# WASHINGTON UPDATE

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An Update on the Status of the
Department of Labor Fiduciary Rule

The Department of Labor ("DOL") had issued a new rule that was scheduled to be phased in between April 10, 2017 and January 1, 2018 that expands the "investment advice fiduciary" definition under the Employee Retirement Income Security Act of 1974 ("ERISA"). The new fiduciary rule was intended to elevate all financial professionals who work with ***retirement plans*** or ***provide retirement planning advice*** to the level of a fiduciary and to require them legally and ethically to meet the standards of fiduciary status. The new rules have had at least some impact on all financial advisors, however, their greatest impact has fallen on those who work on commission, such as brokers and insurance agents.

The status of the fiduciary rule has been uncertain, however, because President Trump issued an executive order and a draft presidential memorandum on February 3, 2017 instructing the DOL to conduct "economic and legal analysis" on the rule's potential impact, and the DOL initially delayed its implementation until June 9, 2017 to collect more comments. Then, on November 29, 2017, the DOL announced a special transition period for the fiduciary rule's Best Interest Contract Exemption (as described on page two) and the Principal Transactions Exemption from January 1, 2018 to July 1, 2019. According to a November 27, 2017 DOL press release that preceded it, the extension would give the DOL time "to consider public comments submitted pursuant to the Department's July Request for Information, and the criteria set forth in the Presidential Memorandum of Feb. 3, 2017, including whether possible changes and alternatives to exemptions would be appropriate in light of the current comment record and potential input from, and action by, the Securities and Exchange Commission, state insurance commissioners and other regulators." It is worth noting that the special transition period did not delay the requirements that advisors act in the best interests of their clients, charge no more than reasonable compensation, and make no materially misleading statements. That part of the rule went into effect on June 9, 2107.

If the DOL were to conclude that the fiduciary rule does hurt investors or firms, it may still theoretically propose a rule "rescinding or revising" it. It is nonetheless important to understand the fiduciary rule because, the rule went into effect on June 9, 2017, and after several years of preparing for it, many mutual funds and other investment companies have begun complying with it. Moreover, in addition to the considerable momentum in favor of compliance within the finance industry, the public supports the additional investor protections, as well.

## The Fiduciary Rule

The new rule's definition of a fiduciary demands that advisors act in the best interests of their clients and put their clients' interests above their own. It leaves no room for advisors to conceal any potential conflicts of interest, and it states that all fees and commissions must be clearly disclosed in dollar form and amount to clients. The rule has expanded the definition of a fiduciary to include any professional making a recommendation or solicitation, and not simply giving ongoing advice. Previously, only advisors who were charging a fee for service (either hourly or as a percentage of account holdings) on retirement plans were considered fiduciaries.

The "fiduciary" standard is much more exacting than the "suitability" standard that had previously been required of financial salespersons, such as brokers, planners and insurance agents, who work with retirement plans and accounts under ERISA. Under a "suitability" standard, if an investment recommendation met a client's defined need and objective, it was deemed appropriate. Under the fiduciary rule, financial professionals are legally obligated to put their clients' best interests first rather than simply finding "suitable" investments. While the new rule has changed or eliminated many commission structures that had governed the industry, it should not be objectionable to obligate a broader category of financial professionals to put their clients' best interests first, as they should have been doing all along. Stated differently, investment recommendations that were deemed suitable as a matter of law were often ill-suited in fact to the needs of the client.

Financial advisors who wish to continue working on commission will need to provide clients with a disclosure agreement, called a "Best Interest Contract" ("BIC") exemption in circumstances where a conflict of interest could exist (for example, the advisor receives a higher commission or special bonus for selling a certain product). The BIC exemption document is essentially a disclosure agreement that an advisor must provide to clients that would permit the advisor to offer products or strategies that could potentially have conflicts of interest and may not be in the best interests of the client.

If a financial advisor is to earn commissions that vary by product, the transaction would need to qualify under the BIC exemption. This is to guarantee that, as a client's fiduciary, the advisor is working unconditionally in the best interest of the client. The BIC exemption would permit firms to use many of their current compensation models if they acknowledge their fiduciary status, give prudent and impartial advice, disclose potential conflicts of interest and information about their revenue model, avoid misleading statements and receive no more than reasonable compensation. Most importantly, all compensation that is paid to the fiduciary must be clearly spelled out. The sale of variable annuities and fixed-indexed annuities to ERISA plan accounts and IRAs is allowed under the fiduciary rule only through the BIC exemption. That is also the case for advice provided to small 401(k) plans.

There are different types of BICs, depending on the recipient. For example, if a financial advisor provides advice to IRAs and plans that are not qualified under ERISA, the BIC would need to be more comprehensive, and this arrangement implies that a fiduciary relationship must be in effect before the parties execute any advisory agreement. Moreover, there must be an agreement reflecting the relevant standards for advice and containing disclosures with respect to compensation and any related conflicts. The BIC provides for mandatory arbitration in individual disputes, but it also retains a client's right to participate in class action litigation against a financial advisor.

On the other hand, if a financial advisor provides advice to ERISA plans, the advice given under such plans is already subject to a fiduciary standard. Therefore, financial advisors would not be required to sign a written contract. A written statement setting forth compensation and the advisor's fiduciary status would be sufficient. In addition, financial advisors would also be required to provide the same disclosures on compensation and potential conflicts as in the more comprehensive BIC.

The final version of the fiduciary rule added a provision for level fee fiduciaries, as well. This deals specifically with recommendations that clients roll their 401(k) balance to an IRA account under a level fee arrangement. The BIC exemption would be more streamlined; it would have to document the reasons the rollover is deemed to be in the best interest of the client. It would also apply in the case where the client will be moved from a commission arrangement to a level fee arrangement. In order to move a client into an advisory relationship, the advisor would need a BIC covering the higher ongoing fee. This more streamlined BIC would require advisors to provide a written statement of fiduciary status and a written rationale explaining the reasons that their recommendation would be in the best interest of the client. There would be no need for other disclosures, however, under this type of BIC exemption.

**<u>Status of the Fiduciary Rule After Recent Court Decisions</u>**

On March 15, 2018, a panel of the Fifth Circuit Court of Appeals struck down the fiduciary rule in a 2-1 decision. See *Chamber of Commerce of the United States of America v. Dep't of Labor*, No. 17-10238 ($5^{th}$ Cir. Mar. 15, 2018). The decision is sweeping in that it rejected the rule that redefined fiduciary investment advice, as well as the new prohibited transaction exemptions, and the modifications to old exemptions adopted along with the rule.

The status of the fiduciary rule is now unclear because the next step is up to the DOL, the ostensible loser in this lawsuit. It has until April 30 to ask for en banc review by the entire Fifth Circuit, which could affirm or overturn the panel decision, or it could ask the Supreme Court to consider the case. The final date to ask for review by the Supreme Court is June 13. Two days before the Fifth Circuit's ruling, the Tenth Circuit Court of Appeals upheld the fiduciary rule, albeit on a much narrower question involving fixed index annuities than the broader suit in the Fifth Circuit. *See Market Synergy Group, Inc. v. Dep't of Labor*, No. 17-3038 ($10^{th}$ Cir. Mar. 13, 2018) A hearing on another suit against the rule had been pending in the D.C. Circuit Court of Appeals, but the plaintiff in that case, the National Association of Fixed Annuities, withdrew its appeal on March 23. As a result of the two cases, there is now a split in the appellate courts, and that is an important factor for the Supreme Court in deciding whether to grant certiorari. The DOL may also decide not to challenge the Fifth Circuit decision, allow it to stand, and stop supporting, implementing, or enforcing the fiduciary rule.

While the option of allowing the Fifth Circuit's decision to stand makes political life easier for the current ideologues in the DOL who want to dispense with the rule, the decision regarding whether to appeal is more difficult. For example, the DOL might want to appeal the decision so that it can revise the regulation on its own terms. Even worse from an institutional point of view, if the decision stands, it could affect the DOL's ability to promulgate other rules in the future.

Regardless whether the DOL decides to appeal the Fifth Circuit's decision, the fiduciary rule may not necessarily go away. The Securities and Exchange Commission ("SEC") is now considering its own version of a new standard to apply to brokers who service retail investors. Whereas DOL's fiduciary rule covered only retirement accounts such as 401(k) plans and IRAs, the SEC rule would apply more broadly to all accounts. The SEC's current standard for brokers has been too lax for several decades, at least since 1975 when brokerage commissions were deregulated. As matters stand now, brokers are required to provide advice that is "suitable," meaning it fits a client's goals and risk tolerance. Because brokers are typically paid on sales commissions, this fact can skew their recommendations toward products that pay them more.

Any new SEC proposed rule is likely to require brokers to provide advice that puts the client's interest before their own financial incentives, in other words, treat the broker as a fiduciary of the client. Financial firms are eager to see how the SEC ultimately describes a broker's duty to his or her client, because it will affect the range of products that brokers can recommend and potentially expose them to greater liability. A proposed SEC rule would also be likely to restrict the ability of brokers to use titles such as "financial advisor," as that title may mislead clients into thinking that brokers have the same legal duties as money managers (also known as investment advisors), who must act in accordance with their clients' best interests under current law. Even though they sometimes provide similar services to investors, the law requires money managers to comply with different regulatory standards than brokers. Investment advisors have complained for years that the rules for brokers are too permissive, and that brokers confuse clients who do not understand the difference between the two professions by using titles such as "financial advisor." The SEC hopes to vote to propose its rule by the end of the second quarter of this year. A period of public comment would follow before the agency could vote to adopt the measure as a final rule.

**Financial Firms and Implementation of the Fiduciary Rule**

At first, mutual funds, investment companies, and other financial institutions opposed the DOL's fiduciary rule, arguing that it would limit consumer choice while raising their compliance costs and potential liability. After their original opposition, however, they saw that the fiduciary rule has proven to be a boon thus far to their business. The rule requires brokers to act in the best interests of retirement plans rather than sell them products that are merely suitable, but which could make brokers more money. Now, financial firms are steering customers toward accounts that charge an annual fee on their assets, rather than commissions that can violate the fiduciary rule, and these fee-based accounts have usually been more lucrative for financial companies. Therefore, it should be no surprise that implementation of the fiduciary rule has proceeded mostly as planned despite initial opposition from financial firms and their enablers, because the firms had already taken steps necessary to comply given the rule's planned implementation date before Trump was elected as president. As a bonus, financial firms found that the rule has been good for their business, too.

For example, Bank of America Merrill Lynch has moved clients from accounts that charge commissions to ones that charge fees. Fidelity has been implementing fiduciary services for retirement plans, and BlackRock and JPMorgan Chase are using technology that improves investment decisions. Likewise, Morgan Stanley has invested in technology firms to improve the products and services it offers wealth-management customers. Accordingly, financial firms have no interest in going back to conducting business before the implementation of the fiduciary rule, and they are unlikely to roll back these profitable arrangements.

It does not follow that every firm has necessarily made similar changes to those large financial firms have made. Moreover, even firms that adopted changes to comply with the fiduciary rule typically apply them to retirement accounts only. Finally, absent effective regulation and enforcement, financial firms could decide to change their policies and practices at any time. Thus, after the Fifth Circuit's decision, the focus has now shifted away from the DOL to the SEC, and what it will do in this area, as it has broader regulatory authority over financial markets.

## Context on the Modern Financial Marketplace and the Fiduciary Standard

Retail commissions to buy or sell shares of stock were typically over one percent before they were deregulated in 1975. They are now in single digits, often five to ten dollars per trade at discount brokers that do not issue stock recommendations. With stock brokerage having been reduced to a commodity service cheaply priced and available from dozens of brokers, rendering financial advice remains a higher-value activity that requires greater professional knowledge than the ability to place a trade, an act that is entrusted now to consumers themselves.

Allowing a broker to mix stock trading and financial advice in a relationship where (s)he is obliged only to recommend "suitable" products is an obsolete business model, poisoned by a conflict of interest at its core. A broker who mixes financial advice with stock trading should have a fiduciary obligation to act in the customer's best interests. Funds with high fees and expense ratios serve the broker's interest but not the customer's, especially if they are sponsored by the broker's employer. It is remarkable that this conflicted arrangement remains in place a full 43 years after its obsolescence, and it is testimony to Congressional and regulatory capture by Wall Street firms and the insurance industry, which is probably even worse at spamming customers with products that disguise their high fees and paltry rates of return. If the SEC acts as it should in regulating all manner of financial advice, the days of such inherently conflicted relationships may finally come to an end.