

UNDERSTANDING THE STANDARD OF CARE FOR BROKER-DEALERS AND THE DEPARTMENT OF LABOR'S FIDUCIARY RULE



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INTRODUCTION

To date, broker-dealers in the United States have generally not been held to a fiduciary standard when dealing with their customers. Broker-dealers were sales organisations that, while subject to various regulatory requirements, were usually not deemed to be fiduciaries except in situations where they controlled decision-making for a client's account. By contrast, investment advisers were generally deemed fiduciaries who were obligated to act in the best interest of their clients.

In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which empowered the Securities and Exchange Commission (SEC) to create a uniform fiduciary standard that would apply to both broker-dealers and investment advisers when dealing with retail accounts. Although the SEC has not yet exercised this authority, in 2016, the Department of Labor (DOL) adopted its own version of a fiduciary rule that applies to all intermediaries, including broker-dealers, that provide investment advice to retail retirement accounts.

The DOL fiduciary rule has been highly controversial and has been challenged in court as well as through proposed legislation that could rescind the rule. Moreover, in February 2017, President Trump directed the DOL to re-evaluate the fiduciary rule and its consequences. As a result, only a portion of the DOL fiduciary rule as adopted in 2016 went into effect on June 9 2017, the initial applicability date. The remaining provisions were scheduled to become applicable on January 1 2018. However, in late 2017, the DOL deferred the applicability date until July 1 2019 in order to afford the DOL additional time to consider the issues raised in the President's directive. The delay also gives the DOL more time to coordinate with the SEC, which has shown renewed interest in adopting a uniform fiduciary standard.

Under the new DOL fiduciary rule, most broker-dealers who provide any form of investment advice to a retail retirement investor will be deemed fiduciaries. The principal consequences of being deemed a fiduciary are:

- The fiduciary must act in the best interest of the customer,
- The fiduciary may not receive commissions or other forms of transaction-based compensation for transactions effected on behalf of the customer, and
- The fiduciary may generally not act as a principal when dealing with the customer.

Recognizing the significant disruption that might result in the securities industry from adoption of its new fiduciary rule, the DOL adopted at the same time two new prohibited transaction exemptions. Those new exemptions are the Best Interest Contract Exemption (the BIC Exemption) and the Principal Transactions Exemption. While these exemptions provide partial relief from the restrictions inherent in the new fiduciary rule, they are conditioned upon a number of controversial requirements that are currently being re-evaluated by the DOL. As a result, although the new fiduciary rule became applicable on June 9 2017, the DOL has delayed implementation of the full BIC and Principal Transaction Exemptions, while stating that the relief provided by these

exemptions is available to fiduciaries who comply with the impartial conduct standards set forth in the exemptions (the Impartial Conduct Standards).

This booklet examines the history of the DOL fiduciary rule, the context in which it was adopted, the rule's requirements, an exception for dealings with institutional retirement investors, the BIC and Principal Transactions Exemptions, treatment of level fee fiduciaries and potential implications for broker-dealers, in light of the continuing uncertainties regarding the final form of the fiduciary rule.

HISTORICAL DIFFERENCES BETWEEN BROKER-DEALERS AND INVESTMENT ADVISERS

For many years, the distinction between broker-dealers and investment advisers was clear: broker-dealers were salesmen offering goods and services, while investment advisers were trusted counsellors offering impartial advice.

A broker-dealer's relationship to its customers was viewed as primarily a transactional relationship. Broker-dealers commonly functioned in both principal and agency capacities when acting for their customers. A broker-dealer might fill a customer buy order on an agency basis by acquiring the securities in the open market. The same buy order might also be filled with the broker-dealer acting as principal and selling the customer securities held in the broker-dealer's inventory. Broker-dealers also act as principal when they underwrite securities sold through a firm commitment public offering, or when they act as a market-maker in specific stocks. When buying or selling securities as principal, broker-dealers act like any other sales organisation, seeking to generate a profit by selling at a mark-up to their cost or acquiring at a mark-down to the price they expect to receive when re-selling the securities.¹ Principal transactions by definition do not entail any fiduciary duty to the customer, as the broker-dealer is acting for its own account.

Even when acting as agent for a customer and assisting the customer to buy or sell securities in the open market, broker-dealers typically disclaim having any fiduciary obligation to their customer, except in the situation where they assume discretionary authority to make investment decisions on behalf of the customer. For non-discretionary accounts, broker-dealers were viewed as service providers, obligated to perform their duties diligently in accordance with industry standards in return for an agreed upon commission. "It is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis."²

By contrast, investment advisers were expected to provide impartial advice that they believed to be in the best interest of their client. An investment adviser's fiduciary obligation to its clients has been recognised by the U.S. Supreme Court³ and by the SEC⁴. Investment advisers are typically compensated on a fee basis, with the fee calculated as a percentage of assets under management, thereby avoiding potential conflicts of interest between the investment adviser and its client.⁵ An investment adviser is generally prohibited from engaging in any principal transactions with a client, except in narrow circumstances subject to client consent.⁶

Of course, broker-dealers also provide advice on investments

to their customers. However, when adopting the Investment Advisers Act of 1940, Congress exempted broker-dealers from the requirements of the Advisers Act, provided that the advice was incidental to the broker-dealer's principal functions, and provided that the broker-dealer did not charge a separate fee for the advice.⁷

The clear distinctions between broker-dealers and investment advisers began to erode in the mid-1970s. In 1975, the SEC adopted a rule that effectively ended the era of fixed commissions for securities brokerage. This rule generated the growth of discount brokers and also led to institutional investors pressuring broker-dealers to reduce their commissions. In addition, technological advances simplified the process of trade execution, reducing the value of services provided by a broker when executing customer trades.

As a result, broker-dealers began to place greater emphasis on the value of their investment advice. Individual brokers were commonly identified as financial advisers. Compensation arrangements followed suit, with growth in fee-based accounts and individual compensation increasingly dependent upon the value of assets in client accounts held at the firm.

Congress recognised this convergence when it passed Dodd-Frank. Citing literature that noted confusion among many investors regarding the roles and duties of broker-dealers and investment advisers, Congress included in Dodd-Frank a provision authorizing, but not directing, the SEC to adopt a uniform fiduciary standard that would apply to both broker-dealers and investment advisers when dealing with retail accounts.⁸

CURRENT STANDARD OF CARE APPLICABLE TO BROKER-DEALERS

Broker-dealers are currently subject to a variety of standards developed through judicial decisions and regulatory actions by the SEC and the Financial Industry Regulatory Authority (FINRA), a self-regulatory organisation for the securities industry.⁹ Broker-dealers are required to “deal fairly” with their customers. This duty is derived from the anti-fraud provisions of the federal securities laws through judicial decisions that interpreted a broker-dealer's holding itself out to the public as an implicit representation that it will deal fairly with its customers.¹⁰

The duty to deal fairly includes a requirement to achieve “best execution” on behalf of customers.¹¹ Best execution requires broker-dealers to execute customer trades on the most favourable terms that are reasonably available. Communications with customers must be fair and balanced.¹² FINRA also has an array of rules that require broker-dealers to provide fair pricing, avoid unreasonable mark-ups and avoid unreasonable underwriting compensation.¹³

Broker-dealers are also required to make recommendations to clients that are “suitable.”¹⁴ Suitability has three different components. First, there is “reasonable basis suitability,” which requires the broker-dealer to investigate and understand the proposed investment or investment strategy so that it has a reasonable basis to conclude that it could be suitable for some investors. Second, there is “customer-specific suitability,” which requires the broker-dealer to determine that the investment is suitable for the specific customer based upon the customer's financial circumstances and investment objectives.¹⁵ In evaluating a customer's circumstances, broker-dealers are required to consider, at a minimum, a customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance. Finally, there is “quantitative suitability,” which is intended to prevent excessive trading or “churning” of a customer's account. Under this prong of the rule, an investment recommendation, even if suitable in and of itself, may be deemed unsuitable if it is part of a pattern constituting excessive trading.

There are significant differences between the suitability standard currently applicable to broker-dealers, and the best interest standard that is a fundamental component of a fiduciary duty. A range of potential investments may be “suitable” for a particular customer, but it is not likely all will be in the “best interest” of the

customer. In this regard, the suitability standard does not require broker-dealers to select the “best” choice from a group of suitable investments. Moreover, the suitability standard does not require broker-dealers to disregard their own interests when making an investment recommendation. In other words, under the suitability standard, a broker-dealer may recommend an investment that generates significant fees for the broker-dealer as long as the investment is suitable for the investor. Traditional fiduciary principles generally require a fiduciary to act in what the fiduciary believes to be the best interest of the person to whom it owes a fiduciary duty, irrespective of the fiduciary’s personal interests.

The gap between the “suitability” and “best interest” standards has been somewhat narrowed in recent years. FINRA has issued guidance stating that, in order to meet FINRA’s suitability standards, an investment recommendation must be “consistent” with the customer’s “best interests.”¹⁶ In the guidance, FINRA requires that broker-dealers not put their interests “ahead of the customer’s interests.” However, there is no requirement to disregard the broker-dealer’s interests. FINRA noted that, while many of its enforcement cases have involved situations where the broker’s recommendations appeared to be motivated by his or her commissions or other economic benefits, suitability does not require that the broker recommend an investment product with the lowest cost. Rather, cost is one of many issues to be weighed in evaluating whether the proposed investment is suitable and “consistent” with the customer’s best interest.

While broker-dealers are not prohibited from engaging in transactions with their customers that involve a conflict of interest, they are expected to have in place policies and procedures to identify and manage conflicts and to ensure that material conflicts of interest are timely disclosed.¹⁷ SEC Rules 15c1-5 and 15c1-6 specifically require written disclosures with respect to certain conflicts (selling securities issued by an affiliate of the broker-dealer and receiving third-party payments in connection with a distribution). More broadly, FINRA has indicated that broker-dealers should manage conflicts by (i) avoiding severe conflicts of interest, (ii) taking actions to mitigate potential conflicts when reasonably possible and (iii) making timely disclosure in a clear and readily understandable format.

STANDARD OF CARE APPLICABLE TO INVESTMENT ADVISERS

An investment adviser is a fiduciary as to its clients. This duty is not specifically set forth in the Advisers Act or the SEC’s rules. Rather, these fiduciary duties are imposed on an investment adviser by operation of law, because of the nature of the relationship between the two parties.¹⁸ Under the Advisers Act, an adviser’s duty is to serve the “best interests” of its clients. This requirement includes an obligation not to subordinate a client’s interests to its own.

According to the SEC, and similar to the standards that are applicable to broker-dealers, investment advisers owe their clients a duty to provide investment advice that is suitable. This duty generally requires an adviser to make a reasonable inquiry into the client’s financial situation, investment experience and investment objectives, and to make a reasonable determination that the advice is suitable in light

of the client’s situation, experience and objectives. An adviser is expected to have a reasonable and independent basis for its recommendations.

An investment adviser’s fiduciary duty also includes the duties of loyalty and care. If an adviser has a material conflict of interest with a customer, it must either eliminate that conflict or fully disclose to the client all material facts relating to that conflict. An investment adviser is expected to take steps to fulfil these obligations. For example, an investment adviser must provide full and fair disclosure of all material facts to its clients and prospective clients. The SEC expects that investment advisers will eliminate, or at least disclose, all conflicts of interest that might cause it, whether consciously or unconsciously, to render advice that is not disinterested.

Not surprisingly, an investment adviser cannot use a client’s assets for its own benefit or for the benefit of other clients (without client consent). Doing so may constitute a “fraud” under Section 206 of the Advisers Act.

The fiduciary standard that applies to investment advisers impacts the compensation that these advisers receive. For example, broker-dealers tend to receive transaction-based compensation, such as trade commissions. In contrast, registered investment advisers often receive their compensation in the form of asset-based fees; in many relationships, they may earn a percentage of assets under management, regardless of how many transactions a client effects. Many market observers believe that that asset-based fees help remove an adviser’s potential incentive to make unnecessary trades.

PROHIBITION ON PRINCIPAL TRANSACTIONS

Transactions in a principal capacity can pose a conflict of interest, to the extent that the financial professional will be across from the investor that it purports to serve. Section 206(3) of the Advisers Act prohibits an adviser, acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client for its own account, without:

- disclosing to the client in writing the capacity in which it is acting; and
- obtaining the client’s consent before the completion of the transaction.

The SEC has stated that this notification and consent must be obtained separately for each transaction; in other words, a blanket consent for transactions is not sufficient.

The SEC had adopted a temporary rule (Rule 206(3)-3T), which expired December 31 2016.¹⁹ The temporary rule permitted investment advisers that are also registered broker-dealers to comply with this provision by providing oral notice of principal transactions, as long as certain conditions were satisfied. Specifically, this rule permitted an investment adviser, with respect to a non-discretionary advisory account, to comply with Section 206(3) by:

- providing written disclosure regarding the conflicts that may arise from principal trades;

- obtaining written, revocable consent from the client authorizing the adviser to enter into principal transactions;
- making certain additional disclosures to the client either orally or in writing and obtaining the client’s consent before each principal transaction;
- sending confirmation statements to the client that disclose the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorised the transaction; and
- delivering to the client a report, delivered annually, listing each of the principal transactions that were effected in this manner.

However, with certain limited exceptions (for example, non-convertible investment-grade debt securities underwritten by the investment adviser or certain of its affiliates), this rule generally was not available for principal trades of securities issued or underwritten by the investment adviser or its affiliates.

Policies and Procedures

Rule 206(4)-7 under the Advisers Act requires a registered investment adviser to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act, including the rules and standards discussed above. These policies and procedures should be designed to prevent, detect, and correct violations of the Advisers Act. An investment adviser must review these policies and procedures at least once per year for their adequacy and effectiveness.

For example, the written policies and procedures must address an adviser’s portfolio management processes, including the allocation of investment opportunities among its clients, and the consistency of investment portfolios with the applicable clients’ investment objectives. The policies and procedures must also govern the accuracy of disclosures made to investors and clients, including account statements and advertisements.

Books and Records

Under Rule 204-2, investment advisers must maintain accurate and current certain books and records relating to the investment advisory business. The books and records are subject to fairly detailed requirements, and relate in large measure to the requirements discussed above. These include:

- records relating to providing investment advice and transactions in client accounts relating to that advice with respect to such advice, including orders to trade in client accounts (referred to as “order memoranda”);
- trade confirmation statements received from broker-dealers; and
- written correspondence that the advisor sent to or received from clients or potential clients discussing its recommendations or suggestions.

Some of these requirements reflect the DOL’s proposed record keeping requirements for determining whether a transaction is in the best interests of a customer.

Exemption for Broker-Dealers

A registered broker or dealer is exempt from the Advisers Act if its investment advice is:

- solely incidental to the conduct of its business as broker or dealer; and
- the broker-dealer does not receive any “special compensation” for providing the investment advice.

The SEC has stated that investment advice is “solely incidental” to brokerage services if the advisory services are rendered “in connection with and reasonably related to the brokerage services provided.” If the advice is not “solely incidental,” the broker-dealer is subject to the Advisers Act, regardless of the form of compensation it receives.

In general, to avoid receiving “special compensation,” a broker or dealer relying on this exclusion must receive only commissions, mark-ups, and markdowns for its services.

Broker-dealers have relied on this exemption in order to remain outside the scope of the Advisers Act’s fiduciary requirements and other substantive provisions. The DOL rules do not contain a similar exemption for broker-dealers.

DODD-FRANK ACT AND THE SEC STAFF STUDY

Section 913 of Dodd-Frank directed the SEC to conduct a study to evaluate the effectiveness of existing legal and regulatory standards to protect retail customers and to assess whether there are any gaps, shortcomings or overlaps in the existing standards that should be addressed by rule or statute. Section 913 authorised, but did not require, the SEC to adopt a uniform fiduciary standard that would govern the conduct of both broker-dealers and investment advisers when dealing with retail accounts and which would require them to “act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.”

Congress included several important provisions in Section 913 that potentially limit the consequences of any uniform fiduciary standard that might be adopted by the SEC. It noted that the receipt of commissions or standard forms of compensation by a broker-dealer should not, in and of itself, violate any uniform fiduciary standard. In addition, Congress stated that the adoption of a uniform fiduciary standard would not necessarily impose upon broker-dealers a continuing duty of care or loyalty to a retail customer after having provided personalised investment advice.

In January 2011, the SEC publicly released the study conducted by its staff (the SEC Study). The SEC Study concluded that there was investor confusion about the different standards of care and a need for harmonisation of the regulatory schemes applicable to broker-dealers and investment advisers. The SEC Study recommended adoption of a uniform fiduciary standard that would apply to both broker-dealers and investment advisers when providing personalised investment advice to retail customers. The SEC Study recommended that this standard would be no less stringent than the standard required of investment advisers under Section 206 of the Advisers Act.

The uniform fiduciary standard recommended by the SEC Study would include both a duty of loyalty and a duty of care. Under the duty of loyalty, conflicts of interest must be eliminated or disclosed. The SEC Study suggested that a disclosure regime would likely consist of both basic disclosures made upon the establishment of an account, and point-of-sale disclosures to address product-specific or transaction-specific conflicts. The SEC Study recommended that the SEC address through rules or guidance how broker-dealers may comply with a new fiduciary standard when

confronted by the conflicts of interest inherent in principal transactions. The duty of care recommended by the SEC Study would require all broker-dealers and investment advisers to adhere to minimum standards of professionalism that would be spelled out in SEC rules or guidance.

The SEC Study received a rocky reception. Two of the then five SEC Commissioners criticised the study, focusing in particular on its alleged failure to adequately consider the economic consequences of its recommendations. Whether because of this split at the SEC, competing priorities or simply the challenge of crafting such a significant change in brokerage practices, the SEC did not implement the recommendations in the SEC Study. Public statements by members of the SEC over the past several years have indicated that the SEC is continuing to study the matter. However, there seemed to be little forward progress until 2017 and the appointment of Jay Clayton as Chair of the SEC. For a summary of recent developments involving the SEC, see the section below entitled *Challenges to the Fiduciary Rule and other Recent Developments*.

DEPARTMENT OF LABOR REQUIREMENTS FOR RETIREMENT ACCOUNTS

Historical fiduciary standards

The DOL has historically been responsible for protecting employee benefit plans. The fiduciary duties that apply to employee benefit plans in the United States have grown over time. Section 165 of the Revenue Act of 1938 (the 1938 Code) required the assets of tax-qualified pension and profit-sharing plans to be held in trust and managed for the exclusive benefit of employees and their beneficiaries. The 1938 Code also prohibited trust funds from being diverted for purposes other than the exclusive benefit of employees.²⁰ Section 302(c)(5) of the Labor Management Relations Act, which was enacted in 1947, requires trust funds held in multi-employer pension plans to be held for “the sole and exclusive benefit of the employees ... and their families and dependents.”²¹

The extent of regulation in this area steadily expanded over time. For example, in the 1954 version of the Internal Revenue Code, the prohibited transaction rules governing exempt organisations were extended for the first time to include tax-qualified plans.²²

Eventually, as the prevalence and significance of private company sector pension plans continued to grow, and in light of several well-publicised scandals with respect to pension plans, Congress was prompted to establish the more detailed federal standard of conduct governing those who administer plans or make investment decisions for plans, which are set forth today in the Employee Retirement Income Security Act of 1974 (ERISA).²³ Events that stimulated Congress to enact ERISA included the collapse of the Studebaker Company, which caused its employees to lose not only their jobs but also the bulk of their defined benefit pension benefits, and allegations that the Central States Teamsters Plan suffered significant investment losses as a result of the influence of organised crime on its investment activities.

Since its enactment in 1974, a “fiduciary” under ERISA has been defined under Section 3(21) of ERISA as follows:

“Except as otherwise provided in subparagraph (B),²⁴ a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section [29 U.S.C §1105(c)(1)(B)].”²⁵

The regulation promulgated in 1975 after ERISA’s enactment to interpret what is meant by rendering investment advice, and which had been in effect for over 40 years until it was superseded in 2016, provided that a person is a fiduciary as the result of rendering investment advice to an ERISA plan, if the person:

- Renders advice as to the value of securities or other property or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property;
- On a regular basis;
- Pursuant to a mutual agreement, arrangement, or understanding with the plan or a plan fiduciary;
- That will serve as a primary basis for investment decisions with respect to plan assets; and
- That will be individualised based on the particular needs of the plan.²⁶

On October 21 2010, the DOL issued a proposed regulation that would have dramatically expanded the situations under which a person would be considered a fiduciary under Section 3(21) of ERISA as a result of rendering investment advice.²⁷ In issuing the proposed regulation, the DOL explained that the current regulation had not been updated since 1975, and that the retirement plan community had changed significantly in the interim, noting the historic shift from defined benefit plans to defined contribution plans, which require individual participants to make investment decisions, and the increased complexity of investment products and services made available to plans.

On September 19 2011, the DOL announced that the proposed regulation would be withdrawn, but that it intended to re-propose it in early 2012. In announcing the withdrawal of the proposed regulation, Phyllis Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration, said that “Many of the people we have met with, particularly on the IRA side, have given us a lot of information that, honestly, we didn’t have when we made the original proposal, and we need time to digest and integrate it into the structure of the rule.”²⁸

On April 20 2015, the DOL issued a new version of the proposed regulation,²⁹ which was then finalised in regulations adopted by the DOL on April 6 2016.³⁰

THE DEPARTMENT OF LABOR FIDUCIARY RULE

The fiduciary rule greatly expands the scope of persons who may be deemed fiduciaries when dealing with retail retirement accounts. Under the new rule, any person who provides investment advice may be deemed a fiduciary, irrespective of whether the advice is furnished in the context of an ongoing relationship or as a one-time event.

The definition of investment advice generally covers the following categories of advice: (1) investment recommendations, which may relate to a specific investment opportunity or a broader investment strategy, and (2) investment management recommendations, including recommendations of other persons to provide investment advice for a fee or to manage plan assets. Persons who provide the advice fall within the general definition of a fiduciary, if they either (a) represent that they are acting as a fiduciary under ERISA or the 1938 Code or (b)

provide the advice pursuant to an agreement, arrangement or understanding that the advice is individualised or specifically directed to the recipient for consideration in making investment or investment management decisions regarding plan assets.

The fiduciary rule differs from the pre-existing standards in a number of respects including:

- no longer requiring the advice to be given on a regular basis (ie, one time advice can make you a fiduciary under the fiduciary rule),
- no requirement that there be a mutual agreement or understanding that the financial intermediary is acting as a fiduciary (ie, if the customer reasonably believes the financial intermediary is acting as a fiduciary, that may be enough to establish fiduciary status), and
- no requirement that the advice serve as the primary basis for the customer's investment decision (ie, any advice regarding the investment decision, no matter how minor, can cause the financial intermediary to be considered a fiduciary).

One controversial feature of the fiduciary rule is that it applies to individual retirement arrangements (IRAs). Because IRAs are not considered plans under ERISA, the 1975 regulation did not purport to apply to them. In justifying the expansion of the fiduciary rule's coverage to IRAs, the DOL explained that because the prohibited transaction rules of the Code (which apply to IRAs and employee benefit plans generally) were parallel to the prohibited transaction provisions of ERISA (which applies to employee benefit plans, but not to IRAs), the fiduciary rule's identification of who is a fiduciary should apply to plans and IRAs subject to the Code, as well as to plans (but not IRAs) that are subject to ERISA. The result of this parallel regime is that persons who become fiduciaries under the fiduciary rule as a result of giving investment advice to an IRA owner, are subject to the self-dealing prohibited transaction rules of the Code, but do not become subject to the fiduciary responsibility provisions of ERISA, unless they otherwise agree or acknowledge that they are acting in a fiduciary capacity.

Actions that cause you to be deemed a fiduciary – giving investment advice to a plan

Under the fiduciary rule, to be considered a fiduciary as a result of giving investment advice, a person has to both be (i) giving advice with regard to certain matters, and (ii) doing so with respect to an ERISA plan fiduciary.

- (i) Advice with regard to certain matters:
 - (a) A recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, or a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA;³¹ or
 - (b) A recommendation as to the management of securities or other investment property, including, among other

things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (eg, brokerage versus advisory); or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer, or distribution should be made.³²

For purposes of the above activities, a recommendation is defined in the fiduciary rule as a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the customer engage in or refrain from taking a particular course of action. The determination of whether a recommendation has been made is an objective rather than subjective inquiry. In addition, the more individually tailored the communication is to a specific customer, the more likely the communication will be viewed as a recommendation. Providing a selective list of securities to a particular customer as appropriate investments for the customer's consideration would be a recommendation as to the advisability of acquiring the securities on the list, even if no specific recommendation is made with respect to any one security. Furthermore, a series of actions, directly or indirectly (eg, through or together with any affiliate), that may not constitute a recommendation when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program.³³

The fiduciary rule looks to FINRA guidance on what constitutes an investment recommendation.³⁴ FINRA has stated that a communication that could reasonably be viewed as a "suggestion" that the client take certain action or refrain from taking certain action in relation to a security or investment strategy constitutes a "recommendation." See FINRA Notice to Members 11-02. Importantly, this could cover virtually all dealings between a broker-dealer and its customer, other than processing unsolicited orders.

- (ii) With respect to the investment advice described in paragraph (i) above, the recommendation is made either directly or indirectly (eg, through or together with any affiliate) by a person who:
 - (a) Represents or acknowledges that it is acting as a fiduciary within the meaning of the [Act] or the Code;
 - (b) Renders the advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the advice recipient; or
 - (c) Directs the advice to a specific advice recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.³⁵

Significance or consequences of broader fiduciary standard

Under ERISA, fiduciaries are prohibited from engaging in certain transactions that are deemed to involve a conflict of interest between the fiduciary and the customer. Fiduciaries are generally prohibited from acting as principal or from receiving transaction-based compensation, such as a brokerage commission. A self-dealing prohibited transaction occurs under ERISA and/or the Code to the extent a fiduciary uses the authority, control or responsibility that makes that person a fiduciary (ie, in this case, giving advice) to cause the plan to pay additional fees or compensation to the person or the person's affiliate.³⁶ The occurrence under ERISA of a prohibited transaction causes the person to have violated ERISA's fiduciary duties. In addition, under the Code, the person committing the prohibited transaction is subject to an initial tax of 15% of the amount involved for each year (or part of a year) beginning when the prohibited transaction occurs and ending when it is "corrected," by either undoing the transaction to the extent possible or restoring the plan's financial position.³⁷ Moreover, there is an additional 100% tax if the transaction is not corrected within 90 days after the IRS mails a notice of deficiency to the person who committed the prohibited transaction.³⁸ A plan is required to report prohibited transactions to the DOL and the IRS in its annual filing on Form 5500.

There is a carve-out from the fiduciary rule for certain transactions with institutional retirement investors (the "Seller's Exception"). In addition, the BIC and Principal Transactions Exemptions provide partial relief for fiduciaries that comply with the provisions of these exemptions. The Seller's Exception and the Principal Transactions and BIC Exemptions are discussed below.

THE SELLER'S EXCEPTION FOR INSTITUTIONAL ACCOUNTS

There are a number of exceptions to the general rule that giving investment advice to a plan causes the advice giver to become a fiduciary. One of the most important of these is the exception for advice received on behalf of a plan or IRA by an independent fiduciary with financial expertise, also called, the "sophisticated investor exception," the "seller's exception" or the "seller's carve-out." Under this exception, the advice giver (the seller) will not be considered a fiduciary if it has not represented or acknowledged that it is a fiduciary and if the person acting on behalf of the plan meets the following criteria:

(A) the seller knows or reasonably believes that the person is (i) a bank as defined in Section 202 of the Advisers Act or a similar institution under state or federal law, (ii) an insurance carrier qualified in more than one state to perform the services of managing, acquiring or disposing of assets of a plan, (iii) an investment adviser registered under the 1940 Act or in some cases under state law, (iii) a broker-dealer registered under the Exchange Act, or (iv) an independent fiduciary that holds, or has under management or control, assets of at least \$50 million (the seller may rely on written representations from the plan or independent fiduciary as to (A));³⁹

(B) the person seeking to take advantage of this exception (the "seller") knows or reasonably believes that the independent fiduciary of the plan or IRA is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies;⁴⁰

(C) the seller fairly informs the independent fiduciary that the person is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with the transaction and fairly informs the independent fiduciary of the existence and nature of the person's financial interests in the transaction;⁴¹

(D) the seller knows or reasonably believes that the independent fiduciary of the plan or IRA is a fiduciary under ERISA or the Code, or both, with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction;⁴² and

(E) the seller does not receive a fee or other compensation directly from the plan,

plan fiduciary, plan participant or beneficiary, IRA, or IRA owner for the provision of investment advice (as opposed to other services) in connection with the transaction.⁴³

For paragraphs (A), (B) and (D) above, the seller may rely on written representations from the plan or independent fiduciary that those requirements are met.⁴⁴ When the fiduciary rule was issued, there was some question as to whether the representations required by the independent fiduciary exception could be satisfied passively, as representations that are deemed to be made by an investor under the terms of a prospectus or offering memorandum. That question was answered in a set of FAQs issued by the DOL. The FAQs included a question as to whether the reasonable belief requirements of the independent fiduciary exception “could be met by including standardised representations in its disclosures that require the bank, insurance carrier, registered broker-dealer or investment adviser, or other independent fiduciary to affirmatively disclaim or modify the representations?” The DOL’s response was that in its view, “negative consent to a written representation can be a written representation for purposes of the reasonable belief requirements.”⁴⁵

In a sense, the notion here is similar to that of Rule 144A under the U.S. Securities Act of 1933. Some entities making an investment decision are deemed to be able to look out for themselves, without needing the protections offered by the relevant regulatory requirements offered to retail investors.

Other issues addressed by the DOL in its FAQs with respect to the sophisticated investor exception include:

- Confirmation that the \$50 million under management requirement under (A)(iv) above, can be met by aggregating amounts from the fiduciary’s retirement and non-retirement accounts and from multiple investors, and that the requirement is deemed to be met if a retirement adviser reasonably relies on representations of the plan fiduciary that it meets those requirements and will notify the retirement adviser in writing if the amount of investments drops below \$50 million.⁴⁶
- Confirmation that the independent fiduciary exception is broad and applies to any transaction related to the investment of securities or other investment property, including advice regarding entering into investment advisory and investment management arrangements.⁴⁷
- Confirmation that the independent fiduciary exception applies to communications with a representative of a fiduciary who is a registered investment adviser, but not with the fiduciary itself; provided that the representative is acting under the control and supervision of the registered investment adviser in accordance with applicable securities laws.⁴⁸
- Confirmation that the independent fiduciary exception is available to a retirement adviser who gives recommendations to an IRA owner (who himself does not qualify as an independent fiduciary); provided that the IRA is represented by a fiduciary who meets the requirements of the independent fiduciary exception and the retirement adviser reasonably believes that the fiduciary is responsible for exercising independent

judgment in evaluating the transaction.⁴⁹

- Confirmation that the independent fiduciary exception will not be invalidated by the presence of a retirement investor at a meeting with the retirement investor’s registered investment adviser fiduciary who meets the requirements of the independent fiduciary exception; provided that the retirement adviser reasonably believes that the registered investment adviser is acting as a plan fiduciary with responsibility for exercising independent judgment in making a fiduciary recommendation to the retirement investor with respect to the transaction at issue. There had been some question whether the retirement investors who are being protected by the independent plan fiduciary are required to be absent from any meeting between the plan fiduciary and the investment adviser where investment matters are being discussed.⁵⁰
- Confirmation that a participant in a qualified plan can be a fiduciary to that plan that meets the independent fiduciary exception, but an IRA owner cannot qualify as the fiduciary of his or her own IRA. According to the FAQs, this somewhat non-intuitive conclusion results because under the Regulation an IRA owner is not a fiduciary with respect to the IRA, and so therefore cannot be an “independent fiduciary” as required under the independent fiduciary exception.⁵¹

Noting that for purposes of the requirement in (D) above that to qualify for the independent fiduciary exception, the plan’s fiduciary must be “independent,” the FAQs provide that the fiduciary rule does not specifically define “independent;” however, the preamble provides that whether a party is considered “independent” will generally involve an analysis of whether there exists a financial interest, ownership interest or other relationship, agreement or understanding that would limit the ability of the party to carry out its fiduciary responsibility to the retirement investor beyond the control, direction or influence of other persons involved in the transaction. The preamble further provides that parties would likely not be independent in any of the following circumstances: (i) the parties belong to a group of corporations under common control or are members of an affiliated service group, (ii) the transaction includes an agreement designed to relieve the fiduciary from any responsibility to the plan or IRA, (iii) the fiduciary is under substantial control and close supervision by a common parent of the parties, or (iv) a fiduciary receives compensation in violation of ERISA’s self-dealing prohibited transaction rules.⁵²

THE BEST INTEREST CONTRACT EXEMPTION

The BIC Exemption provides an avenue for broker-dealers who are deemed fiduciaries to receive commissions or other transaction-based compensation when dealing with retail retirement accounts. The exemption covers a broad range of securities, but only applies to transactions that are effected on an agency or riskless principal basis.⁵³ The BIC Exemption does not apply to (i) an adviser who has discretionary authority over the plan or IRA, or is an employer or an affiliate of the employer whose employees are covered under the plan, (ii) compensation received as the result of a principal transaction, or (iii) compensation

received as a result of advice generated by an interactive website (robo-advice).

The Impartial Conduct Standards

Compliance with the BIC Exemption may currently be achieved through compliance with the Impartial Conduct Standards that are set forth in the exemption. The Impartial Conduct Standards include the following elements.

(1) The advice must be in the “best interest” of the retirement investor. In order to meet the best interest standard, the advice must reflect the care, skill, prudence, and diligence that would be used by a prudent person acting in a like capacity and familiar with such investment matters. The advice must be based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor.⁵⁴ The fiduciary is obligated to seek current information from the investor regarding his or her circumstances. Finally, the advice must be rendered without regard to the financial or other interests of the fiduciary or any the fiduciary’s affiliates.

(2) The fiduciary (and its affiliates) must not receive, directly or indirectly, compensation for their services that is in excess of reasonable compensation (within the meaning of ERISA Section 408(b)(2) and Code Section 4975(d)(2)).⁵⁵ The DOL has noted that the reasonableness of compensation should be determined by reference to current market prices, while recognizing that greater compensation might be justifiable for transactions or investments that are difficult to execute.

(3) Statements by the fiduciary to the retirement investor about the recommended transaction, fees and compensation, material conflicts of interest, and any other matters relevant to a retirement investor’s investment decisions, will not be materially misleading at the time they are made. Importantly, this prong of the Impartial Conduct Standards probably requires fiduciaries to adequately disclose any material conflicts of interest. Failure to do so could mean that representations made with respect to the investment would be deemed misleading, thereby disqualifying the transaction from coverage under the BIC Exemption.

Additional requirements of the BIC Exemption

The BIC Exemption, as adopted by the DOL in 2016, contains numerous additional requirements that are not currently applicable. Such additional requirements include: (i) a written contract with the customer that complies with detailed requirements set forth in the BIC Exemption, (ii) a prohibition on exculpatory provisions disclaiming or otherwise limiting the liability of the fiduciary, (iii) a prohibition on requiring a customer to waive class-action rights and (iv) detailed disclosure requirements. In addition, the BIC Exemption as adopted by the DOL would not be available for transactions effected by the fiduciary if the securities were issued by the fiduciary or an affiliate. (This is the case, for example, in a wide range of debt securities and structured notes where the lead underwriter is an affiliate of the issuer.)

The DOL is currently evaluating these additional requirements and limitations. It is not clear the extent to which these requirements and limitations will survive and be included in the exemption when it is finalized. The DOL has already indicated in court filings that it does expect to retain the prohibition on class-action waivers. Additional changes are likely to be made as the DOL continues its re-evaluation as directed by the President.

THE PRINCIPAL TRANSACTIONS EXEMPTION

The Principal Transactions Exemption provides an avenue for broker-dealers who are deemed to be fiduciaries to act in a principal capacity when dealing with retail retirement accounts. This is an important exemption given the many situations in which broker-dealers act as principal, such as selling securities from inventory, market-making and firm commitment underwritten offerings.

However, the Principal Transactions Exemption is only available for a narrow

range of investments. Instruments covered by the Principal Transactions Exemption are (i) certificates of deposit,⁵⁶ (ii) unit investment trusts, (iii) U.S. Treasury and Agency securities and (iv) U.S. dollar-denominated debt issued by U.S. corporations in offerings registered under the Securities Act of 1933.⁵⁷ Equity securities, debt securities issued in exempt offerings and debt securities issued by non-U.S. companies are not covered by the Principal Transactions Exemption.⁵⁸ As a result, the Principal Transactions Exemption as currently structured is of limited usefulness and will force the securities industry to consider alternative models for underwritten offerings of securities that are not covered by the exemption.

Compliance with the Principal Transactions Exemption currently only requires adhering to the Impartial Conduct Standards discussed above and seeking to obtain the best execution reasonably available under the circumstances with respect to the Principal Transaction.⁵⁹ The Principal Transactions Exemption as adopted by the DOL in 2016 includes contract and disclosure requirements that are substantially similar to those required by the BIC Exemption. In addition, the Principal Transactions Exemption as originally adopted includes conditions that would further restrict the securities eligible for coverage under the exemption by prohibiting use of the exemption (i) when the fiduciary or an affiliate is the issuer or acting as an underwriter of the securities (as is frequently the case with respect to many financial products, such as structured notes), and (ii) for corporate debt securities that are not liquid and that involve more than a “moderate” level of credit risk. Unfortunately, these terms are not precisely defined, leaving a significant amount of uncertainty.

These additional requirements and conditions are currently under review by the DOL and it is not clear to the extent to which they will survive and be included in the exemption when it is finalised.

LEVEL FEE FIDUCIARIES

Level fee fiduciaries are fiduciaries that charge an advisory fee and do not receive any transaction-based compensation. Many brokerage firms maintain fee-based accounts where the customer pays a fee calculated as a percentage of the assets in the account. By definition, such accounts do not pay transaction-based compensation, and therefore are not impacted by the restrictions on variable compensation under the fiduciary rule. However, level fee fiduciaries are fiduciaries and are required to act in the best interest of their customers and to avoid conflicts of interest.

Level fee fiduciaries must not receive any payments from third parties that might incentivise the level fee fiduciaries to recommend products promoted by those third parties. Level fee fiduciaries should have undivided loyalty to their customers and should limit their compensatory arrangements to the type of asset-based or similar fees commonly used by investment advisers.

The DOL has recognised the potential conflict involved when a level fee fiduciary is asked to provide advice on a rollover of retirement accounts. The result of that advice might be the establishment of a new account that will generate an ongoing stream of fees for the level fee fiduciary. To accommodate the

potential conflict inherent in these situations, the DOL included within the BIC Exemption a streamlined exemption, in which a level fee fiduciary may provide advice on rolling over assets in a retirement plan into a fee-based account if the level fee fiduciary complies with the Impartial Conduct Standards, and documents the basis for its recommendation.

CHALLENGES TO THE DOL FIDUCIARY RULE AND OTHER RECENT DEVELOPMENTS

Following its adoption, the DOL fiduciary rule faced immediate challenges in the courts and in Congress. A number of securities and insurance industry groups initiated litigation challenging the DOL’s authority and the process it undertook to adopt the fiduciary rule. With one minor exception discussed below, those challenging the DOL fiduciary rule in court lost their cases, although a number of those cases are now on appeal.

The one partially successful challenge involves a case brought by Thrivent Financial for Lutherans (Thrivent) in the federal district court in Minnesota. On November 7 2017, the district judge in that case granted Thrivent a preliminary injunction that prohibits the DOL from enforcing the prohibition on class-action waivers contained in the BIC and Principal Transactions Exemptions. However, the DOL had already indicated in its pleadings that it did not intend to retain that provision. Moreover, the court granted the DOL’s motion for a stay, noting that the continuing re-evaluation of the fiduciary rule by the DOL might eliminate the issues in contention in the Thrivent case.

Members of Congress have also criticised the fiduciary rule, arguing that it will result in smaller investors losing access to professional advice. Some members of Congress have also argued that the DOL exceeded its authority and, in any event, regulation of investment advice should rest with the SEC. Congress passed legislation to block the fiduciary rule in April/May 2016, but the legislation was vetoed by President Obama.

The Financial CHOICE Act of 2017 would have repealed the DOL fiduciary rule and would have required any new rule adopted by the DOL to conform to standards adopted by the SEC. However, before adopting any uniform fiduciary standard, the SEC would have been required to report to Congress on (i) whether retail customers are being harmed because broker-dealers are held to a different standard of conduct from that of investment advisers; (ii) consideration of alternative remedies that could reduce any confusion and harm to retail investors due to the different standards of conduct; (iii) whether adoption of a uniform fiduciary standard would adversely impact the commissions of broker-dealers or the availability of certain financial products and transactions; and (iv) whether the adoption of a uniform fiduciary standard would adversely impact retail investors’ access to personalised and cost-effective investment advice.

The Protecting Advice for Small Savers Act of 2017 would also have repealed the DOL fiduciary rule and would have added a best interest standard for broker-dealers by amending the Securities Exchange Act of 1934 (the Exchange Act). This legislation would have also prohibited the DOL, the Treasury Department and the states from adopting

standards for broker-dealers that vary from those set forth in the new Exchange Act provision.

The prospects for a legislative repeal of the DOL fiduciary rule are hard to predict as of the date of this booklet.

Although the prospects for a successful judicial or Congressional repeal of the fiduciary rule remain cloudy, there are strong indications that both the DOL and the SEC are endeavouring to develop a fiduciary standard that will enhance the protection of retail investors while avoiding significant disruption of the securities industry. Their efforts in this regard are guided by the memorandum issued by President Trump in February 2017, in which he directed the DOL to consider the following questions:

- Whether the fiduciary rule has harmed or is likely to harm investors due to a reduction of access to certain retirement product structures and related financial advice;
- Whether the fiduciary rule has resulted in dislocations or disruptions within the retirement services industry that may adversely affect investors or retirees; and
- Whether the fiduciary rule is likely to cause an increase in litigation, and an increase in the prices that investors and retirees must pay to gain access to retirement services.⁶⁰

The SEC and the DOL have expressed a desire to cooperate in their efforts, and both have issued requests for public comment on a wide range of issues. The DOL has requested comment about whether it has struck the right balance between the interests of consumers in receiving broad-based investment advice and the need to protect them from conflicts of interest. The DOL is also seeking comment about how the industry has adapted to the fiduciary rule as it went into effect on June 9 2017, as well as comment on how the BIC and Principal Transactions Exemptions might be revised.

The SEC has also requested input from the public on a long list of questions related to the concept of a uniform fiduciary standard for broker-dealers and investment advisers. The SEC is seeking comments on whether it should employ a disclosure-based approach versus a standard-of-conduct-based approach to protect retail investors. It has also sought information about how industry trends such as the growth in fee-based accounts or the development of robo-advisers might impact retail investors and the risks that would be addressed through a uniform fiduciary standard. The SEC has asked for input on how conflicts of interest are disclosed and how these conflicts might be harming retail investors.

Further complicating the situation has been a movement to enact a fiduciary standard for broker-dealers at the state level. Both Connecticut and Nevada have taken action to enact such standards, and a number of other states are considering similar actions. It is not clear if such state laws as applied to broker-dealers would be preempted by Section 15(h) of the Exchange Act. However, it is generally acknowledged that allowing each state to adopt its own standard of care for broker-dealers could cause significant confusion and disruption in the securities industry, and substantially increase compliance costs.

Thus, the potential outcomes range from an outright repeal of the DOL fiduciary rule with no comparable replacement, to a messy matrix with different standards of care adopted by various federal agencies and state authorities. Importantly, many industry leaders acknowledge the need for some form of best interest standard when dealing with retail accounts. Many brokerage firms have invested heavily in new policies and arrangements intended to comply with such a standard. Moreover, the high profile public debate on this issue has raised the awareness of investors and made it increasingly difficult for broker-dealers to disclaim a best interest standard, even if they are legally permitted to do so.

Future of the uniform fiduciary standard

Although there are too many moving parts to predict the final outcome, it appears that there is somewhat of a consensus developing along the following lines:

- Broker-dealers and other financial intermediaries should be required to adhere to a best interest standard when advising retail investors.
- The best interest standard will likely be similar to the Impartial Conduct Standards that are currently in effect for retail retirement investors.
- The same standard of care should apply to retail retirement accounts and to other retail accounts.
- To the extent that broker-dealers are deemed fiduciaries, there should be readily available exceptions that would permit broker-dealers to receive transaction-based compensation and to effect transactions with retail investors on a principal basis, subject to timely disclosure regarding conflicts of interest and compensation payable to the broker-dealer and its affiliates.
- Material conflicts of interest, including those arising from compensation arrangements, must be identified, managed and fully disclosed.
- The new standard should avoid requirements that would imperil the availability of professional investment advice and certain investment products to smaller retail accounts.

IMPLICATIONS FOR BROKER-DEALERS

Broker-dealers are currently subject to the fiduciary rule when dealing with retail retirement investors. To the extent that they receive transaction-based compensation or act as a principal in dealing with such accounts, they must comply with the Impartial Conduct Standards. In addition, it seems increasingly likely that some form of best interest standard will be applied to broker-dealers more broadly when they provide investment advice to any retail account. In order to comply with this new paradigm, broker-dealers should implement the following measures:

Meet with retail retirement investors on a regular basis and make sure they have an adequate understanding of the client's current circumstances and objectives.

Serving a customer's best interests is not possible without a thorough understanding of the customer's financial situation and investment objectives. This information should be periodically updated. Procedures should be available to address and resolve any situation where a retail customer fails to cooperate in the provision of current information.

Conduct thorough diligence on all investment products offered to retail retirement investors.

Such diligence should include comparing product features and fees with those of comparable products in order to be able to conduct a best interest analysis. Bear in mind that a determination of suitability will no longer suffice and the

fiduciary needs to decide which of the suitable investments is in the best interest of the customer. The quality of this analysis is particularly important if "proprietary products" (ie, products that are managed or sponsored by the relevant financial institution or an affiliate), are being sold to retail accounts, given the inherent conflicts of interest associated with these products.

Document the basis for the fiduciary's conclusion that a particular investment product is in the best interest of the customer.

Investment recommendations are necessarily a judgment call, and even the savviest advisers will make calls from time to time that do not work out well for their clients. If a fiduciary's advice is challenged, it will be critically important for the fiduciary to be able to demonstrate that it undertook a prudent and thorough analysis before making its investment recommendation.

Evaluate internal compensation arrangements to ensure that they do not improperly incentivise sales personnel to recommend products that are not in the best interest of retail retirement investors.

Historically, broker-dealer compensation systems often incentivised the sale of proprietary products, or products that generated higher commissions and fees. Compensation arrangements should be reconfigured to eliminate any built-in bias towards products that are not necessarily in the best interest of the retail investor. The DOL has recognised that compensation systems will reward those who produce more revenues. However, the DOL has encouraged fiduciaries to re-think their compensation systems, with a view to mitigating the risk of untoward incentives. As an example, the DOL suggested that compensation grids be designed with relatively small incremental increases tied to higher revenue targets.

Train all sales personnel and supervisors to comply with the new requirements.

Broker-dealer personnel need to understand the differences between a suitability standard and a best interest standard. They also need to become familiar with the requirements of the DOL fiduciary rule as currently in effect. Failure to adequately train not only increases the risk of problematic behaviour, it also increases the risk that regulators responding to such problematic behaviour will impose harsher sanctions on the broker-dealer firm for its failure to properly train its personnel.

Monitor account activity with a view to detecting potential deviations from the new best interest standard.

Supervisors should be vigilant in seeking to identify and address any potential departures from the obligation to act in the best interest.

Establish procedures for documenting the reasonableness of compensation received from transactions with retail retirement accounts.

Fiduciaries should implement procedures to ascertain market prices, and should maintain records demonstrating

support for any determination that commissions or other fees are consistent with market standards. In addition, fiduciaries should exercise care when proposing to recommend products generating higher fees, and ensure that the higher fees are justified by the complexity of the product and/or the difficulty of executing the transaction.

**Establish and enforce procedures to identify and manage conflicts of interest.
Be certain to disclose all material conflicts of interest.**

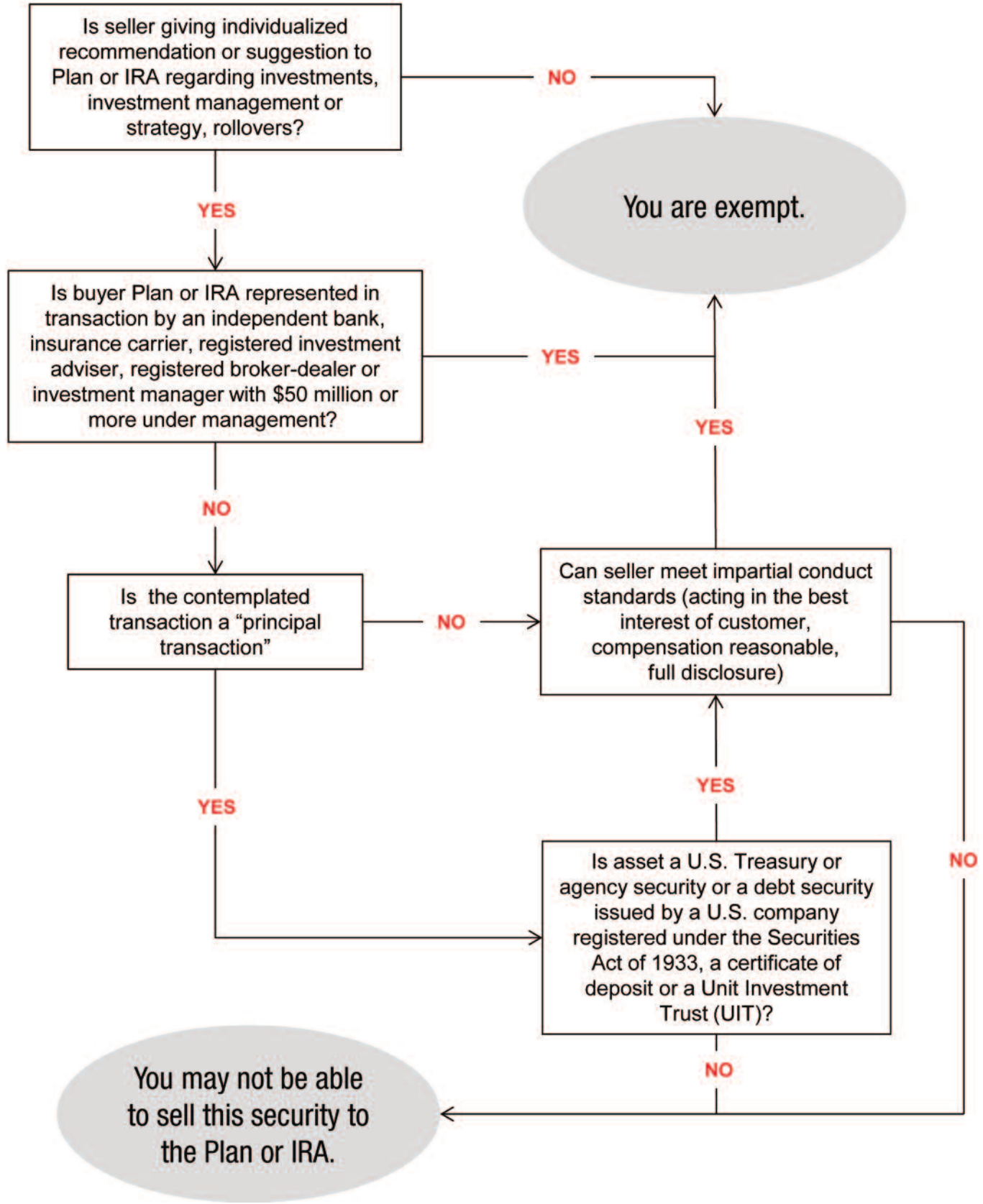
In addition to making fair and balanced disclosure about the investment products they are selling, fiduciaries should also make certain they identify conflicts of interest with their customer and, to the extent these conflicts are not eliminated, disclose the conflicts prior to closing the sale. The disclosures should include information about the fiduciary's fees, as well as any other material conflicts of interest.

Revisit distribution arrangements for new issues to ensure they comply with the new fiduciary rule.

Under the fiduciary rule, broker-dealers may not act as principal when selling to retail retirement investors, unless they are able to avail themselves of an available exemption. The Principal Transactions Exemption only covers a limited range of securities. As a result, distributions of securities not covered by the Principal Transactions Exemption, such as common stock, may need to be restructured. Potential solutions include (i) not selling to retail retirement investors, (ii) selling the securities on a best efforts or agency basis rather than on a firm commitment or principal basis, and (iii) selling the securities to another dealer who then resells on an agency basis.

CONCLUSION

The DOL fiduciary rule and related exemptions are likely to generate continuing discussion and possible change. In addition, it appears the SEC is actively proceeding on the development of a uniform fiduciary standard. As a result, additional changes are likely over the next 18 to 24 months. However, it appears that ultimately some form of best interest standard will apply to broker-dealers when dealing with retail accounts. It also appears that regulators will increasingly focus on the importance of managing and disclosing conflicts of interest. Broker-dealers would be well-advised to adjust their practices accordingly, while continuing to monitor ongoing developments.



ENDNOTES

1. *de Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1302 (2d Cir. 2002).
2. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 201 (1963).
3. See, eg, Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2012) [hereinafter Advisers Act].
4. Investment advisers may also charge wealthier clients a fee calculated as a percentage of the gains in the client's account.
5. Advisers Act, 15 U.S.C. § 80b-6(3) (2012). Please see the discussion below for additional details about 15 U.S.C. § 80b-6(3) (2012).
6. Advisers Act, 15 U.S.C. § 80b-2(a)(11)(C) (2012).
7. While Dodd-Frank did not use a quantitative measure to define retail accounts, rules adopted by FINRA define institutional accounts as accounts with more than \$50 million in assets. See, FINRA Rule 4512(c).
8. FINRA is the successor to the National Association of Securities Dealers, or NASD.
9. *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943); cert. denied, 321 U.S. 786 (1944).
10. FINRA Rule 5310.
11. FINRA Rule 2210.
12. FINRA Rules 2121, 2122 and 5110.
13. FINRA Rule 2111.
14. Broker-dealers are not required to evaluate customer-specific suitability for institutional accounts that have at least \$50 million of investments and that acknowledge they will take responsibility for determining suitability.
15. FINRA, Regulatory Notice 11-02 (2011); FINRA, Regulatory Notice 12-25, (2012).
16. See FINRA, Report on Conflicts of Interest (October 2013).
17. See *In re Arleen W. Hughes*, Exch. Act Release 4048 (Feb. 18 1948); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).
18. In determining not to extend the temporary rule, the SEC noted that few firms relied upon it, and, as such, it decided not to take further action to extend the sunset date. Individual exemptive relief may be available to investment advisers upon application to the SEC and prior to the sunset date, the SEC issued a number of exemptive orders consistent with the conditions of the temporary rule.
19. I.R.C. § 401(a)(2)(2012).
20. 29 U.S.C. § 186(c)(5) (2012).
21. I.R.C. § 503(b)(1954); See H.R. Rep. No. 1337, 83d Cong., 1st Sess. A.169 (1953), reprinted in 1954 U.S. Code Cong. & Admin. News 4017, 4071.
22. 6P.L. 93-406, 93d Cong., 2d Sess. (1974) (codified at 29 U.S.C. §§ 1101-14 (1988)).
23. Paragraph (B) of ERISA Section 3(21) applies generally to assets invested in a mutual fund, and is not directly pertinent to the subject of this booklet.
24. 29 U.S.C. §1002(21) (underlining added).
25. 29 C.F.R. § 2510.3-21(c); 40 Fed. Reg. 50,843 (Aug. 31 1975). To be a fiduciary under the statute, the person also has to receive "a fee or other compensation, direct or indirect" in connection with rendering such investment advice.
26. 75 Fed. Reg. 204,65263 (Oct. 22 2010).
27. Florence Olsen, *Labor Department Will Withdraw, Re-Propose Rule Expanding Definition of Plan Fiduciary* BNA PENSION & BENEFITS REPORTER (Sept. 26 2011).
28. 80 Fed. Reg. 75,21927 (April 20 2015).
29. 81 Fed. Reg. 68,20945 (April 6 2016).
30. 29 C.F.R. § 2510.3-21(a)(1)(i).
31. 29 C.F.R. § 2510.3-21(a)(1)(ii).
32. 29 C.F.R. § 2510.3-21(b)(1).
33. 81 Fed. Reg. 68,20945.
34. 29 C.F.R. § 2510.3-21(a)(2).
35. 29 C.F.R. § 2510.408h-2(c)(1).
36. 29 C.F.R. § 4975(a).
37. 29 C.F.R. § 4975(b).
38. 29 C.F.R. § 2510.3-21(c)(1)(i).
39. 29 C.F.R. § 2510.3-21(c)(1)(ii).
40. 29 C.F.R. § 2510.3-21(c)(1)(ii).
41. 29 C.F.R. § 2510.3-21(c)(1)(iv).
42. As a result, the seller can still be compensated for its advice, as long as the compensation is paid by an entity or person other than the plan or IRA. See, FAQs II Q&A 28.
43. 29 C.F.R. § 2510.3-21(c)(1).
44. Conflict of Interest FAQs Transition Period, Q&A 13 (May 2017).

45. FAQs II Q&A 20 and 21.
46. FAQs II Q&A 22.
47. FAQs II Q&A 23.
48. FAQs II Q&A 25.
49. FAQs II Q&A 24.
50. FAQs II Q&A 26 and 27.
51. FAQs II Q&A 28.
52. Accordingly, a transaction in an underwritten offering effected on a principal basis would not typically be eligible.
53. Best Interest Contract Exemption, § VII(d)(2016).
54. Best Interest Contract Exemption, § VII(c)(2)(2016).
55. Here, “certificates of deposit” appears to include so-called “structured CDs” the performance of which are linked to the performance of an underlying asset, such as an equity index.
56. Final Principal Transactions Exemption, §§ I(b) and VI(j)(2016). In light of this provision, “bank notes” offered under Section 3(a)(2) of the Securities Act of 1933 would not qualify, notwithstanding any relevant credit rating.
57. Accordingly, and perhaps oddly, SEC-registered notes issued by an investment grade U.S. issuer might qualify, but SEC-registered notes issued by a non-U.S. issuer with an even higher credit rating would not qualify.
58. Transaction Period Principal Transactions Exemption, § VII.
59. Presidential Memorandum on Fiduciary Duty Rule (Feb. 3 2017), available at: <https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule>.

USEFUL REFERENCES:

Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, available at: <http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/02/DoddFrankSection913.pdf>.

Study on Investment Advisers and Broker-Dealers, As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, U.S. Securities and Exchange Commission, January 2011, available at: <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

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