"WHILE YOU WERE WAITING…"

An Update on the Proposed Uniform Fiduciary Standard for the Financial Industry

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I. INTRODUCTION

There remains much confusion regarding the proposed uniform fiduciary standard (the "Proposal") put forth by the U.S. Department of Labor (the "DOL"). Unfortunately, despite the months-long comment period, days of hearings, and months of meetings between the DOL and interested parties, the contents of the final rule are anyone's guess. The DOL has gone so far as to indicate it would be modifying the Proposal prior to submitting the final rule for approval, but the nature of those modifications is still a source of great debate. One thing is for certain, absent successful legislative intervention, the DOL's final rule will be published in the Federal Register this year – most likely in late spring or early summer. The draft final rule was sent to the Office of Management and Budget ("OMB") for review on January 28, 2016. This update to our White Paper, released mid-2015, will examine the status of the Proposal and comments submitted regarding the Proposal, and attempt to prepare readers for the eventual final rule. We expect to update our analysis again in the near future, but this is how we see things now.

II. REFRESHER COURSE

On April 14, 2015, the DOL released a Proposal for comment that would enact a sweeping, principles-based approach to defining investment fiduciaries under the Employee Retirement Income Security Act of 1974 ("ERISA") and the provision of individualized investment advice to individual retirement accounts ("IRAs") under section 4975 of the Internal Revenue Code, as well as IRA "rollover advice."[2] The original five-part test for determining functional fiduciary status under ERISA is defined as a person who does not have discretionary authority over plan assets and who, for compensation:

1. Renders advice as to the value of the securities or other property;
2. On a regular basis;
3. Pursuant to a mutual agreement;

4. The advice serves as the primary basis for investment decisions; and
5. The advice is individualized.

All five prongs of the test must be met to be deemed an investment fiduciary under ERISA.

The Proposal would remove prongs 2 and 4 from the definition. Investment activities covered by the Proposal would include individualized investment advice and investment management recommendations, non-ESOP investment appraisals, and recommendations of investment professionals to qualified plans and IRAs. This would greatly expand the current duty of registered representatives to non-advisory IRAs and qualified plans.

The Proposal includes additional exemptions from the definition of fiduciary not included in the 2010 proposed rule, including the following:

1. Seller's Carve Out: Two alternatives are available to a broker.
    a. The first applies to providing advice to plans with more than 100 participants in which the broker reasonably believes that the fiduciary with control over plan assets has sufficient expertise to evaluate the transaction, and obtains written confirmation from the fiduciary that the fiduciary will not rely on the seller to act in the plan's best interest or provide impartial advice. The broker must disclose any financial interest in the transaction and cannot be paid directly by the plan.
    b. The second applies to plans with at least $100 million in plan assets and that otherwise meet the same conditions as the first carve out, except that the broker does not have to obtain written confirmations but must "fairly inform" the fiduciary of his or her adverse interests.

2. Swaps: Recommendations to a plan fiduciary to enter into a swap or securities-based swap regulated by the SEC or CFTC.
3. Plan Sponsor Employees: Internal staff of the company sponsoring the plan that provides advice and receives no compensation beyond "normal compensation."
4. Investment Platform Providers: The person markets investment options to the plan without regard to individualized needs through a platform from which the plan fiduciary may select options. The platform provider must disclose in writing he or she is not providing impartial investment advice or acting as a fiduciary.
5. Objective Criteria or Financial Data: The person limits advice to identifying investment alternatives that meet objective criteria provided by the plan fiduciary (*e.g.*, expense ratios, size of fund, type of asset, etc.), or providing data and comparisons with independent benchmarks.
6. ESOP Appraisals: Applies to persons providing appraisals to employee stock ownership plans.
7. Investment Education: A person who provides information on investment options in an IRA or plan without making specific recommendations regarding investment products or IRA alternatives. Educational materials can include information on investment concepts such as risk and return, diversification and dollar-cost averaging, as well as objective requests for information.

The Proposal also includes "Prohibited Transaction Exemptions" ("PTE") in response to comments to the 2010 proposed rule that argued the proposal would have banned or *de facto* eliminated brokerage commission and other indirect forms of compensation. The most important of the Proposal's PTEs is the Best Interest Contract Exemption ("BICE"). The BICE provides

that brokerage firms would still be able to set their own compensation practices with respect to providing individualized investment advice to a plan or IRA, provided the compensation is reasonable and the brokerage firm enters into a contract with the customer or plan that it:

1. Acknowledges fiduciary status;
2. Adheres to basic standards of impartial conduct;
3. Warrants compliance with federal and state laws governing advice;
4. Discloses basic conflicts of interest;
5. Discloses the cost of the firm's advice; and
6. Has adopted policies and procedures reasonably designed to mitigate conflicts of interest.

The IRA customer or plan would have a private right of action to assert breach of contract in a legal forum. In essence, the brokerage firm and registered representative would be contractually bound to act in the best interests of the customer, in addition to any applicable law, rule or regulation.

The Proposal also requests comments on a conceptual "Low Fee PTE," which would apply to variable compensation received by brokers for recommending certain "high-quality, low-fee investments" in a given product class. The DOL believes such an exemption could minimize compliance burdens for advisers when they offer products with little potential for material conflicts of interest. This conceptual exemption is not going to be included in the final rule.

The third PTE of note is the Principal Transaction Exemption, which would allow brokers to recommend higher-quality fixed-income securities out of inventory to plan participants and IRA accounts. This exemption would require a contractual agreement like the

BICE, the broker would have to obtain two price quotes from unaffiliated counterparties for the same or a similar security, and the transaction price would have to be as favorable to the plan or IRA as the two quotes.

III. PROCEDURAL STATUS AND POLITICAL RODEO

The Proposal has been through the political wringer and appears to have come out the other side. The DOL advanced a final version of the Proposal to OMB for review on January 28, 2016.[3] OMB's review could take up to 90 days unless it is expedited and finished within four to six weeks. Once the final rule is approved by OMB, it will be sent back to the DOL for public release in the Federal Register. After the final rule is published in the Federal Register, Congress will have 60 days to adopt a joint resolution of disapproval, if Congress wants to stop the regulation. If Congress adopts such a resolution, President Obama would have the chance to veto it (all indications suggest he would). The DOL indicates implementation of the final rule will begin eight months after it is published in the Federal Register (assuming it survives any would-be disapproval resolution).

These final stages come after a prolonged struggle beginning with the release of the Proposal in April 2015. Since that time, there have been two separate comment periods, between which public hearings lasting four days were held, followed by several months of consideration by the DOL of more than 3,500 comments submitted by interested parties. In addition, several legislators have sponsored bills meant to derail the Proposal. At least one such bill included language of a proposed fiduciary standard drafted by the sponsors and was meant to supplant the Proposal. Most recently, Rep. Peter Roskam, R-Ill. a member of the House Ways and Means Committee, introduced a bill on December 18, 2015 to halt the Proposal. The bill has the support of Republicans and several Democrats, including Reps. Richard Neal (MA) and John Larson

(CT).[4] As of the date of this supplement, two such bills were approved by the House Education and Workforce Committee. It is not clear whether the full House will take them up.[5]

IV. WORD ON THE STREET

The Proposal drew over 3,500 comments from a wide range of concerned and potentially affected investment industry parties, politicians, consumer rights activists and anonymous citizens. By far, the largest concern or area of focus for the commenters is the BICE, followed by the breadth of the "seller's carve-out," and the costs associated with complying with the Proposal.

A. Comments Regarding the BICE

The BICE has been a focus of proponents and opponents to the Proposal alike from the time the Proposal was released. In essence, the BICE provides that a person rendering individualized investment advice to an ERISA qualified plan or an IRA holder may receive compensation that creates a conflict of interest for the adviser (*e.g.*, commission, gross dealer concessions, 12b-1 fees, non-monetary awards, etc.) if the adviser enters into a binding contract with the investor that provides the adviser will act in the best interest of the investor "without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party." Comments from industry participants have ranged from the BICE is too exclusive and needs to be softened, to the BICE is completely unworkable and needs to be abandoned. Consumer groups, by contrast, laud the intent of the BICE and its binding nature as a necessary part of any final version of the Proposal, and suggest that if any changes are to be made, the timing of the contract required by the BICE is the only reasonable amendment to the rule.

More specifically, the "*without regard to…*" language has drawn the ire of the investment industry *en masse*. At its heart, the BICE is supposed to allow for compensation that would otherwise be essentially prohibited under the Proposal, such as differential commissions and differing levels of 12b-1 fees depending on the mutual fund recommended.[6] In its comment letter to the DOL, the Investment Company Institute ("ICI") referred to this language as "fiduciary-plus standard."[7] ICI expresses concern that a court might interpret this language as setting a more stringent standard than ERISA's existing fiduciary duties.[8] These comments were echoed by the American Council of Life Insurers ("ACLI"), which expressed concern that this language could be interpreted to imply that any adviser who has any financial interest in a transaction recommended to a retirement plan or IRA has violated the Best Interest standard.[9] The ACLI further expressed concern that this could include having an interest in receiving any commission in any amount.[10] FINRA has echoed this sentiment about the Best Interest standard in general and adds that the BICE, as proposed, does not adequately clarify how differential compensation can be demonstrated to be based upon neutral factors so as to be considered reasonable.[11] FINRA recommends deleting the "without regard to" language, at a minimum.[12]

By contrast, proponents of the Proposal and the BICE have argued that this language expressly allows for the receipt of commissions and other would-be prohibited compensation, effectively substituting for the tougher ERISA standard that would otherwise prohibit conflicted compensation.[13] The "without regard to" language that is included as part of the standard is designed to ensure that, although conflicted payments are permitted, they are not allowed to influence recommendations to the retirement investor.[14] SIFMA, on the other hand, argues that providing advice without regard to what one might earn requires the financial professional not know what he or she could be paid.[15]

Another main concern of those in the investment industry is the time at which an adviser must enter into the BICE with the retirement investor. For example, would an adviser have to enter into a binding contract with a potential retirement investor customer who simply phoned the adviser and asked whether the adviser provides rollover services? According to PIABA, rollover services and advice regarding rollovers are some of the most important advice an adviser can offer to a retirement investor – and fraught with the potential for conflicted advice.[16] Thus, the contract should be entered into prior to the investment professional rendering a "recommendation" of any kind, including whether to rollover one's assets in a prior employer's retirement plan.[17]

SIFMA, however, argues that entering the contract at the onset of a relationship with a client ignores the reality of such a relationship.[18] Such a requirement might discourage some retirement investors from initiating a relationship with an adviser.[19] Many retirement investors enter into contracts with investment firms, not individual advisers, and having advisers execute such contracts is not logistically feasible.[20] In addition, many questions from retirement investors are handled by call centers, and forcing each person employed by an investment institution with whom a retirement investor speaks to enter into such a contract would be extremely impractical.[21] This argument is echoed by FINRA member firms, including Cetera Financial Group, which feel investors being asked to enter into a complicated, multi-paged contract at an initial meeting with an adviser will likely be suspicious of the contract and, by relation, of the adviser.[22]

A third concern with respect to the BICE is the way in which it would be enforced. FINRA argues that the consequences of non-compliance with the BICE are unclear.[23] FINRA recommends the DOL clarify that the receipt of differential compensation by a financial

institution or adviser that failed to comply with all aspects of the warranties or to provide all of the disclosures required by the BICE would not by itself constitute a prohibited transaction in violation of ERISA.[24] With respect to remedies for breach of the contract required by the BICE, FINRA questions whether a financial institution would be allowed to include a liquidated damages clause, or whether a customer could require rescission as a remedy, effectively making the contract a guarantee.[25] FINRA recommends financial institutions not be allowed to include a liquidated damages clause but be allowed to preclude rescission as a remedy for breach.[26]

Finally, many financial institutions argue that the BICE would limit access to entire classes of investment products. In the Proposal, the DOL lists asset types that meet its stated view that investments recommended to retirement savers must have an appropriate degree of transparency, liquidity, and marketability – the "permissible assets." The Proposal specifically excludes several asset types that presumably do not meet the DOL's standards in this regard. At least one financial institution, Cetera Financial Group, argues that limiting the types of investments available to retirement investors actually subverts the DOL's attempt to ensure that advisers act in the best interests of those customers.[27] Cetera also advocates for a "grandfather" clause to apply to all investment recommendations made prior to a final rule.[28] Advisers, then, would not have to immediately enter into the contract required by the BICE to give advice regarding investments already made.[29] Similarly, advisers would not be subject to the prohibition of relying on the BICE with respect to investments already made in asset types not included among "permissible assets."[30]

B. Comments Regarding the Breadth of the "Seller's Carve-Out"

Many financial institutions commented on their concerns regarding whether the marketing of their firms' services would constitute giving investment advice under the Proposal

so as to make them fiduciaries. According to Charles Schwab, the details of the Proposal's broad definition of "recommendation" could encompass customary, non-fiduciary sales and marketing activities, where there is no expectation of a fiduciary relationship.[31] Schwab argues that the proposed version of the seller's carve-out does not resolve this issue because it does not apply to situations such as RFPs, where a broker may be asked to give a proposal that includes information regarding specific investments, and because the carve-out is only available to advisers to larger plans – those with at least 100 participants or $100 million in assets.[32] Some commenters recommend extending the seller's carve-out to plans of all sizes, arguing that individual investors and small plans are able to decipher when they are receiving investment advice versus being sold a service.[33]

Proposal proponents continue to argue that smaller plans and individual retirement investors need the fiduciary standard the most. Some proponents, however, appear to agree that the carve-out could be expanded, but argue that such an expansion of the seller's carve-out would need to be accompanied by express disclosures that the "seller" is not acting in an advisory capacity, even naming the person relying on the carve-out a "salesperson" rather than financial advisor.[34]

C. Comments on the Bottom Line

The other 900 lb. gorilla in the room is the cost to comply with the Proposal. Projected costs associated with the anticipated disclosures required under the Proposal, education of customers regarding the new rule and its effect on them, and continued compliance with the final rule have been estimated to be seven to eight figures annually for many financial institutions. For example, Fidelity Investments estimates it will cost at least $40 million to execute contracts required by the BICE with its existing IRA customers.[35] In addition, Fidelity anticipates $46

million in other start-up and year-one costs associated with the conflict and compensation disclosures required by the Proposal, as well as $18 million in annual ongoing costs.[36] By contrast, the Proposal anticipated the costs associated with the implementation of the rule – inclusive of execution of the contract, making the required disclosures, and the data retention requirements – to be $77.4 million and $29.2 million in subsequent years industry-wide. Unanimously, industry participants anticipate far greater costs associated with implementing the final rule than the Proposal asserts, as well as a much longer implementation period than the DOL's proposed eight months. These additional costs will eventually be passed on to the customers, argue many commenters, which will erode investor savings projected to result from the Proposal.

V. <u>READING THE TEA LEAVES…STILL</u>

The DOL has been tight lipped about its intentions for the final rule, despite repeatedly asserting it will take into consideration each and every one of the comments received. One DOL deputy assistant secretary, Timothy Hauser, did make public comments about potential modifications to the BICE pursuant to criticism. Specifically, Mr. Hauser said the DOL is seeking an "upfront, enforceable commitment of fiduciary status," but is flexible about rule language on when the dotted line must be signed.[37] Mr. Hauser continued to say that the "exact timing of it, the exact way that you do that, we're open to suggestions and would like to make that as easy and non-problematic as possible from a business standpoint."[38]

So, what will the final rule look like? Based on the comments submitted, in conjunction with some of the testimony given at the hearings, here are some potential modifications to the Proposal:

- The BICE will not require the contract to be executed prior to individualized investment advice being given. That is, the contract will not have to be entered at the initial meeting unless the adviser recommends specific investments to be purchased (or sold).
- Financial institutions will be able to market their services without being considered fiduciaries as long as no individualized advice is given, only objective information is provided, and the retirement investor and/or plan being provided with information is informed that the adviser is not acting in a fiduciary capacity.
- Disclosures regarding compensation and breakpoints for certain investment products will not have to be stand-alone documents, but will allow reference to other information sources disclosing certain data specific to the respective investments.
- The list of "permissible assets" will be modified or excluded altogether.
- Platform Providers will be able to provide objective, non-individualized investment options without becoming fiduciaries under the rule.

VI. IF YOU'RE NOT FIRST…YOU'RE THE SEC

The SEC remains steadfast in its assertion that the Proposal will further complicate markets, confuse investors, and provide an unworkable regulatory scheme for financial institutions. In fact, former SEC Commissioner Daniel Gallagher penned his own comment letter to Hon. Thomas Perez, Secretary of the DOL, to say that the rule, when finalized, will harm investors and the U.S. capital markets.[39] Former Commissioner Gallagher went on to say that the Proposal is a mess and a total give to the plaintiff's bar.[40] The SEC, however, has taken increasing heat for not proposing any uniform fiduciary standard despite being authorized to do so five years prior to the Proposal.[41] While SEC Chair Mary Jo White argues the SEC remains committed to analyzing all of the possible complications from implementing a uniform standard

before proposing a new rule, she has been taken to task for not acting more decisively on this and other issues. The SEC has indicated its desire to take the lead on defining the standard for providing investment advice in this country; however, the Commission has admitted it is only in the beginning stages of penning a proposal for a uniform fiduciary standard. It is not likely we will see a proposed rule from the SEC in 2016.

VII. SOMETHING WICKED THIS WAY COMES

Because it appears that the Proposal will become final sometime in late spring – early summer, financial institutions affected by the Proposal should start preparing for the increased requirements. The following are probable compliance and regulatory concerns advisers should begin to consider now and prepare to address sooner than later:

- Dual registration: registered representatives without Series 65 licenses may want to consider becoming dually registered in anticipation of switching IRA brokerage accounts to advisory platforms where appropriate.
- Conflict Disclosures: Firms should begin to consider exactly what conflicts need to be disclosed (with an emphasis on differential compensation and fees paid to advisers by issuers) and the process of collecting all of the relevant information in order to design an efficient disclosure document to be provided upon implementation of the final rule. Several commenters suggested that an adapted version of the Form ADV might be used as a template, with disclosures about specific compensation derived from recommended securities.
- Compensation Structures: Firms should begin analyzing whether any differential compensation and/or non-monetary compensation schedules employed by the firm may

be altered to lessen the implication that such compensation creates a conflict necessitating disclosure.

- Investments Offered: Firms should begin re-assessing their lists of approved investments, including any limitations on recommending outside investments as opposed to proprietary investments.

VIII. CONCLUSION

Despite the fact that much confusion remains surrounding the Proposal, a final rule is all but certain to be published in the Federal Reporter in the coming months. Implementation of such a final rule will likely be an arduous and costly endeavor for those affected, so financial institutions should begin getting their ducks in a row now (if they have not already). It is time to stop resisting the Proposal's uniform fiduciary standard and begin creating a culture that is able to work within it. The attorneys at Kaufman Dolowich & Voluck, LLP are ready to assist in the understanding and implementation of the requirements under any final rule.

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[2] Notice of Proposed Rulemaking, Definition of the Term "Fiduciary": Conflict of Interest Rule – Retirement Investment Advice, 80 Fed. Reg. 21928 (Apr. 20, 2015)

[3] *See Legislative Efforts to Stop DOL Fiduciary Rule Destined to Fail, ERISA Attorney Says*, InvestmentNews, February 4, 2016

[4] *See* Schoeff, Mark, Jr., *Roskam Anticipates House Approval of Bill to Stop DOL Fiduciary Rule,* InvestmentNews, January 21, 2016.

[5] *See Two Bills to Stop DOL Fiduciary Rule Advance in House,* InvestmentNews, February 2, 2016.

[6] *See* Fiduciary Rule Notice, 80 Fed. Reg. 21928, 21929.

[7] *See* Investment Company Institute Comment Letter Re: ZRIN 1210-ZA25: Proposed Best Interest Contract Exemption, July 21, 2015.

[8] *Id.*

[9] *See* American Counsel of Life Insurers Comment Letter Re: Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice…, July 21, 2015.
[10] *Id.*
[11] *See* FINRA Comment Letter Re: Proposed Conflict of Interest Rule and Related Proposals, RIN – 1210 – AB32, July 17, 2015.
[12] *Id.*
[13] *See* Consumer Federation of America Comment Letter Re: Conflict of Interest Rule, RIN 1210-AB32…, September 24, 2015.
[14] *Id.*
[15] *See* SIFMA Comment Letter Re: RIN 1210-AB32, July 20, 2015
[16] *See* PIABA Comment Letter Re: RIN 1210-AB32: Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice.
[17] *Id.*
[18] *See* SIFMA Comment Letter, *supra.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *See* Cetera Financial Group Comment Letter Re: Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, RIN 1210-AB32, July 21, 2015.
[23] *See* FINRA Comment Letter, *supra.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *See* Cetera Financial Group Comment Letter, *supra*.
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *See* Charles Schwab & Co., Inc. Comment Letter Re: Definition of the Term "Fiduciary" (RIN 1210-AB32)…, July 20, 2015.
[32] *Id.*
[33] *See* Prudential Financial, Inc. Comment Letter Re: Revised Definition of Investment Advice and Related Exemptions, September 24, 2015.
[34] *See* Consumer Federation of America Comment Letter, *supra.*
[35] *See* Fidelity Investments Comment Letter Re: Definition of the Term "Fiduciary"…, September 24, 2015.
[36] *Id.*
[37] Schoeff, Mark, Jr., *DOL Official Promises 'Changes' to Fiduciary Rule,* InvestmentNews, July 16, 2015.
[38] *Id.*
[39] *See* Commissioner Gallagher's Comment Letter Re: Fiduciary Proposal, July 21, 2015.
[40] *Id.*
[41] *See* Schoeff, Mark, Jr., *Lawmakers Chafe at SEC's Slog through Fiduciary Rule Process*, InvestmentNews, October 23, 2015.