

# CAPCO

## **THE DOL FIDUCIARY RULE RISES AGAIN**

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It may be that the fourth time is the charm for the Department of Labor (DOL) fiduciary rule after previous attempts in 2010, 2016, and 2020. At the end of October, they released a long-expected proposal to expand the definition of an investment advice fiduciary and amend several prohibited transaction exemptions.

This initiative bolsters the administration's drive to protect retirement investors and remove junk fees that cost retirees billions of dollars each year. Many of the key provisions of the new rule revive ideas first presented in the 2016 fiduciary rule, which was ultimately vacated by the Fifth Circuit in 2018.

## MODERNIZING ERISA FOR THE CURRENT DECADE

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The unprecedented need for retirement services has increased since 2016 as the baby boomer generation accelerates to retirement age, and new legislation, such as the SECURE Act 2.0, has created an environment where more working people of all ages will likely have employer-sponsored retirement accounts. This proposal is centered on criteria in the five-part test that determines when someone is a fiduciary by providing investment advice under the Employee Retirement Income Security Act (ERISA). The DOL contends that the marketplace has changed significantly since 1975 when the original five-part test was implemented and now “fails to capture many circumstances in which an investor would reasonably believe they were receiving advice from an investment professional who was rendering services to the investor based upon the investor's best interest.”<sup>1</sup>

While displaying a similar essence, the 2023 proposal is framed by the DOL to be more narrowly focused than its 2016 counterpart, with a distinct aim of addressing the key issues that contributed to its previous demise. Even with the

adjustments, it includes the same objectives of addressing outdated retirement protections as well as counteracting perceived conflicts of interest in retirement advice that can result in lower investment returns, produce higher costs, and prolong meeting clients' financial goals.

There is no doubt the DOL, and the proposal's supporters hope the more targeted changes will not overstep the DOL's jurisdictional reach this time. However, in a repeat of 2016, there will almost certainly be legal challenges from industry participants and political opponents who have already spoken out against it. Comments have already been made available for review with many requesting clarifying language, such as explicitly incorporating an exemption for unsolicited client rollover requests, while others were a rebuke of the entire proposed rule and challenge the authority of the DOL to implement. Depending on how the DOL responds, the final rule could vary from its current form based on the feedback received or be entirely struck down by the courts.

# CLOSING GAPS TO ADDRESS CONFLICTS OF INTEREST

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At its core, the 2023 proposal addresses conflicts of interest, which have been a focus area for several regulatory bodies over the years. The DOL's proposal defines the potential conditions whereby someone making direct or indirect investment recommendations needs to meet fiduciary standards:

- “The person either directly or indirectly (e.g. through or together with any affiliate) has discretionary authority or control, whether or not pursuant to an agreement, arrangement, or understanding, with respect to purchasing or selling securities or other investment property for the retirement investor”
- “The person either directly or indirectly (e.g. through or together with any affiliate) makes investment recommendations to investors on a regular basis as part of their business and the recommendation is provided under circumstances indicating that the recommendation is based on the particular needs or individual circumstances of the retirement investor and may be relied upon by the retirement investor as a basis for investment decisions that are in the retirement investor's best interest”
- “The person making the recommendation represents or acknowledges that they are acting as a fiduciary when making investment recommendations”.<sup>1</sup>

While most advisors likely do the right thing, there is enough conflicted advice to cost retirees an estimated tens of billions of dollars each year. For instance, the negative impact over time from moving retirement investors out of low cost, well-diversified portfolios into higher cost options can sometimes be drastic. The new proposal expands the requirement for advisors to meet a higher standard and duty of care in a wider range of scenarios, while also closing several notable gaps that allowed some advisors to put their own interests ahead of those of their client. To address these concerns, the proposed rule hits three main areas that are important to be aware of.

First and foremost, it strengthens requirements around product recommendations so that virtually any suggested investment product must be in the savers' best interest. Some products, such as fixed annuities, real estate, and certain banking products currently fall outside the authority of the Securities and Exchange Commission (SEC) under Reg BI (Regulation Best Interest). There are also certain investment advice providers that are not covered by Reg BI or fiduciary obligations within the Advisers Act.<sup>2,3,4</sup>

In addition, the proposal includes advice on rolling assets out of employer-sponsored plans such as a 401(k), as one-off advice like this is generally exempt from existing fiduciary rules but could have significant impact on client outcomes. Bringing this under the fiduciary umbrella should lead to advice that helps the investor make the best decision for them instead of the advisor's bottom line. However, it could reintroduce difficulties, also highlighted in review of the 2016 attempt, where investment professionals would need to present the costs of the various recommended options, including the client's existing 401(k) account where fee information may not be readily or even publicly available. This would likely add costly manual activities for firms providing advice and could disrupt the rollover process for retirement investors.<sup>2,3,4</sup>

Finally, it also covers advice to plans and plan fiduciaries about what investments to make available as options in 401(k) plans and other employer-sponsored plans. This is particularly relevant on the back of the SECURE Act 2.0 that encourages firms to offer employer sponsored retirement plans. Many have likely never acted as a plan sponsor before and could rely heavily on advice when constructing them. Requiring fiduciary care for sponsors should help employee outcomes by reducing fees and offering more choices for diversification. It also has the potential to reduce risk for the employer from being sued for subpar program options (recent examples of this occurred with Anthem, Franklin Templeton, and Brown University).<sup>2,3,4</sup>

# NOT AS SIMPLE AS IT SEEMS

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Upon first reading, it sounds reasonably straight forward, but critics have condemned it as another excessively broad overreach that will drive advisors out of the industry and reduce choices available for low-to-middle-income investors to get the advice they need.<sup>5</sup> It is intended to run parallel with the SEC's Reg BI, which does not have the same prohibited transactions as ERISA, adding another layer of complexity and inconsistency for advisors to navigate. Critics also point out the continued redefining of fiduciary creates unnecessary instability for retirement plans and their participants. On the other hand, proponents have emphasized the numerous benefits for savers

around better advice, lower fees, and improved investment outcomes, as well as leveling the playing field for advisors to compete for business.

Wherever you stand on the merit of the 2023 proposal, if passed, there will be meaningful impacts and burdens placed on investment professionals to record and evidence compliance with the new obligations. This was observed with previous best interest rules that sparked a cottage industry of new tools and services to help determine, demonstrate, and document that advice and product selections met "best interest" thresholds.

# NOW WHAT?

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2023 was a dynamic year for the retirement industry with significant rule-making activity, volatile markets, rising interest rates, ESG themes, fee compression, industry consolidation, new technology, and now a revisit to the definition of a fiduciary to bring it to a close. If the DOL's proposal in its current form becomes a rule, there will be several key areas of consideration.

## **Updated Compliance Regiments**

Firms will need updated compliance regiments – and/or employ new technology solutions – on a transaction-by-transaction basis, along with updated exemptions handling to account for the new rules. This may also require additional full-time employees (FTEs) to meet enhanced documentation processes. There is an advantage for larger players to absorb the changes, risks, and costs of compliance, which could contribute to further industry consolidation. Moreover, steps should be taken in preparation for change implementation:

- Select strategies that ensure compliance while at the same time creating process continuity and minimizing negative impacts to the financial advisor and their interactions with clients.
- Early identification of the proposal's most challenging aspects helps to focus planning efforts well in advance.

## **Product Reconciliations Across Complementary Rules and Regulations**

Firms should reconcile product sets that do not fall under Reg BI and align them with other rules and regulations, such as the SECURE Act 2.0, which included updated mandates around certain products in retirement accounts. It is surprising to see how similar products have very different regulatory requirements and governing rules. For instance, an assessment is particularly essential to fixed and fixed indexed annuities,

which, unlike variable and some indexed annuities, are not considered securities and are governed by a patchwork of state laws. Any review should also include analysis of commissions received by the firm and comparisons in performance to similar, less costly options.

### **Changing Client Engagement Practices**

Firms should rethink how they engage certain clients in light of the associated risks arising under the new standards. For instance, current rules treat plan sponsors as sophisticated investors, which does not always accurately reflect their level

of financial acumen. Picking less optimal investments can have a significant impact on returns over time, and potentially serious implications for those recommending them. An extreme example is the events leading up to the 2008 financial crisis: pension funds holding AAA rated residential mortgage-backed securities (MBS) – which they had been advised were safe investments – suffered heavy losses when the sub-prime mortgage crisis blew up.<sup>6</sup>

## **WHY GETTING IT RIGHT IS CRUCIAL**

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At the end of June 2023, the Defined Contribution (DC) market represented a \$10.2 trillion industry, significantly higher than the \$6.5 trillion seen at the time of the 2016 proposal, though down from the \$11.2 trillion at the end of 2021.<sup>7</sup> The DC market could see above trend growth as barriers to plans diminish and if the political appetite to expand access to retirement accounts proves successful.

The sheer magnitude of the growing DC market, paired with the complexity of various regulations and standards creates significant operational and technological barriers to change. It is important to note that a significant portion of regulatory compliance costs are labor related, thus adding layers of disclosure and compliance oversight that will likely strain existing resources necessitating additional headcount, at minimum. A more feasible scenario is a combination of more people, modified processes, and new or enhanced technology, and identifying the best strategy around the mix of each should minimize impacts to advisors, clients, and profitability while maintaining or increasing competitive advantage.

While size is key, demographics tell an important story here as well. Baby boomers control approximately 50% of the wealth in the US (approximately \$78 trillion)<sup>8</sup> and are quickly approaching

retirement age with 100% reaching at least the age of 65 by 2030. They are followed closely by Generation X who control the next biggest piece of US wealth at 29.5% (approximately \$46 trillion)<sup>8</sup> who will be reaching the age of 65 between 2030 and 2045.

As these demographic changes continue to advance, a pivot from asset growth to asset preservation and income generation will be seen, as well as an unprecedented amount of retirement plan rollovers. At the same time, a shift from brokerage to advisory relationships is already underway<sup>9</sup> for qualified and retirement assets that will only further accelerate with an implementation of the proposed rules, which suggests strong near-term and long-term demand for trustworthy and retirement-focused financial guidance.

While the DOL is likely to modify aspects of its initial proposal, it will still yield significant changes to how wealth managers and financial markets operate within the retirement space. Firms that recognize both the challenges and opportunities are starting to aggressively evaluate their strategic response along with the implications on their current operating and business models to ensure they preserve clients and revenue.

1. <https://www.govinfo.gov/content/pkg/FR-2023-11-03/pdf/2023-23779.pdf>
2. [https://images.thinkadvisor.com/contrib/content/uploads/documents/415/WH-Fact-Sheet\\_Retirement-Security\\_2023.10.31-1.pdf](https://images.thinkadvisor.com/contrib/content/uploads/documents/415/WH-Fact-Sheet_Retirement-Security_2023.10.31-1.pdf)
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4. <https://www.shrm.org/resourcesandtools/hr-topics/benefits/pages/dol-releases-new-fiduciary-rule.aspx>
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6. <https://www.imf.org/external/pubs/ft/fandd/2009/06/blanchard.htm>
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8. <https://www.nasdaq.com/articles/more-than-half-of-us-wealth-belongs-to-baby-boomers--will-other-generations-catch-up>
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Capco, a Wipro company, is a global technology and management consultancy focused in the financial services industry. Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its award-winning Be Yourself At Work culture and diverse talent.

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