Client Alert

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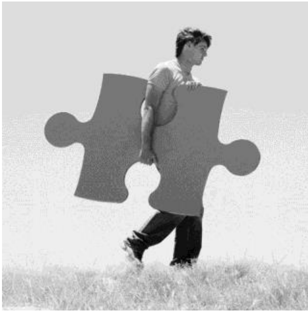

Living with the DOL Fiduciary Rule: Be Prepared for the June 9 Implementation Date

The first phase of the Department of Labor's ("DOL") new fiduciary rule ("Fiduciary Rule") is scheduled to be implemented on June 9, 2017. The Fiduciary Rule greatly expands the categories of persons who are deemed fiduciaries when dealing with retail retirement investors. It was adopted by the DOL in April 2016 together with new prohibited transaction exemptions: the Best Interest Contract Exemption ("BIC Exemption") and the Principal Transactions Exemption ("Principal Transactions Exemption").

To date, the Fiduciary Rule has survived all challenges. In response to an executive order issued by the President directing the DOL to re-evaluate the rule, the DOL postponed implementation of the more complex provisions of the BIC Exemption and the Principal Transactions Exemption until January 1, 2018, in order to afford the DOL more time to conduct the mandated re-evaluation. However, certain provisions were only delayed for 60 days and are scheduled to be implemented on June 9, 2017.

On May 22, 2017, the DOL announced it did not intend to seek any further delays of the June 9 implementation date. With less than three weeks to go before June 9, it appears unlikely that the initial phase of the Fiduciary Rule will be derailed.[1] For those market participants who have not yet prepared for implementation, the time has come to act.

What parts of the Fiduciary Rule will be implemented on June 9?

On June 9, 2017, the expanded definition of "fiduciary" will go into effect. In addition, fiduciaries who receive commissions or other variable compensation will be required to adhere to the Impartial Conduct Standards described below.

The detailed and controversial contract and disclosure provisions of the BIC Exemption and the Principal Transactions Exemption will not be implemented on June 9. As a result, starting on June 9, fiduciaries may make recommendations to retail retirement investors:

- As level fee fiduciaries who receive only a level fee (e.g., a fee based on a fixed percentage of assets under management) and no other fees in relation to the account (e.g., no 12b-1 fees);

  Or

- As fiduciaries to commissionable accounts, provided that they adhere to the Impartial Conduct Standards. Fiduciaries to commissionable accounts will not be required on June 9 to comply with the other provisions of the BIC Exemption and the Principal Transactions Exemption.

[1] The Financial Choice Act, currently pending in the House of Representatives, would block implementation of the Fiduciary Rule. However, the chances of such legislation being enacted in the next three weeks appear to be negligible given the current political situation in Washington. To date, all litigation challenges to the Fiduciary Rule have failed.

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Who is a fiduciary under the new Fiduciary Rule?

Under the Fiduciary Rule, any person who for compensation provides advice about investments, investment strategies or investment counsellors will be deemed a fiduciary, even if the advice is episodic and not part of an on-going relationship.[2] Communications that are limited to educational information or to promoting the services of the financial institution would not be deemed investment advice. However, any statements regarding specific investment products or strategies that could reasonably be construed as suggesting action by the customer would be deemed investment advice. A recommendation to roll over assets in a retirement plan into a 401(k) or similar account would also be deemed investment advice, causing the person making the recommendation to be deemed a fiduciary.

Thus, most representatives of broker-dealers, as well as many insurance agents and some commercial bank employees, may well be deemed fiduciaries when discussing specific investment actions with retail retirement accounts.

What are the consequences of being deemed a fiduciary as of June 9, 2017?

Fiduciaries who continue to receive commissions or other variable compensation must comply with the Impartial Conduct Standards starting on June 9, 2017. These standards require that the fiduciary:

- Act in the "Best Interest" of the client.
- Charge only reasonable compensation.
- Avoid any misleading disclosures regarding investment products, fees and any material conflicts of interest that might affect the fiduciary.

While these principles may appear straightforward, their implementation should be carefully planned, as outlined below.[3]

What do I need to do to implement a "Best Interest" standard?

The "Best Interest" standard set forth in the Fiduciary Rule requires the fiduciary to act with the care and skill that a prudent person would employ in like circumstances, based upon the investment objectives, risk tolerance, financial circumstances and needs of the retirement investor. To meet this standard, fiduciaries should:

- Meet with their retail retirement investors on a regular basis and make sure they have an adequate understanding of the client's current circumstances and objectives.
- Conduct thorough diligence on all investment products offered to retail retirement investors. Such diligence should include comparing product features and fees with comparable products in order to be able to conduct a "Best Interest" analysis.
- Document the basis for the fiduciary's conclusion that a particular investment product is in the Best Interest of the client.
- Evaluate internal compensation arrangements to ensure that they do not improperly incentivize sales personnel to recommend products that are not in the best interest of retail retirement investors.

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[2] There is an exception for certain "institutional" retirement investors that are managed by a bank, broker, investment manager, insurance company or other independent fiduciary with at least $50 million under management.

[3] On May 22, 2017, the DOL issued Field Assistance Bulletin 2017-02, in which it stated that until January 1, 2018, the DOL will not pursue claims against fiduciaries who are working diligently and in good faith to comply with the Fiduciary Rule. This temporary enforcement policy would not apply to the rights or obligations of private litigants. In FAB 2017-02, the IRS also confirmed that the IRS has agreed not to apply the excise taxes of the Internal Revenue Code to transactions that are covered by the DOL's temporary enforcement policy.

- Train all sales personnel and supervisors to understand the differences between a “suitability” standard and a “Best Interest” standard.
- Monitor account activity with a view to detecting potential deviations from the new “Best Interest” standard.

How do I comply with the reasonable fees requirement?

In the release adopting the Fiduciary Rule, the DOL indicated that the reasonableness of fees should take account of:

- Prevailing “market” prices for the services provided, and
- The complexity of the investment product and the scope of monitoring required by the fiduciary.

Fiduciaries should maintain records demonstrating support for any determination that commissions or other fees are consistent with “market” standards. In addition, they must exercise vigilance with respect to products generating higher fees to ensure that such higher fees are justified.

How do I comply with the fair disclosure requirement?

Broker-dealers are already required by SEC and FINRA rules to make fair and balanced disclosure about investment products.[4] As fiduciaries, required disclosures must include information about the fiduciary’s fees and material conflicts of interest.

What do level fee fiduciaries need to do?

Level fee fiduciaries are generally not subject to the Impartial Conduct Standards. However, the principles inherent in such standards apply equally to all fiduciaries. The key difference for level fiduciaries: the fee structure they use is deemed to align their interests with their clients, thereby making them less vulnerable to claims that their recommendations are not in the Best Interest of their clients.

Financial institutions or advisers choosing to act as level fee fiduciaries must not receive any form of variable compensation. They must refrain from charging their clients with fees other than level fees and they must not accept payments from third parties relating to services or products furnished to their fiduciary clients.

Moreover, when a level fee fiduciary provides advice to a client on rollovers, they are acting in a manner that may result in an increase in their level fees. Therefore, in such circumstances, level fee fiduciaries must comply with the Impartial Conduct Standards, and they should carefully document the basis for their recommendation.

What are the implications of the new standards for issuers and underwriters?

Issuers and underwriters need to understand how the new regulatory requirements will affect distributors who face retail retirement investors.[5] Distributors selling on a commissioned basis will need to evaluate the features and costs of investment products, comparing them to similar product offerings, in order to conclude whether or not the products can be recommended as being in the Best Interest of a retail retirement investor. This will inevitably put pressure on issuers and their advisers to keep costs down and to minimize or avoid third-party payments that might “taint” the product in the view of compliance personnel at the distributors.

Alternatively, products may be designed and/or marketed with the understanding that they will be distributed to retail retirement investors solely through level-fee fiduciary channels.

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[4] Some investment products, such as unregistered bank notes or certificates of deposit, are not necessarily subject to all of the detailed disclosure requirements set forth in SEC rules. However, most product manufacturers, especially when these products are planned for distribution to retail or retirement investors, utilize a comparable set of disclosures.

[5] For example, a variety of product manufacturers have updated their “know your distributor” diligence to identify those dealers who are selling products to retirement investors and have supplemented or updated their MSDA forms to address the application of the Fiduciary Rule.

The Principal Transactions Exemption strictly limits the categories of securities that may be sold on a principal basis to retail retirement investors. In addition, the BIC Exemption includes provisions that prevent fiduciaries from utilizing the exemption to sell securities issued by their affiliates to retail retirement investors. However, these provisions will not be implemented on June 9. Therefore, traditional underwriting arrangements may continue in place pending resolution of the current evaluation being conducted by the DOL.

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