Report on Survey Regarding the Implications of the Department of Labor's Fiduciary Rule and Best Interest Contract Exemption on Massachusetts-Registered Investment Advisers

I. Executive Summary

The Registration, Inspections, Compliance and Examinations ("RICE") Section of the Securities Division of the Office of the Secretary of the Commonwealth (the "Division") issues this report on its Survey Regarding the Implications of the Department of Labor's Fiduciary Rule ("Fiduciary Rule") and Best Interest Contract ("BIC") Exemption on Massachusetts-Registered Investment Advisers (the "Survey"). The Survey, which was promulgated on July 27, 2016, was issued to gauge how Massachusetts-registered investment advisers might be impacted by the Fiduciary Rule.

The Fiduciary Rule expands the Employee Retirement Income Security Act of 1974 ("ERISA") fiduciary standard to "persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of a [retirement] plan or IRA as fiduciaries in a wider array of advice relationships."[1] This new standard is more stringent than the fiduciary standard investment advisers are currently subject to under the Investment Advisers Act of 1940 ("40 Act").[2] The standard under the 40 Act requires fiduciaries, among other things, to act in good faith, to disclose material facts and conflicts, and to use reasonable care to avoid misleading clients.[3] The Fiduciary Rule imposes a higher fiduciary standard, requiring that:

1. fiduciaries must act in the best interests of their clients, manage plan assets prudently, and avoid conflicts of interest; and
2. fiduciaries are prohibited from self-dealing, representing interests that are adverse to the interests of a retirement investor, and from receiving compensation from a third party with respect to advice given on retirement accounts.

The BIC Exemption, however, allows receipt of otherwise prohibited compensation for advice involving retirement accounts if one adheres to certain contract requirements and standards. The Survey results helped the Division identify areas for training for Massachusetts-registered investment advisers.

[1] Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (April 8, 2016) (amending 29 C.F.R. pt. 2509, 2510, 2550)

[2] The 40 Act "reflects a congressional recognition […] of the delicate fiduciary nature of an investment advisory relationship[.]" SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963); see also Transamerica Mortgage Advisors (TAMA) v. Lewis, 444 U.S. 11, 17 (1979) ("As we have previously recognized, § 206 establishes "federal fiduciary standards" to govern the conduct of investment advisers[.]")

[3] 375 U.S. 180 at 194

II. Key Findings

The Survey response rate was 35%. It was sufficient to gauge the potential impact of the Fiduciary Rule on adviser practices. According to the Survey, 86% of Massachusetts-registered investment advisers provide retirement advice to Retirement Investors (hereinafter "Participants").[4] Of these Participants:

- 52% of Participants indicated that over 50% but less than 100% of their clients are Retirement Investors;
- 27% of Participants indicated that over 20% but less than 50% of their clients are Retirement Investors;
- 15% of Participants indicated that over 0% but less than 20% of their clients are Retirement Investors; and
- 6% of Participants indicated that 100% of their clients are Retirement Investors.

The Fiduciary Rule will apply to all Massachusetts-registered investment advisers who provide advice on retirement accounts. About 98% of Participants responded that they provide advice regarding IRAs. About 80% responded that they provide advice regarding rollovers. The rollover advice was typically the result of clients either switching jobs or moving their employer-sponsored plan into their personal retirement portfolio.

The Survey also asked Participants to describe the nature of advice provided to Retirement Investors. The majority of Participants indicated that they provide advice concerning the management/allocation of client investments, while some explained that they also provide financial planning advice.

The Fiduciary Rule generally prohibits an adviser or institution from claiming the BIC Exemption if the adviser or institution has or exercises discretionary authority or control over retirement accounts. The Survey results indicated that:

- 66% of Participants maintain discretion over client accounts
- 34% of Participants do not maintain discretion over client accounts

[4] As the Survey indicated, Retirement Investors are defined as plan participants or beneficiaries, Individual Retirement Account (IRA) owners, and "retail" fiduciaries of plans or IRAs (generally persons who hold or manage less than $50 million in assets, and are not banks, insurance carriers, registered investment advisers or broker dealers), including small plan sponsors. Best Interest Contract Exemption, 81 Fed. Reg. 21002 (April 8, 2016) (amending 29 C.F.R. pt. 2509, 2510, 2550), https://www.federalregister.gov/articles/2016/04/08/2016-07925/best-interest-contract-exemption.

The Fiduciary Rule will impact how an adviser may be compensated for providing advice on retirement accounts. Survey data showed that Massachusetts-registered investment advisers are compensated in a variety of ways for providing advice on retirement accounts. The responses[5] indicated the following:

- 86% of Participants are compensated via a percent of assets under management ("AUM");
- 22% of Participants are compensated via a flat fee;
- 30% of Participants are compensated via an hourly fee; and
- 13% of Participants are compensated via a fixed fee.

The BIC Exemption requires advisers to have written policies and procedures designed to mitigate the impact of conflicts of interest. The responses indicated the following:

- 49% of Participants do not have any specific written policies and procedures;
- 48% of Participants have written policies and procedures;
- 2% of Participants did not answer this question;
- 1% of Participants indicated a yes and no response to this question;[6] and
- 2% of Participants did not answer this question.

When asked to estimate the potential impact on their business if they entered into a BIC Exemption:

- 36% of Participants indicated that they would not be impacted;
- 24% of Participants indicated that they would be minimally impacted;
- 10% of Participants indicated that they would be moderately impacted;
- 6% of Participants indicated that they would be significantly impacted;
- 20% of Participants were unsure of the potential impact; and
- 2% of Participants did not answer this question.

Despite the data, many Participants indicated that they were already fiduciaries, and thus were not sure how the new Fiduciary Rule would impact them. 75% of Participants indicated that they wanted to receive training, and 56% of Participants provided comments regarding the training they would like to receive. A large number of Participants indicated that they would like training on how to comply with the Fiduciary Rule and BIC Exemption. Other Participants wanted to know specifically how they will need to amend their contracts in order to comply with the Fiduciary Rule or to take advantage of the BIC Exemption.

[5] Participants were allowed to select more than one manner of compensation. The statistical response rate only reflects each time at least one of the types of compensation was selected.

[6] One of those Participants clarified its answer, stating that policies exist sometimes for IRAs, but not 401(K)s or 403(B)s.

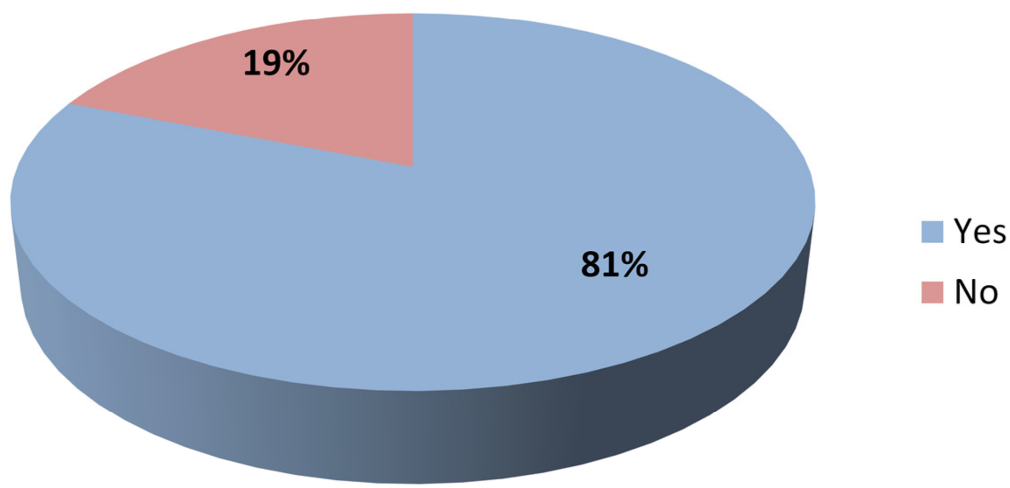
III. Conclusion

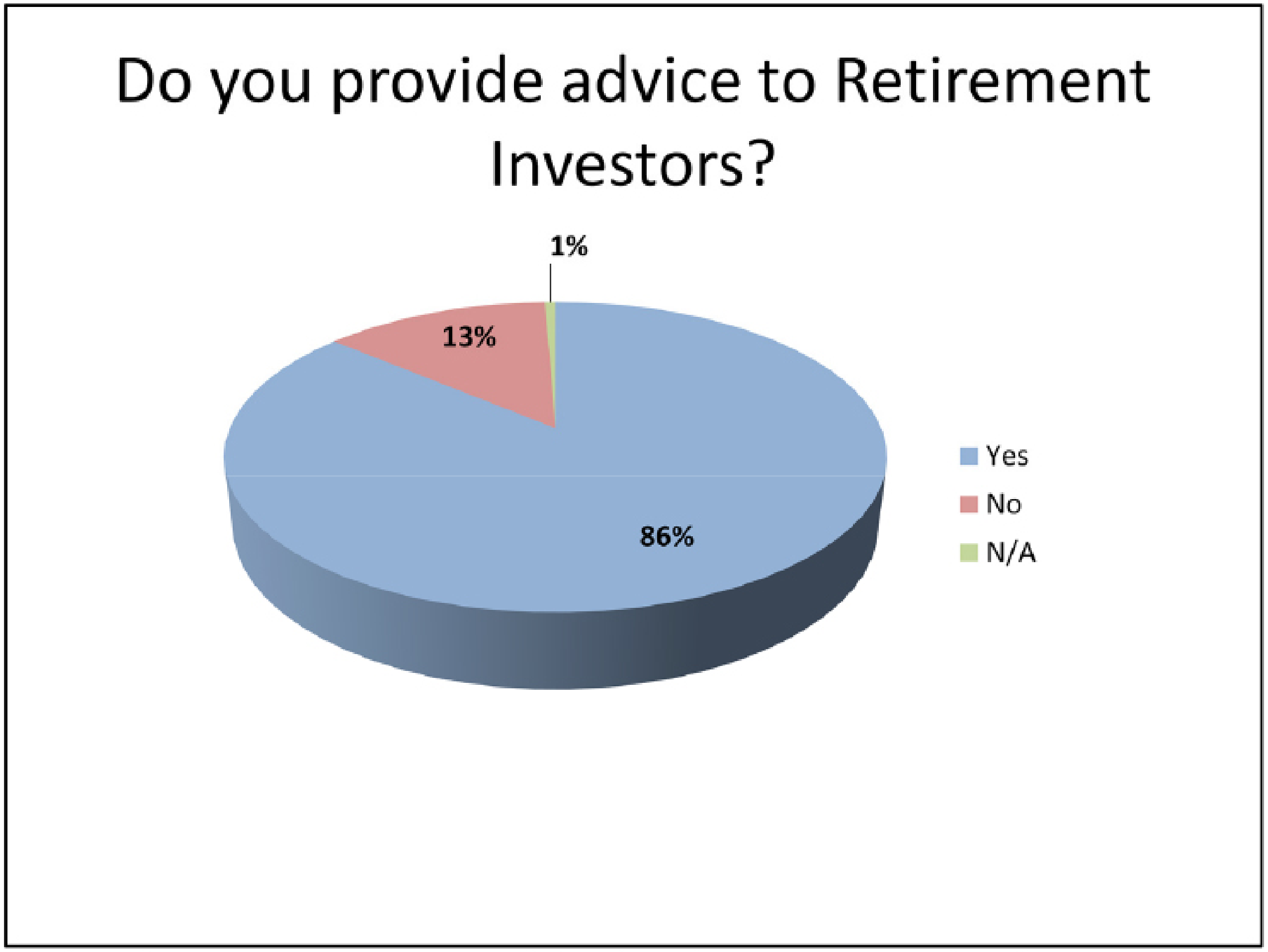
The Fiduciary Rule will have an impact on Massachusetts-registered investment advisers. The Survey suggests that Massachusetts-registered investment advisers are unaware that the Fiduciary Rule holds all advisers providing advice to Retirement Investors to an ERISA standard. Findings also show that Massachusetts-registered investment advisers are largely unaware of the impact the Fiduciary Rule will have on their obligations to Retirement Investors.

The Division plans to provide training on the Fiduciary Rule and BIC Exemption prior to the Fiduciary Rule's applicability date of April 10, 2017. This training will discuss the Fiduciary Rule's impact and will provide an overview of the Fiduciary Rule and BIC Exemption. Please note that the Division has not yet promulgated guidance regarding the Fiduciary Rule and BIC Exemption.

Survey Results: The Department of Labor's Fiduciary Rule and Best Interest Contract Exemption Impact on Massachusetts-Registered Investment Advisers

Is your Principal Place of Business in Massachusetts?

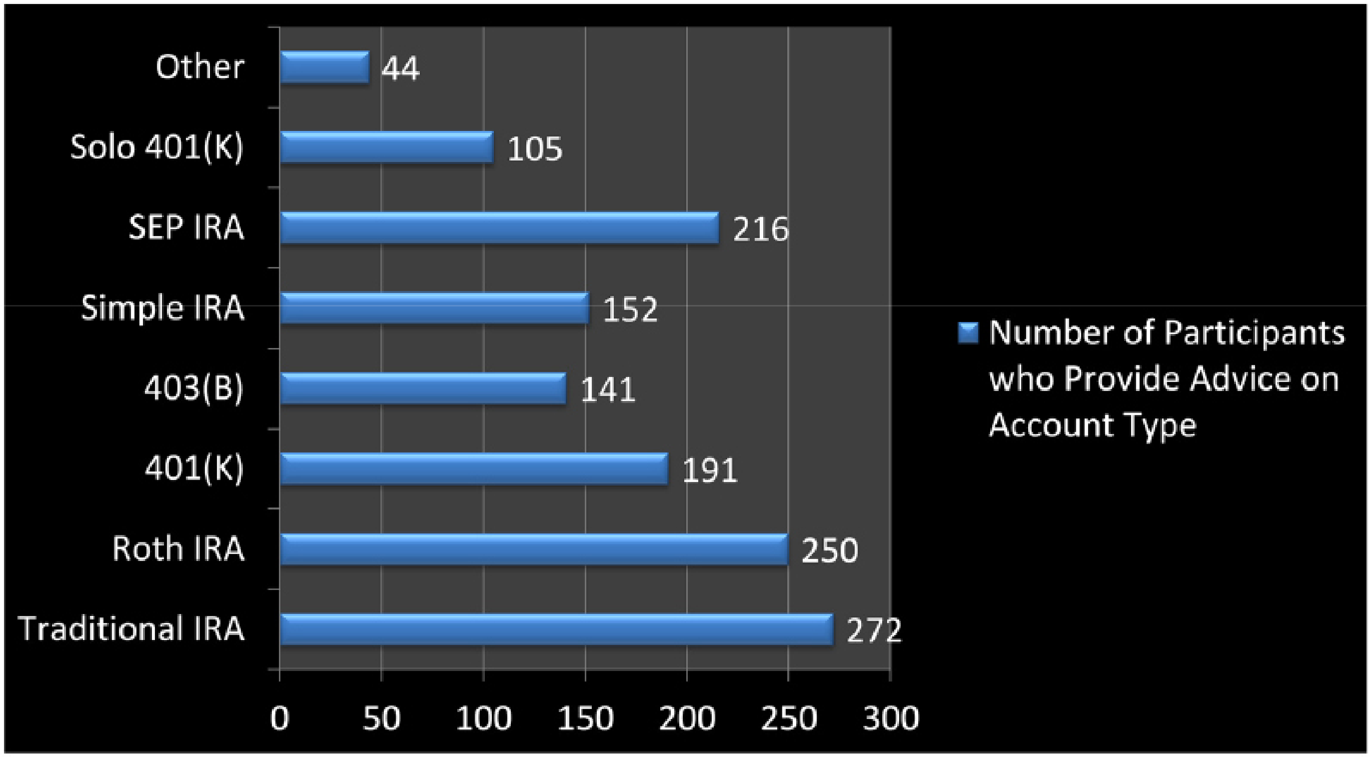




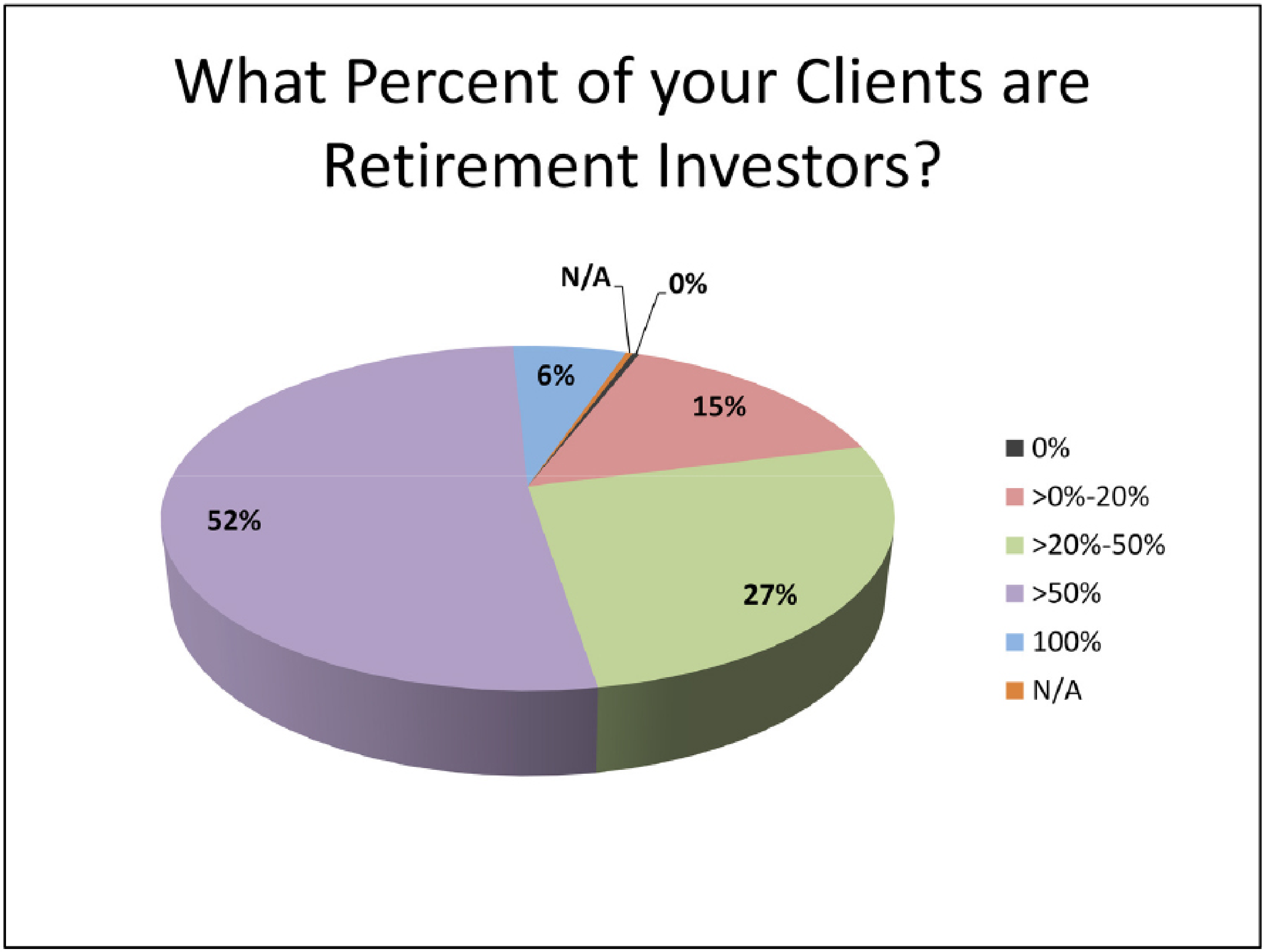
As the survey indicated, Retirement Investors are defined as plan participants or beneficiaries, Individual Retirement Account (IRA) owners, and "retail" fiduciaries of plans or IRAs (generally persons who hold or manage less than $50 million in assets, and are not banks, insurance carriers, registered investment advisers or broker dealers), including small plan sponsors.

Out of 327 Participants, only 282 provided retirement advice which is 86% of survey participants. The remaining survey questions will be reflective of those who responded "yes" (and the two individuals who did not answer the question). These 284 will be referred to as the "Participants."

For what types of accounts do you provide advice?



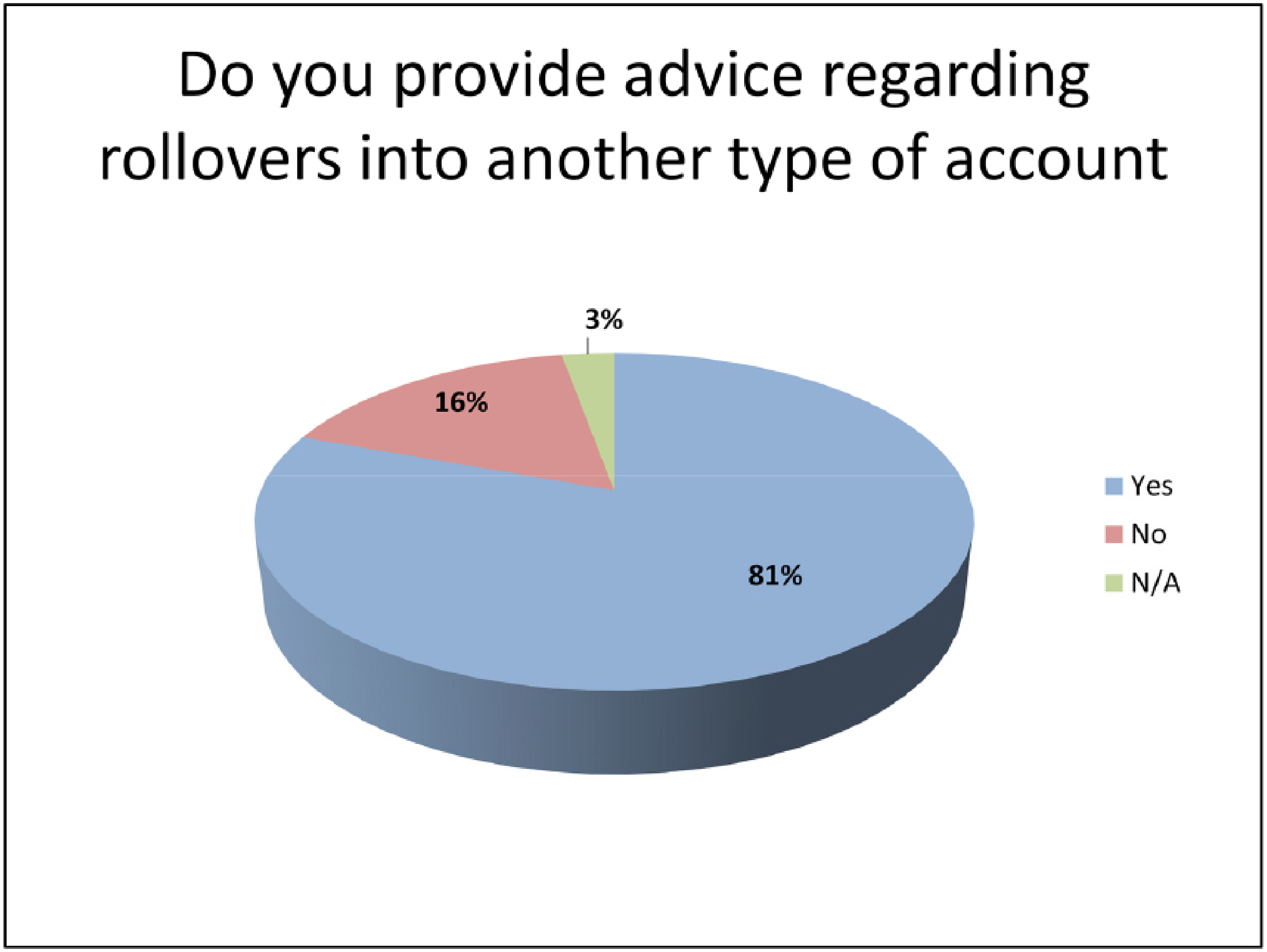
The date above represents the number of times Participant indicated that they provide advice on the particular retirement account. It does not address the advisers who provide advice on more than one retirement account type; however, 269 of 284 (94%) Participants indicated that they provide advice on more than one account type.



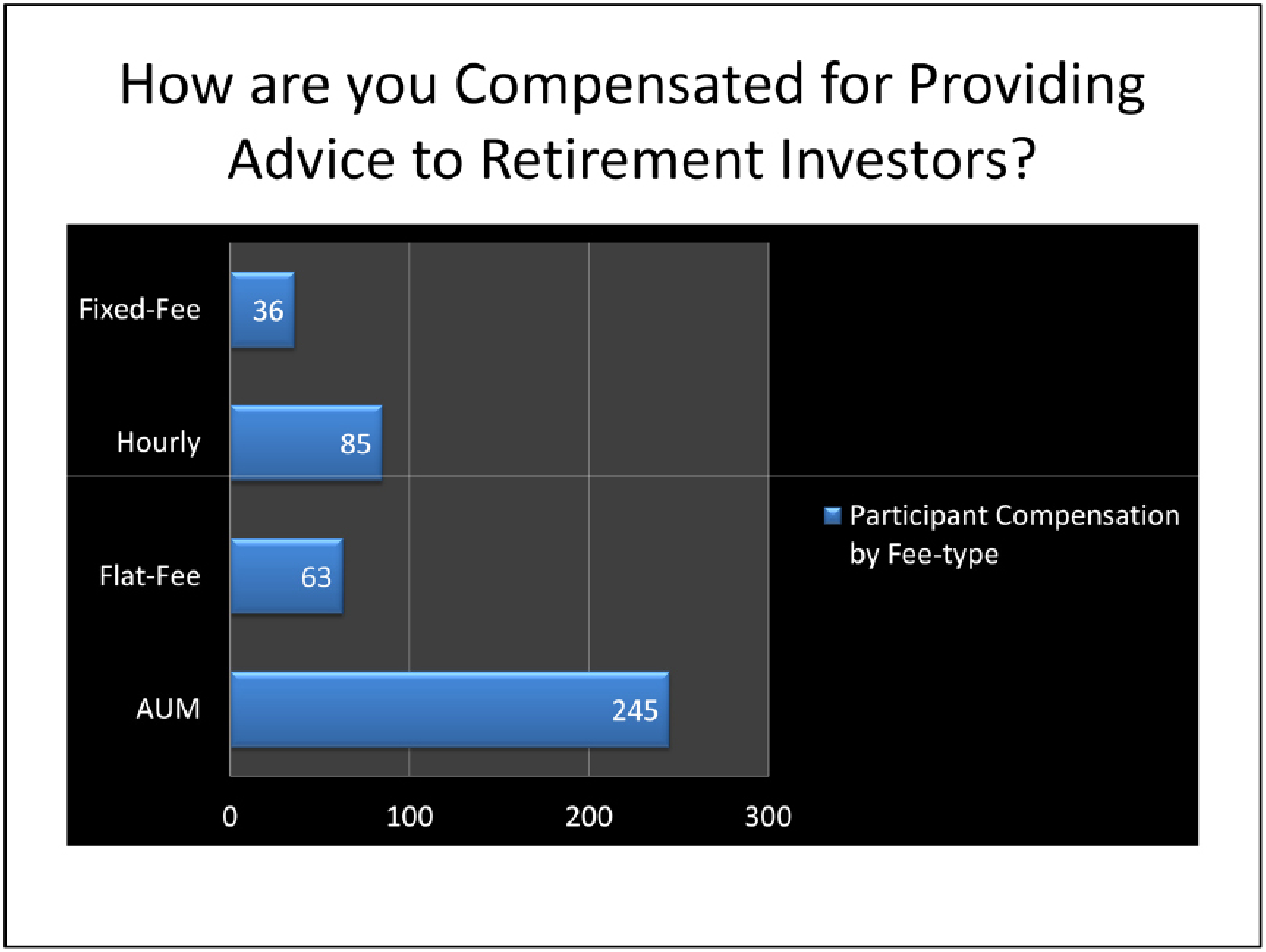
One Respondent did not answer the question.

Nature of the Advice Provided to Retirement Investors

- Many advisers provided a multitude of services. Participants' responses indicated that these as some of the most common services provided:
  - Investment management
  - Portfolio allocation
  - Financial planning
  - Retirement plan rollovers

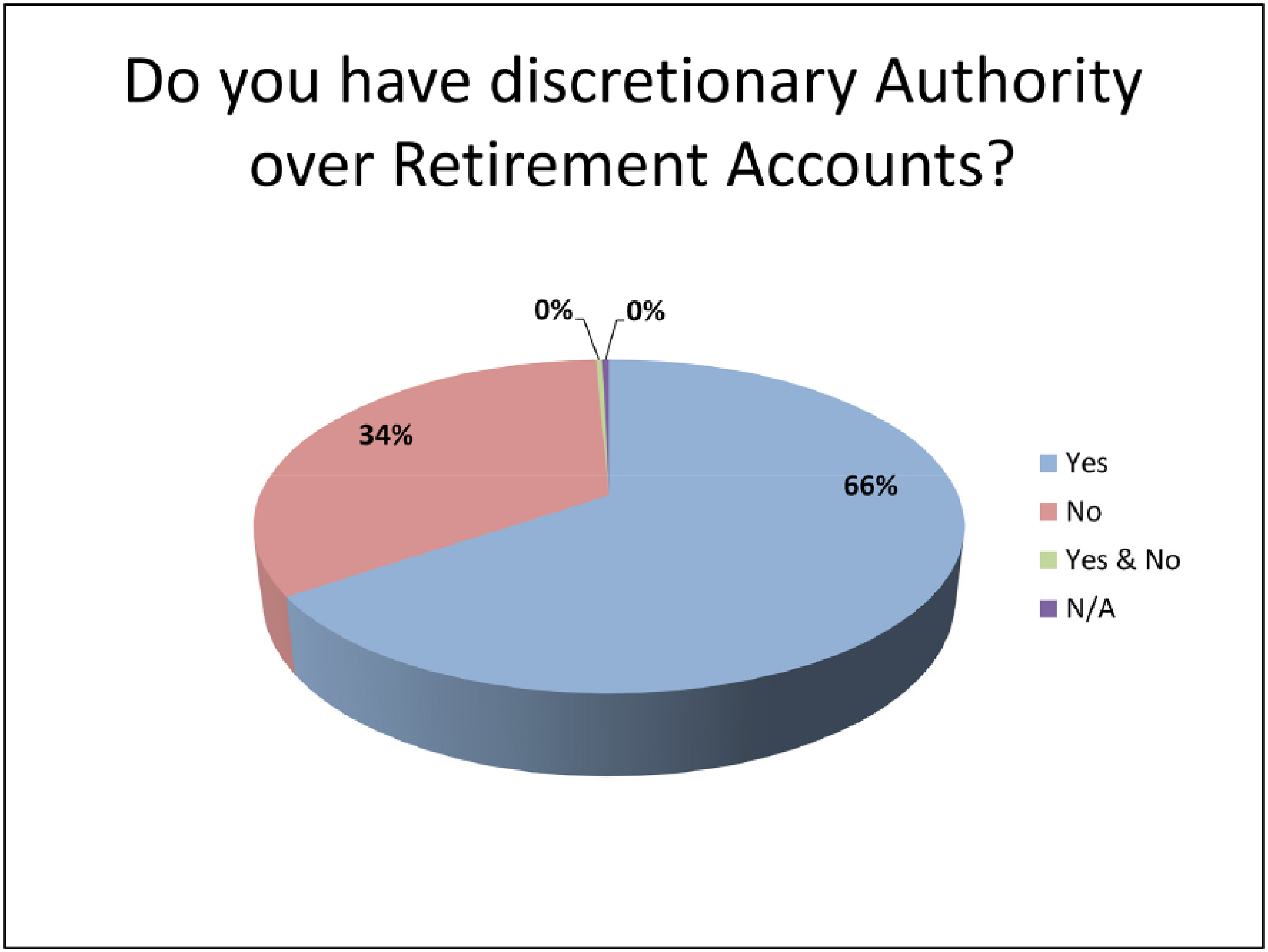


A large amount of the Participants indicated that their rollover advice was usually based on advising a client on the implications of rolling over an employee sponsored plan to a private account.

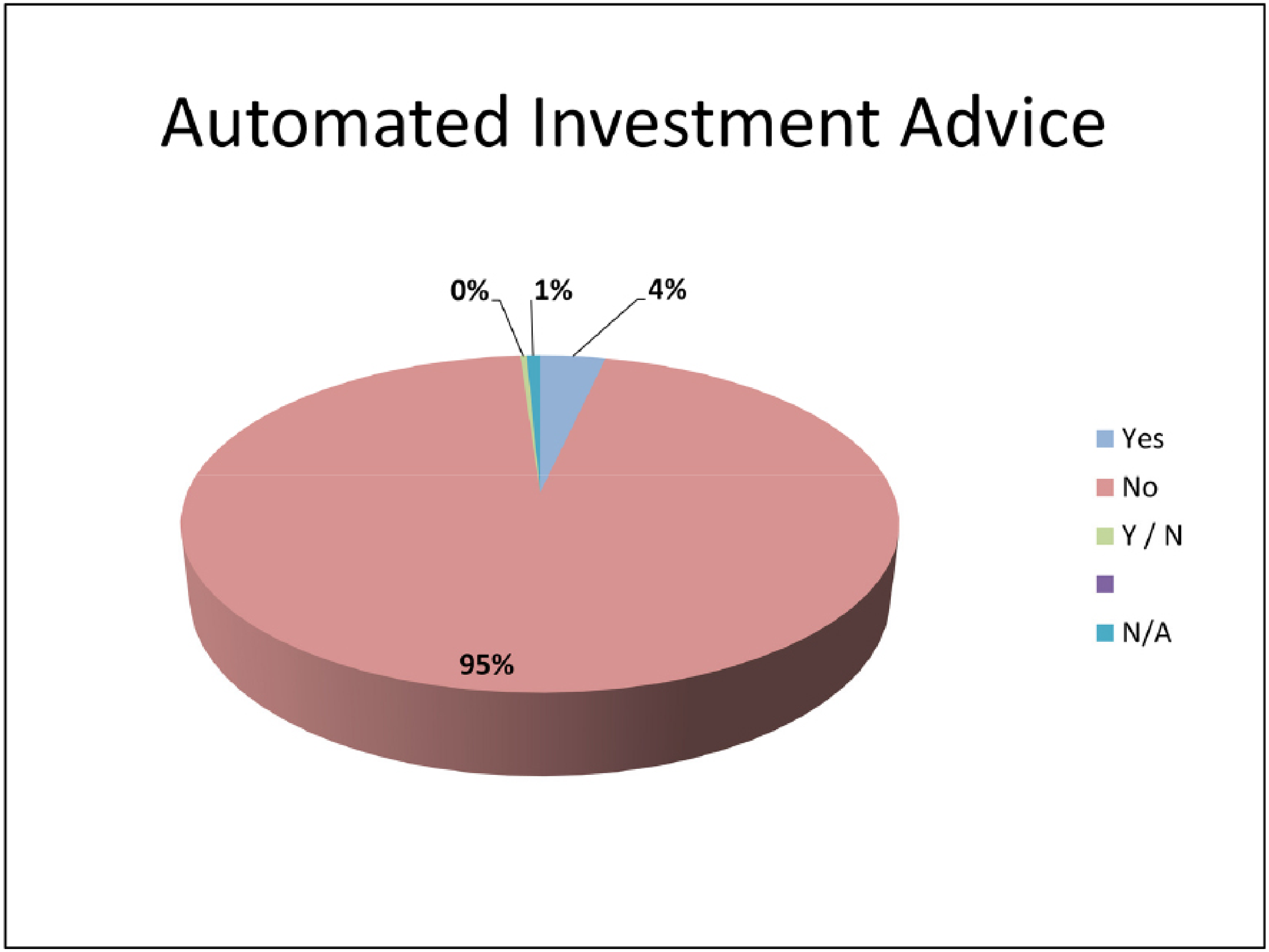


As with Question 2, the date above represents the number of times Participants indicated that they were compensated by the listed fee structure. It does account for the advisers that are compensated by more than one type of fee.

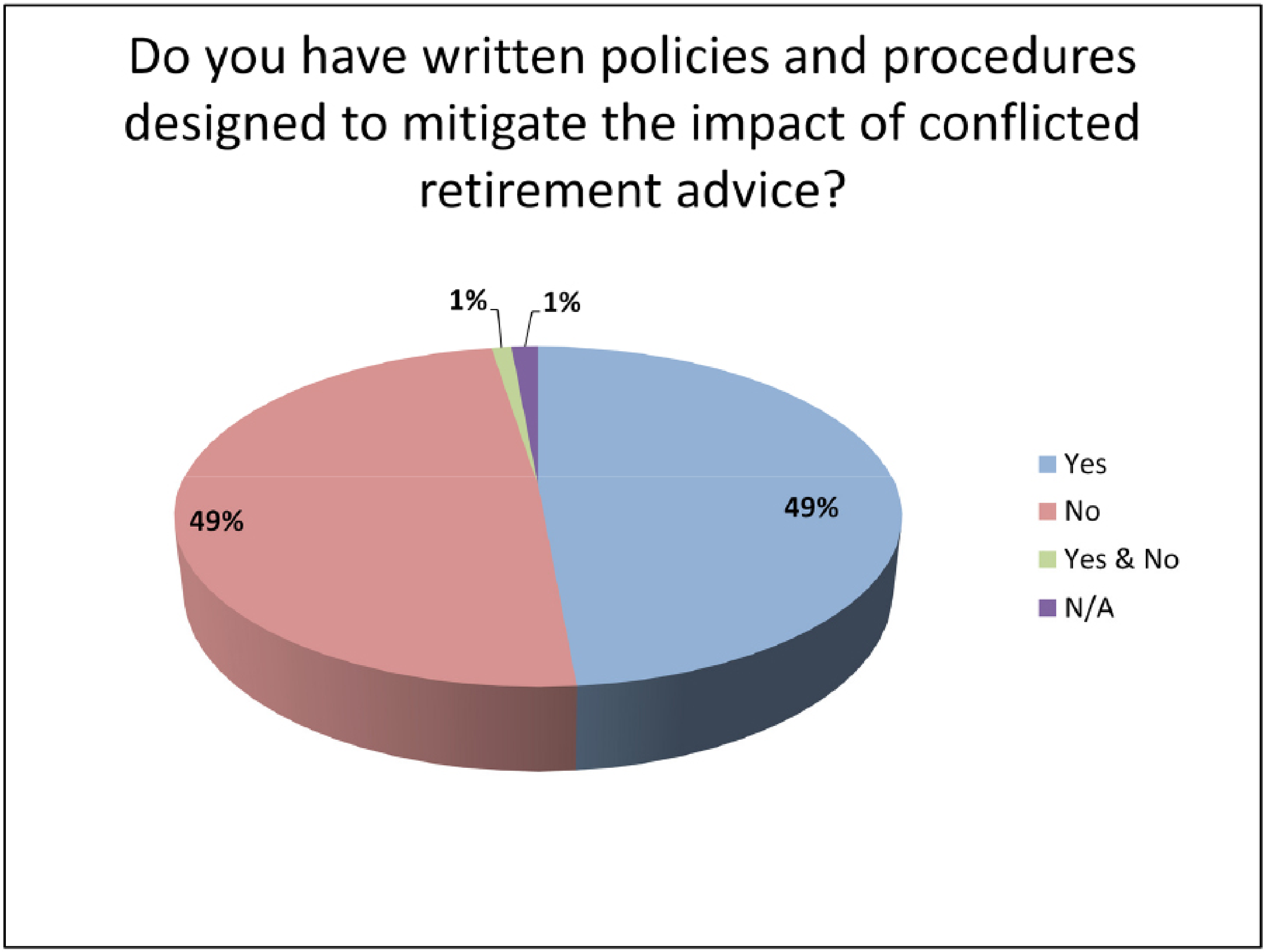
Compensation via a percent of AUM is a key area of interest in regards to the new Fiduciary Rule.



Those Participants who answered Question 7 also were asked to provide their total discretionary AUM for their last fiscal year. In response to the Survey, the total amount of discretionary assets under management across all Participants totaled $13,943,671,590.14.



Investment advice provided solely by "robo-advisers" without any personal interaction from an investment adviser prohibits an adviser from utilizing the BIC Exemption, unless the "robo-adviser" is a Level Fee Fiduciary.



To utilize the BIC Exemption, one must "[i]mplement policies and procedures reasonably and prudently designed to prevent violations of the Impartial Conduct Standards[.]"

While over 50% of Participants feel that at most, the new rule will have a minimal effect on their business, the remaining 38% are either unsure, or think there will be a greater impact. This highlights the uncertainty about the application of the Fiduciary Rule to Massachusetts-registered investment advisers.

Would training on the DOL Rule and the BIC Exemption be helpful to you?