

THE
NATIONAL LAW REVIEW

Fiduciary Rule and Discretionary Investment Management: Interesting Angles on DOL's Fiduciary Rule #53

Thursday, June 29, 2017

This is 53rd 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.

In recent conversations I have learned that many broker-dealers and RIAs do not understand how the prohibited transaction rules and exemptions (and, particularly, the Best Interest Contract Exemption) apply differently to discretionary accounts and non-discretionary accounts. This article discusses some of those differences.

One similarity, though, is that ERISA's prudent man rule and duty of loyalty apply for both discretionary and non-discretionary advice to retirement plans and participants.

However, ERISA does not generally govern investment advice to IRAs. As a result, absent the need for a prohibited transaction exemption, advisers to IRAs will not be governed by fiduciary/best interest standard of care. For example, where an adviser (and his or her supervisory entity) provides discretionary or non-discretionary investment advice to an IRA on a "pure" level fee basis, the adviser and the entity are subject to the fiduciary standards under the securities laws, but are not covered by the new fiduciary rule. That is because, where an adviser is providing advice for a reasonable level fee, it is not a prohibited transaction. As a result, an exemption is not needed. (By the way, a "pure" level fee is compensation that does not vary based on the advisory decisions or recommendations and that is not paid by third parties, e.g., 12b-1 fees, insurance commissions, etc. Also, the fee must be level across all related and affiliated parties.)

However, where there is a financial conflict of interest for non-discretionary or discretionary investment advice to an IRA, a prohibited transaction results. That includes, for example, where the adviser or supervisory entity (or any affiliated or related party) receives compensation in addition to the level fee. Examples of those additional, and conflicted, payments are: 12b-1 fees; insurance commissions and trails; proprietary products; asset-based revenue sharing; and payments from custodians.

Where conflicted payments are received, and a prohibited transaction occurs, the adviser and the supervisory entity will need an exemption. If the adviser provides non-discretionary investment advice, the Best Interest Contract Exemption (BICE) is available, if its conditions are satisfied. BICE requires only that the adviser and the supervisory entity comply with the Impartial Conduct Standards during the transition period (the transition period is from June 9 to December 31, 2017, but will likely be extended). The Impartial Conduct Standards are that the adviser and entity adhere to the best interest standard of care, receive no more than reasonable compensation for their services, and make no materially misleading statements. The entity--the broker-dealer or RIA firm--also needs to have procedures and practices to ensure that the conflicts do not result in advice that is not in the best interest of the retirement investor.

However, BICE cannot be used for prohibited transactions that result from discretionary investment management. In fact, there are only a few exemptions for discretionary investment management, and none as broad as BICE. For example, there is an exemption for the use of proprietary mutual funds.

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As a result, many—and perhaps most—financial conflicts (that is, prohibited transactions) that result from discretionary investment management decisions are absolutely prohibited, because there are not exemptions for the conflicted payments.

The moral of this story is that RIA firms and broker-dealers need to distinguish between discretionary investment management and non-discretionary investment advice. For the time being, at least, most conflicts of interest for nondiscretionary advisers are permissible, if the Impartial Conduct Standards are satisfied. However, for discretionary investment management, there are few exemptions and most financial conflicts will be prohibited without any available exemptions. To the extent that the prohibited transaction rules are being inadvertently violated for managed IRAs, now is the time to correct the errors.

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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