

Operational Considerations of the DOL Fiduciary Rule for Accounts Held Direct-at-Fund

JANUARY 2017

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DOL Fiduciary Rule: Operational Considerations

On April 6, 2016, the Department of Labor (DOL) issued a final rule defining who is a “fiduciary” under Section 3(21) of the Employee Retirement Income Security Act of 1974 and Section 4975(e)(3) of the Internal Revenue Code as a result of giving investment advice to an employee benefit plan, plan fiduciary, plan participant or beneficiary, individual retirement account (IRA), or IRA owner. As the DOL notes, the final rule treats persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of a plan or IRA as fiduciaries in a wider array of advice relationships.¹

In advance of the applicability date² of the final rule, funds and intermediaries should reevaluate their processes and procedures related to accounts held direct-at-fund.³ In particular, funds and intermediaries should carefully consider shareholder requests to change the designated broker-dealer of record. Allowing shareholders to change their broker-dealer of record directly with the fund could have significant compliance implications for the newly designated intermediary. This is particularly true if the new broker-dealer of record is unaware that the change has been made. If an intermediary is unaware of an associated account or customer, they will be unable to ensure proper steps are taken to comply with the final rule (e.g., enter into a Best Interest Contract⁴ or move the customer into an advisory model). Funds and intermediaries also should evaluate procedures around the acceptance of new direct-at-fund accounts that have a third party designated as broker-dealer of record. Similarly, new direct-at-fund accounts established by a shareholder without the knowledge of the designated broker-dealer of record could cause significant issues for the intermediary.

An Investment Company (ICI) working group developed this paper to serve as a guide for funds and intermediaries as they begin creating processes and procedures to address the treatment of direct-at-fund accounts after the applicability date of the final rule.

Change of Dealer: Accounts Held Direct-at-Fund

Before April 10, 2017, funds and intermediaries should reevaluate their existing processes and procedures related to shareholder requests to change their designated broker-dealer of record on direct-at-fund accounts. This reevaluation should be a collaborative effort in order to minimize the operational impact and compliance risk for all parties. Parties should consider the following changes to current operating procedures.

Funds

- » Modify existing “change of dealer” request forms to include a section for the new broker-dealer of record to indicate its approval or acknowledgment of the change.⁵

¹ 81 Fed Reg. 20946 (April 8, 2016).

² The final rule was effective on June 7, 2016, but the general applicability date is April 10, 2017.

³ For the purposes of this paper, *direct-at-fund* includes accounts opened by check and application with a named broker-dealer, as well as National Security Clearing Corporation (NSCC) Networking Matrix Level 0 and 4 accounts, and accounts without a matrix level assigned. Accounts opened electronically (e.g., NSCC Networking or Automated Customer Account Transfer Service [ACATS] transfer) are assumed to be acceptable to both funds and intermediaries and are not addressed in this paper.

⁴ Along with the final rule, the DOL issued a number of prohibited transaction exemptions, including the Best Interest Contract exemption. The Best Interest Contract is an agreement between the retirement investor and the financial institution which—if the specific terms outlined within the exemption are met (e.g., acknowledgment of the adviser’s and financial institution’s fiduciary duty to the investor, disclosure of compensation and other fee information)—allows compensation otherwise prohibited under the final rule to be paid.

⁵ Funds will not be expected to authenticate the new broker-dealer’s signature or acceptance on the revised form.

- » Require all requests to change a broker-dealer of record to come directly from the new broker-dealer of record⁶ rather than from the account holder.
- » Develop a process to reject any change of dealer request received directly from a shareholder without proper acknowledgment from the new broker-dealer of record.⁷ Provide the shareholder with notification of the rejection, along with instructions regarding the proper process to enact the change.
- » Ensure the fund’s transfer agent is sending daily direct account networking (DAN) files,⁸ including F51 records,⁹ to their intermediary partners for all matrix Level 0 accounts.
- » Consider sending DAN position and activity files to intermediary partners.

Intermediaries

Intermediaries should recognize that in many cases, any monitoring of the policy by funds will be on a best efforts basis. Therefore, intermediaries must institute controls on their end to mitigate and address policy violations. As such, intermediaries should consider the following changes to current operating procedures.

- » Establish policies and procedures for how clients might make the intermediary the broker-dealer of record on their account. Consider whether the client may use a fund-specific change of dealer form that includes the acknowledgment of the new broker-dealer of record to enact the change directly with the fund, or if the client must go through the intermediary to make the update.
- » Communicate the policy to the registered representatives and financial advisers.
- » Communicate the policy to all mutual fund partners and discuss options for monitoring the procedure. All parties should reach agreement on how the policy will be applied, including any limitations funds may have in their ability to monitor changes.
- » Ensure daily DAN files, including the F51 record, are being received from funds and are uploaded and acted upon. If F51 files are not being received, the intermediary should request that the fund begin sending the F51 files on a regular schedule.
- » Consider requesting that funds send DAN position and activity files¹⁰ with increased frequency as the applicability date of the rule approaches.¹¹

⁶ The shareholder’s authorization would be required and indicated on the request to change the broker-dealer of record.

⁷ Funds should also consider if any changes to prospectuses or website disclosures are necessary to correspond with any process modifications.

⁸ “Networking” refers to the National Securities Clearing Corporation’s Networking service, which supports the exchange and reconciliation of investor account activity data. The Networking service is segmented into three levels, with Level 3 (accounts controlled by broker-dealers) being the most common. For trust networked accounts, the bank as the designated trust generally provides the investor servicing and reporting. DAN files allow funds to pass information to broker-dealers, other intermediaries, and the designated trust entity on customer accounts held directly at the fund.

⁹ F51 records include information pertaining to any new direct-at-fund or trust networked account established as well as details related to any account maintenance activity processed on an existing direct-at-fund or trust networked account.

¹⁰ DAN position (i.e., F58 file) and activity (i.e., F55 file) files report account balance and transaction activity for accounts held direct-at-fund.

¹¹ This is more important for intermediaries choosing to institute policies and procedures prohibiting accounts held direct-at-fund.

Both Parties

- » Communicate to ensure that all parties are aware of the intermediary's policy regarding changes to the broker-dealer of record on accounts held direct-at-fund and the related responsibilities and expectations. Intermediaries should recognize that in many cases, any monitoring of the policy by funds will be on a best efforts basis. Therefore, intermediaries must institute controls on their end to mitigate and address policy violations.
- » Discuss required reporting between parties to identify any inadvertent change of dealer on an account held direct-at-fund. Reporting may occur via NSCC DAN F51 files, by manual spreadsheet, or as combination of NSCC DAN files and manual spreadsheets.

Change of Dealer: Trust Networked Accounts

Similar to accounts held direct-at-fund, funds, trust entities, and intermediaries should reevaluate their existing processes and procedures related to requests to change their designated broker-dealer of record on direct-at-fund accounts before April 10, 2017. Because the trust entity is generally the only party with authority to act on a trust networked account, it is critical that the trust entity be informed about any changes to the broker-dealer of record on an account. Parties should consider the following changes to current operating procedures.

Funds

- » Modify existing "change of dealer" request forms to include a section for the trust entity to indicate its approval or acknowledgment of the change.¹²
- » Require all requests to change a broker-dealer of record to come directly from the trust entity associated with the account¹³ rather than from the account holder.
- » Develop a process to reject any change of dealer request received directly from a shareholder without proper acknowledgment from the trust entity associated with the account and from the new broker-dealer of record. Provide notification of the rejection to the shareholder and the trust entity, along with instructions regarding the proper process to enact the change.
- » Do not list the trust entity associated with the account as the default broker-dealer of record without authorization from the trust entity. In many cases a trust entity cannot serve as the broker-dealer of record.
- » Ensure the fund's transfer agent is sending daily DAN files, including F51 records, to the appropriate trust entity and the broker-dealer of record for all trust networked, Level 0 accounts.
- » Consider sending DAN position and activity files to applicable trust entities and intermediary partners.

Intermediaries

- » Establish policies and procedures in conjunction with trust partners for how clients may enact a change in the broker-dealer of record on an account to the intermediary's firm. Consider whether the client may use a fund-specific change of dealer form that includes the trust entity's acknowledgment to enact the change directly with the fund, or if the client must go through the trust entity to initiate the update.
- » Communicate the policy to registered representatives and financial advisers.

¹² Funds will not be expected to authenticate the trust entity's signature or acceptance on the revised form.

¹³ Even though initiated by the trust entity, the shareholder's authorization would be required and indicated on the request to the change of broker-dealer of record.

- » Communicate the policy to all mutual fund partners and discuss options for monitoring the procedure in advance of the effective date of the procedure. All parties, including the trust entity, should reach an agreement on how the policy will be applied, including any limitations funds may have related to their ability to monitor changes.
- » Ensure daily DAN files, including the F51 record, are being received from funds and are uploaded and acted upon. If F51 files are not being received, the intermediary should request that the fund begin sending the F51 files on a regular schedule.
- » Consider requesting that funds send DAN position and activity files on an agreed-upon frequency.

Trust Entity

- » Establish policies and procedures in conjunction with intermediary partners for how clients may change the broker-dealer of record on an account.
- » Ensure daily DAN files, including the F51 record, are being received from funds and are uploaded and acted upon. If F51 files are not being received, the trust should request that the fund begin sending the F51 files on a regular schedule.

All Parties

- » Communicate to ensure that all parties are aware of the trust entity and intermediary's policy regarding changes to broker-dealer of record on accounts held direct-at-fund and the related responsibilities. The trust entity must be included in the communication process, whether it is a tri-party consultation or a conversation between the intermediary and the trust. All parties should recognize that in many cases, any monitoring of the policy by funds will be on a best efforts basis. Therefore, trust entities and intermediaries must institute controls on their end to mitigate and address policy violations.
- » Discuss required reporting between all parties, including the trust entity, to identify inadvertent changes of dealer on an account held direct-at-fund. Reporting may occur via NSCC DAN files, by manual spreadsheet, or as a combination of NSCC DAN files and manual spreadsheets.

New Direct-at-Fund Accounts

In response to the final rule, some intermediaries may choose to institute a policy prohibiting its registered representatives and advisers from establishing any new accounts held direct-at-fund. Therefore, before April 10, 2017, funds and intermediaries should reevaluate their existing processes and procedures related to the acceptance of new direct-at-fund accounts. This should be a collaborative effort to minimize the operational impact and compliance risk for all parties. Parties should consider the following changes to current operating procedures.

Funds

- » Understand intermediary partners' policies and procedures related to direct-at-fund accounts.
- » Consider if any controls can be implemented to prevent the opening of new direct-at-fund accounts on an intermediary-by-intermediary basis, including any implications under Securities and Exchange Commission (SEC) Rule 22c-1 of the 1940 Act.¹⁴

¹⁴ The majority of funds will not be able to establish systematic or automated controls to prevent the establishment of new accounts.

- » Communicate clearly to their intermediary partners what controls, if any, can be implemented to prevent the establishment of new direct-at-fund accounts.
- » Ensure the fund's transfer agent is actively sending daily DAN files, including F51 records, to their intermediary partners for all matrix Level 0 accounts.

Intermediaries

- » Communicate to mutual fund partners as soon as possible their policies related to direct-at-fund accounts, including any restrictions, and discuss options for monitoring the policy in advance of the effective date of the procedure. All parties should reach an agreement on how the policy will be applied, including an understanding of any limitations funds may have related to their ability to monitor changes.¹⁵
- » Communicate the policy to registered representatives and financial advisers and ensure proper educational efforts have been undertaken.
- » Ensure daily DAN files, including F51 records, are being received from funds and are uploaded and acted upon.
- » Consider requesting that funds send DAN position files on an agreed-upon frequency. If F51 files are not being received, the intermediary should request that the fund begin sending the F51 files on a regular schedule.
- » Consider developing policies and procedures to address any new direct-at-fund accounts that may be inadvertently established, including whether to pull the account in-house to a brokerage position or orphaning the account to the fund.¹⁶

Both Parties

- » Communicate to ensure that all parties are aware of the intermediary's policy regarding the establishment of accounts held direct-at-fund and the related responsibilities.
- » Discuss any required reporting between parties to identify any direct-at-fund accounts established inadvertently. Reporting may occur via NSCC DAN files, by manual spreadsheet, or as combination of NSCC DAN files and manual spreadsheets.
- » Establish a process to immediately resolve any issues, including commission payments, associated with any direct-at-fund accounts established inadvertently. Agreement should be reached on how such accounts will be handled (e.g., intermediary pulls account in-house or resigns as broker-dealer of record), including treatment of any associated commission and 12b-1 payments.

¹⁵ Intermediaries should recognize that monitoring of any policy prohibiting new direct-at-fund accounts is not the responsibility of the fund and, in many cases, will be a manual effort by the funds. Therefore, intermediaries must institute controls on their side to mitigate and address policy violations.

¹⁶ See ICI's Operational Process Flows and Considerations Related to Dealer/Custodian Resignations in Response to the Fiduciary Rule for industry practices related to the orphan account process. The white paper is available at www.ici.org/pdf/ppr_16_operational_process.pdf.

New Direct-at-Fund Accounts Opened by Transfer

As discussed above, some intermediaries may choose to institute a policy prohibiting its brokers and financial advisers from establishing any new accounts held direct-at-fund. As intermediaries develop policies and procedures related to the prohibition of new direct-at-fund accounts, consideration should be given to how certain life events (e.g., divorce, death, minor reaching the age of majority) will be addressed under the program. Generally, provisions that allow for transfers due to specified life events should be included within any policy prohibiting the establishment of new direct-at-fund accounts. Parties should consider the following changes to current operating procedures.

- » Evaluate impact to commissions, if any. Transfer transactions typically do not involve new money and are generally non-commissionable, but intermediaries should review such transactions for any possible impact to commissions, including 12b-1 fees. A process should be established to immediately resolve any issues, including commission payments.
- » Develop reporting. Intermediaries should consider developing a report from the DAN files identifying accounts open by transfers. For example, the report could be triggered by the initial transaction processed (based upon transaction code) within a new account.

New Direct-at-Fund Accounts Opened by Exchange

Similar to new direct-at-fund accounts open by transfer, intermediaries should consider how new direct-at-fund accounts opened via exchange will be treated. Intermediaries should consider the following changes to current operating procedures.

- » Evaluate impact on grandfathered accounts/assets.¹⁷ On the surface, an exchange transaction may not affect a shareholder's grandfathered status,¹⁸ but the underlying 12b-1 schedule of the new fund/account could be problematic. Intermediaries should consider developing a process to identify new direct-at-fund accounts open by exchange and evaluate the impact, if any, of the commission schedule (including 12b-1 fees) of the new fund/account.
- » Establish a process to immediately resolve any issues, including the disposition of commission payments, associated with any direct-at-fund accounts established by exchange. Agreement should be reached with funds on how such accounts will be handled (e.g., intermediary pulls account in-house or resigns as broker-dealer of record), including treatment of any associated commission and 12b-1 payments.

¹⁷ The Best Interest Contract exemption includes a grandfathering provision that allows advisers to continue receiving compensation relating to assets invested before April 10, 2017, provided certain conditions are met. The grandfathering provision covers systematic purchase programs that were in place before April 10, 2017, and any additional advice regarding grandfathered investments must satisfy the best interest and reasonable compensation requirements of the exemption.

¹⁸ For more information regarding grandfathered status of direct-at-fund accounts, see ICI's Monitoring Direct-at-Fund Assets and Accounts with Grandfathered Compensation in Response to the DOL Fiduciary Rule, forthcoming (available at www.ici.org/fiduciary_rule/implemented/back).



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