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“Real” Requirements of Fiduciary Rule: Interesting Angles on DOL’s Fiduciary Rule #47

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This is my 47th article about interesting observations concerning the Department of Labor’s fiduciary rule and exemptions. These articles also cover the DOL’s FAQs interpreting the regulation and exemptions and related developments in the securities laws.

I have seen articles and heard comments about the fiduciary rule and exemptions that are misleading. The purpose of this article is to clarify the requirements of the fiduciary rule and the related exemptions.

In order to discuss the “fiduciary package” of guidance, we need to divide it into two categories. The first is the transition rule, for the period from June 9 to December 31, 2017. The second category is the final set of the regulation and exemptions, which are scheduled to become applicable on January 1, 2018, and which are being reviewed by the DOL for changes.

The Transition Rules

The transition rules require, in essence, that advisers, and their supervisory entities, “adhere to” the following:

- The Best Interest Standard of Care. The Best Interest standard of care is a combination of ERISA’s prudent man rule and duty of loyalty. The consequence is that advisers and their supervisory entities need to engage in a prudent process to develop their investment and insurance recommendations to plans, participants and IRA owners.
- Reasonable compensation. “Reasonable compensation” is a market-based standard. In other words, what would a transparent and competitive market pay for the services of the adviser and his or her supervisory entity?
- Misleading statements. The adviser cannot make materially misleading statements about the investments, fees, material conflicts of interest or other matters that would be material to the investment decision.

I used the phrase “adhere to” (as the guidance does) to emphasize that there is no contract or disclosure requirement. In other words, it is a conducted-based standard.

Think about it. Beginning on June 9, an adviser’s recommendations to plans, participants and IRAs has to be prudent and loyal; the adviser cannot mislead the retirement investor; and the adviser and supervisory entity’s compensation must be reasonable. The question is, are these reasonable requirements?

However, on January 1, 2018, the full Best Interest Contract Exemption (BICE) will apply. As currently written, it is disruptive of existing practices, and would be expensive to comply with. That is obviously a problem. However, it will likely be revised. Unfortunately, we don’t know what the changes will be. Hopefully, though, they will reduce the compliance burden while maintaining investor protections.

Notice, though, that I referenced needed changes to the Best Interest Contract Exemption, but not to the fiduciary rule. That’s not to say that the fiduciary rule cannot be improved . . . because it can. However, most of the objections are to the Best Interest Contract Exemption and not to the rule. Unfortunately, people put a label on the package of guidance and, when objecting to the fiduciary rule, their complaints are usually about the Best

Interest Contract Exemption. That adds to the confusion about the fiduciary standard of care and its requirements, as opposed to the concerns about the conditions in the exemptions.

While there are some concerns about the fiduciary rule itself, for example, some broker-dealers argue that the Securities and Exchange Commission should write a single fiduciary rule for all investment accounts, including both qualified and non-qualified accounts. That raises the issue of whether there is, or should be, a distinction between accounts that are designed for producing retirement income and those that are intended for personal investing. If the answer is "yes," then investment advice will be different for the two types of accounts, regardless of which agency writes the rules.

To further complicate matters, the main issue is the prohibited transaction rules, which are statutory, rather than regulatory. Neither the SEC, nor FINRA nor the DOL, can issue regulations that conflict with a statute. As a result, even if the standard of care is changed, the prohibited transaction exemptions will continue to be written by the Department of Labor. In other words, the SEC does not have the statutory authority to create exemptions from the prohibited transaction rules.

As concluding thoughts, while the fiduciary regulation and the transition rules for the exemptions will require changes in practices (for example, fiduciary training and documentation), those rules should not be overly burdensome or expensive to comply with. However, that changes on January 1, 2018 when the final exemptions will apply. Fortunately, the DOL will be reviewing the requirements of those exemptions and, hopefully, the requirements will be modified to be more reasonable in terms of the cost and burden of compliance.

The views expressed in this article are the views of Fred Reish, and do not necessarily reflect the views of Drinker Biddle & Reath.

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