THE
NATIONAL LAW REVIEW

The Fiduciary Rule: What's Next (Part 3)?: Interesting Angles on the DOL's Fiduciary Rule #87

Monday, April 16, 2018

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Financial Institutions & Banking
Labor & Employment
All Federal

This is my 87th article about interesting observations concerning the Department of Labor's (DOL) fiduciary rule and exemptions. These articles also cover the DOL's FAQs interpreting the regulation and exemptions and related developments in the securities laws.

This is the third of my four-part series on the critical questions raised by the 5th Circuit Court of Appeals decision to "vacate," or throw out, the Fiduciary Rule. The first article, Angles #85, discusses the three critical questions for the SEC and DOL to answer. The second article, Angles #86, discussed the first critical question, "Who is a fiduciary?"

This post covers the second critical question, "What is the fiduciary standard of care?"

For purposes of advice to retirement plans and participants, that's an easy answer. It's ERISA's prudent man rule and duty of loyalty. That standard is statutory and, as a result, it cannot be modified by rule or regulation—by the DOL or SEC.

There is a large amount of guidance, both from the DOL and the courts, on how to comply with the standard. For example, a fiduciary advisor must engage in a prudent process—at the level of a hypothetical, knowledgeable person—taking into account that the purpose of the investments is to provide retirement benefits. That means that an advisor must consider the "relevant" factors for making a prudent recommendation. You might call that a "duty to investigate," and then to evaluate. Courts have also said that fiduciaries must use generally accepted investment theories and prevailing investment industry standards (*e.g.*, for asset allocation and selection of investments).

But, of course, those standards only apply if an advisor is a fiduciary. Fiduciary status was discussed in Angles #86.

The issue is more complex for fiduciary advice to IRAs. Where an advisor to an IRA owner does not engage in prohibited transactions—for example, charges a reasonable level fee (and the advisor, supervisory entity and all affiliated and relates parties do not receive anything in addition to that fee), there is not a prohibited transaction. As a result, neither the IRS nor the DOL have a basis for further regulating the advisor. On the other hand, where an advisor (or the supervisory entity, or any affiliated or related party) receives conflicted compensation, that would be a prohibited transaction and an exemption would be needed. Generally speaking, there are two forms of conflicted compensation. The first, and most common, is any payment from a third party (for example, a 12b-1 fee from a mutual fund or a commission from an insurance company). The second form of conflicted compensation is sometimes referred to as "variable" compensation (for example, a commission on each recommended transaction in a brokerage account).

Before the 5th Circuit decision, the primary exemption for those conflicts was BICE (the Best Interest Contract Exemption). That exemption permitted conflicted compensation if the advisor and the supervisory entity (*e.g.*, a broker-dealer) adhered to the best interest standard of care (and other Impartial Conduct Standards). However, the 5th Circuit Court of Appeals threw out BICE, as well as the fiduciary regulation. After that decision, there are only a few exemptions for conflicted advice—and they are very limited.

However, the DOL will likely issue a new exemption to replace BICE, and will impose conditions. It remains to be seen what those will be. But, it's possible that some standard of care would be imposed, perhaps the new standard that the SEC is working on—and it's almost certain that disclosures will be required.

One thing that is certain is that the limitation for reasonable compensation will be a requirement of the exemption. It's a statutory provision in both the Code and ERISA.

At this point, it's impossible to know what the SEC's new standard of care will be. There are important questions to be answered. For example, will the standard be the same for RIAs and broker-dealers when investment advice is given to retail investors, such as IRA owners? While uncertain, it is possible that a duty of loyalty will be applied to both types of advisors. And, since RIAs are already fiduciaries under the securities laws, it's hard to imagine that a lower standard of care would be required for RIAs.

On the other hand, there is some discussion that the SEC might develop an "enhanced" suitability standard for broker-dealers. While that sounds interesting on paper, it's more difficult to imagine what it would be. For example, the DOL has said that, if a recommendation is not suitable, it would not be prudent. However, the DOL went on to say that, if a recommendation is suitable, that doesn't necessarily mean that it's prudent. So, the question is, will the SEC draw a line between those two standards and, if so, where will that line be?

On a related point, and as a guess, I don't believe the DOL or the SEC will say that the new standards can be enforced by retail investors. In other words, it is likely that the standards will only be enforceable by regulators. While that may be the outcome for the case for IRAs and other retail accounts, ERISA allows for private claims for violations of its provisions, and those statutory rights cannot be taken away by rules or regulations. As a result, advice to plans and participants will be enforceable as private claims.

Since the SEC's proposed guidance will be issued in the near future, we will know the answers soon enough.

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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Source URL: https://www.natlawreview.com/article/fiduciary-rule-what-s-next-part-3-interesting-angles-dol-s-fiduciary-rule-87