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Unexpected Consequences of Fiduciary Rule - Interesting Angles on the DOL's Fiduciary Rule #65

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Unexpected Consequences of Fiduciary Rule

This is my 65th 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.

The fiduciary and best interest standards of care, as well as the prohibited transaction rules, will impact advisors in some unexpected ways. That is particularly true of investment advice to IRAs. Here is an example.

When plan or IRA assets are held by a custodian, an advisor often has the ability to recommend either transaction-fee (TF) mutual funds or no-transaction fee (NTF) mutual funds. The recommendation of either TF or NTF funds is a fiduciary act for plan assets, and it will be a best interest act for IRA assets—if the advisor or his or her firm receives any payments beyond a stated advisory fee that is level. (In effect, the payments from the custodian "unlevelize" the advisory fee.)

For both the prudence and best interest standards of care (which are virtually identical), an advisor must consider whether it is prudent to recommend a TF fund or an NTF fund. The issue is that NTF funds typically have a higher expense ratio, while TF funds charge an initial transaction cost but usually have a lower expense ratio. As a general statement, NTF funds would be appropriate for short-term holdings, while TF funds would be more cost-effective for longer term holdings.

To further compound matters, there are also prohibited transaction issues. Some custodians pay money to advisors if the advisors select NTF funds (because, I assume, the custodians make more money on NTF funds). The Department of Labor would consider those payments to be prohibited transactions, since they result from an advisor's recommendation and since they generate payments above and beyond the advisor's stated level fee.

However, not all is lost. Under the Best Interest Contract Exemption (BICE), where an advisor receives additional compensation that is prohibited under these rules, the additional compensation is permissible, if the conditions of the exemption are met. One of the BICE conditions is that the total compensation cannot be more than a reasonable amount. Note that, for plan purposes, the additional compensation would need to be disclosed in the advisor's 408(b)(2) disclosures. In addition, and for both plan and IRA assets, it is possible, perhaps even likely, that an assertion could be made that undisclosed compensation is impermissible (since, arguably, the advisor is setting its own compensation as a result of the nondisclosure). As a result, an advisor should disclose, at the beginning of the fiduciary relationship, all of the compensation which the advisor will or may receive.

However, there are two other conditions for BICE. The first is that the advisor cannot make any materially misleading statements about the transactions or the compensation. The second is that the advisor must adhere to the best interest standard of care. That standard of care includes deciding whether the prudent recommendation is to use TF or NTF funds. If those conditions are not satisfied, the additional compensation is impermissible, at least from the perspective of the Department of Labor.

To make matters even more complex, the Best Interest Contract Exemption only protects compensation resulting from non-discretionary advice. So, for example, if the advisor is the one who decides to use NTF funds, that decision amounts to discretion. In that case, BICE would not be available to permit the prohibited payments from

the custodian.

Now that the final fiduciary rule applies (as of June 9, 2017), advisors need to review all of their sources of compensation directly or indirectly from “qualified” assets (that is, plans, participants or IRAs). The changes are more far-reaching than most people think.

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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