] *See* U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations: Examination Priorities for 2015 at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf and Financial Industry Regulatory Authority: 2015 Regulatory and Examination Priorities Letter at http://www.finra.org/industry/2015-exam-priorities-letter.

In addition, on June 22, 2015 the SEC issued a National Risk Alert to registered investment advisers outlining the *"Retirement-Targeted Industry Reviews and Examinations (ReTIRE) Initiative[5],"* which addressed the following areas of focus:

- Reasonable Basis for Recommendations
- Conflicts of Interest
- Supervision and Compliance Controls
- Marketing and Disclosure

Although not as pointed as comments from the President and DOL, making sure that fees charged to retirees are "reasonable" is of great concern to both the SEC and FINRA. A reasonableness standard has governed the financial services industry since fees and commissions were deregulated back in 1975. However, there is a perception which can be supported by guidance in recent speeches that "reasonable" is being interpreted differently by regulators and there is pressure to opt for low-cost investments in retirement accounts.

Important Compliance Considerations

As reflected above, regulators are definitely focused on investment recommendations and fees being charged to retirement accounts. Fees are revenue for broker-dealers and advisory firms and, therefore, are very important to senior management. In an effort to help balance these two contradicting forces, below are some compliance protocols covering the four focus areas of the ReTIRE initiative that Chief Compliance Officers ("CCOs") may want to implement, as applicable:

Reasonable Basis for Recommendations

Review, and have appropriate area managers review the firm's policies, procedures, and sales practices surrounding retirement accounts. Consider the firm's consistency with fiduciary and suitability obligations pertaining to the following:

- Selection process on the type of account chosen for retirement account transfers (*e.g.,* IRA rollovers)
- Performance and documentation of due diligence on investment options
- Making initial investment recommendations
- Providing ongoing investment management to retirement accounts

Also, focus on how suitability information is gathered, documented and applied when recommendations are made. Perform testing to confirm that investments in retirement accounts appear in line with client's stated investment objectives and risk tolerance levels.

Conflicts of Interest

In the ReTIRE Initiative Risk Alert, the SEC listed the following conflicts of interest areas as being "inherent" for financial firms:

- Business structure
- Compensation structure
- Personal issues or relationships
- Relationships with vendors

[5] *See* U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, National Examination Program Risk Alert Volume IV, Issue 6 (June 22, 2015): Retirement-Targeted Industry Reviews and Examinations Initiative at https://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf.

Conflicts need to be identified and either eliminated or mitigated. Begin with reviewing the firm's marketing, sales and account selection process and compare with the fees charged and services provided to clients and investors. Importantly, all material conflicts of interest not otherwise eliminated must be disclosed in the firm's Form ADV brochure. Depending on the severity of a conflict, consider whether additional stand-alone disclosures signed by clients are appropriate.

Supervision and Compliance Controls

Review the firm's internal controls, oversight and supervisory policies and procedures, as appropriate, and test for compliance with applicable requirements contained therein. The overriding principle of compliance controls is oversight. Make sure each process is being independently supervised by a manager, when possible.

Marketing and Disclosure

Marketing collateral distributed to clients and investors must not be deceptive or misleading. Under its ReTIRE initiative, the SEC is focusing on whether such collateral is true and accurate and does not omit material information, that disclosure of fees are complete and accurate, and the use of credentials or other endorsements are valid and not misleading.

To monitor compliance with these focus areas, all marketing and advertising issued by the firm should be reviewed by the CCO or a designee prior to distribution. Consider implementing a "marketing approval" form that outlines, among other things, the target audience. Create a reference checklist that outlines the regulatory "dos and don'ts" when marketing to the public.

Utilize an IRA Rollover Disclosure form, which is a stand-alone form that documents the reasonable basis for recommendations, discloses conflicts of interest and fees.

More specific to the fees charged to retirement accounts, below are some additional compliance steps to consider:

Consider having a written fee policy. Retirement advisers provide recommendations to plan sponsors on a number of different issues including fee disclosure to the plan (ERISA Section 408(b)(2)) and plan participants (ERISA Section 404(a)(5)). Many retirement advisers are enhancing fee disclosure via a written fee policy which compliments the required 408(b)(2) disclosure. The fee policy will stipulate how expenses are to be allocated between the plan sponsor and participants. For any portion allocated to participants the fee policy will further address whether the fees are allocated via the equalization (per capita) method or the recapture method (pro rata). The policy may also address the use of passive low-cost investments. Finally, the policy will state how fees are to be monitored on an ongoing basis. Fee policies can be incorporated in the investment policy statement or they can be stand-alone documents.

Consider implementing a policy requiring annual fee benchmarking. Fee benchmarking compares the plan's fees (custodial, record-keeping and advisory) with a peer group and is an excellent way to determine and document if the fees are reasonable. Fee benchmarking is generally performed through third party vendors that collect the data and provide a report.

Consider fee policies for retirement accounts of the financial adviser's immediate family. There is a little known provision in ERISA (and the IRC) whereby earning a fee or commission on an individual retirement account or qualified plan account of a financial adviser's immediate family member would constitute a prohibited transaction for which there is no exemption[6] (an immediate family member meets the definition of a "disqualifying person"). In a proactive move, one of the country's largest financial services firms has implemented a policy mandating that fees cannot be charged on the retirement accounts of immediate family members, or the fees or commissions must

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[6] *See* Internal Revenue Service: Retirement Plan Investments FAQ at http://www.irs.gov/Retirement-Plans/Retirement-Plan-Investments-FAQs.

be rebated back to the client account[7]. Now that precedence has been established firms should consider implementing similar policies.

Conclusion

Recent regulatory actions are consistent with a larger trend in the industry of focusing on fees, which will most likely continue. Firms should be proactive and take steps to document the justification for their recommendations and fees. The SEC's ReTIRE initiative reminds firms of their fiduciary obligation to supervise and implement compliance controls.

For more information, please do not hesitate to contact CCLS at info@corecls.com, at (619) 278-0020 or visit us as www.corecls.com. Thank you.

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[7] *See* Investment News: LPL Cracking Down on Brokers Who Collect Retirement Account Fees From Family Members (July 17, 2015) at http://www.investmentnews.com/article/20150717/FREE/150719902/lpl-cracking-down-on-brokers-who-collect-retirement-account-fees.