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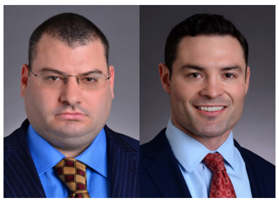

The Labor Department's Fiduciary Rule—How Will This Affect Your Retirement Investments?

By David Graff and Christopher Ayers*

Since 1974, ERISA — the Employee Retirement Income Security Act — has provided the Labor Department with the authority to protect Americans' tax-preferred retirement savings. Yet the basic rules governing retirement investment advice have not been meaningfully changed since then, notwithstanding that 401(k) plans did not exist at the time the act was passed and IRAs had just recently been authorized. That long period of regulatory stasis ended when the Labor Department finalized a new rule addressing conflicts of interest in retirement advice on April 8, 2016. By passing 81 Fed. Reg. 20946, the Labor Department hopes to fulfill its obligations to protect and educate investors as they try to navigate the world of brokers and other financial services while planning for their own retirements.

Who and What Does This Rule Affect?

The primary goal of this rule is to stop advisors from putting their own interests, i.e., earning high commissions, above their clients' interests in obtaining the best investments at the lowest prices. As a result, the relationship between brokers and clients has been redefined, elevating the brokers' commitment to one of fiduciary duty. A fiduciary duty exists between two people when one of them is under a duty to act for or give advice for the benefit of another, and must act solely in the other party's interests, not their own.

Previously, Registered Investment Advisors were the only type of advisors required to act as fiduciaries. The new rule, however, requires all advisors — including brokers — to act as fiduciaries when making recom-

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mendations or giving advice on 401(k) plans or IRAs, including recommendations for a rollover or a distribution.

As fiduciaries, brokers and other financial advisors giving advice on retirement investments must put the client's interest above their own. The Labor Department defines "investment advice" as a recommendation to some financial plan, advice on buying, selling or holding securities or other investment property, and any recommendations as to investing securities or other property after the property has been rolled over, transferred or distributed from a plan or IRA. A "recommendation" is defined as "a communication that, based on its content, context and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action." Recommendations as to managing securities, which include recommendations on investment policies or strategies, portfolio composition, selecting other people to provide investment advice or services, and any recommendations with respect to rollovers, transfers, or distributions from a plan or IRA, are also considered covered investment advice under the new rule. The "fundamental threshold element in establishing the existence of fiduciary investment advice is whether a 'recommendation' occurred." Furthermore, the Labor Department adds, "for a recommendation to constitute fiduciary investment advice, it must be rendered for a 'fee or other compensation.'" The department also notes that the more individually tailored a communication involving advice is, to a specific person or persons, the more likely that communication will be considered a recommendation. Furthermore, the fee or compensation can be considered a direct or indirect result of the advice received by the investor and will be viewed as a fee or compensation if the compensation would not have been paid, but for the transaction or service that followed in connection with the recommendation.

Exceptions to the Rule

Not all communications from a financial advisor constitute fiduciary investment advice. First, if the communication does not meet the department's definition of a recommendation (i.e., a "reasonable person" would not view the statements as an investment recommendation), then the communication will be considered non-fiduciary.

Second, advisors may still inform and educate the public about retirement savings and general financial and investment information without it rising to the level of "investment advice." Thus, an advisor can include specific investment alternatives as examples in a hypothetical asset allocation model intended to educate beneficiaries as to what investments are available to them. Similarly, service providers who offer a "platform" or selection of investment alternatives are also exempt from the fiduciary duty requirements, as marketing a general platform without regard to the individualized needs of beneficiaries is considered too general of a communication and recommendation to be considered fiduciary investment advice. Statements made in "general circulation newsletters, television, radio or public media talk show commentary or remarks at conferences" also fall within this category. However, providers must still represent in writing to the plan fiduciary that they are not providing impartial investment advice or giving advice in a fiduciary capacity. Even employees working in a company's payroll, accounting, human resources or financial departments, and who regularly develop reports and recommendations for the company and its employees, are not investment advice fiduciaries if those employees do not receive other compensation beyond their normal pay for work performed in connection with these recommendations.

Interestingly enough, advisors are still allowed to collect commissions and compensation from revenue-sharing arrangements, so long as the financial institution acknowledges the fiduciary duty status of its advisors and clients. Essentially, this means the advisor must give prudent advice that is in the customer's best interest, avoid making misleading statements, and charge a "reasonable" compensation. By implementing the Best Interest Contract Exemption, the

Labor Department hopes to reinforce practices where retirement investors receive advice that is in their best interest while also allowing advisors to continue receiving commission-based compensation. The exemption includes "requirements for full and fair disclosure of important information, including descriptions of material conflicts of interest, fees or charges paid by the retirement investor, and a statement of the types of compensation the firm expects to receive from third parties in connection with recommended investments." In addition, investors have the right to obtain detailed disclosure of costs, fees and other compensation in connection with specific investment recommendations, on request. Financial institutions that have a fiduciary duty must also have policies and procedures designed to "mitigate harmful impacts of conflicts of interest" and must disclose basic information about conflicts of interest to their customers. In sum, financial institutions can continue to have conflicts of interest and profit from their investment advice; however, their customers must have full knowledge of the conflicts and have a way of keeping their advisors accountable.

What Does This Mean for Retirement Investors?

Because all financial advisors giving recommendations on investments are now classified as fiduciaries, investors finally have a means of holding advisors responsible for bad investment advice where their advisors made a profit and the investors suffered. Currently, the Labor Department has "the right to bring enforcement actions against fiduciary [advisors] to plan sponsors and participants who do not provide advice in their clients' best interest." By redefining who is considered a fiduciary, the department is expanding the scope of its prosecution power to bring action against any financial advisor who puts their own interests in making a profit above a client's. Moreover, the Best Interest Contract Exemption allows customers to "hold fiduciary [advisors] accountable for providing advice in their best interest through a private right of action for breach of contract." Previously, clients who received bad advice on an IRA investment, for example, could do nothing to hold the advisor accountable for the losses the client incurred. Now, customers who receive bad advice and suffer great losses in their investments can sue their advisors for breach of contract and breach of fiduciary duty. It's also noted, however, that advisors can usually demonstrate they acted in their clients' best interest if they can show they used a reasonable process, adhered to professional standards, determined it was in the client's best interest, and documented "their compliance with the financial institution's policies and procedures required by the Best Interest Contract Exemption." Therefore, the rule is not simply a free pass for customers to sue, as they must take on the heavy burden of proving their advisor breached their fiduciary duty when giving them bad investment advice.

Conclusion

The revised definition of fiduciary and compliance with the new rule don't take effect until April 10, 2017, and the Labor Department has adopted a phased implementation approach for the Best Interest Contract Exemption by providing a transition period from the April 10, 2017, applicability date to January 1, 2018, under which fewer conditions apply. This gives financial institutions and advisers time to prepare for compliance with all conditions under the exemptions while also providing basic safeguards for the interests of retirement investors. All transactions on or after January 1, 2018, must fully comply with the exemptions.

There has been some pushback on the new rule and some worry it could harm consumers and small investment practices. The threat of increased liability could push some advisors away from their tradition of charging clients based on transactions and instead induce them to start billing clients on a set fee. Moreover, because fee-based accounts do not make much economic sense for firms if the accounts have low balances, many advisors are expected to drop undersized retirement accounts. Smaller brokerages and companies might have difficulty offering 401(k)s and other plans because the stricter rule could increase the costs of running them.

Currently, several lawsuits have been filed by groups such as the U.S. Chamber of Commerce and the American Council of Life Insurers against the new rule, challenging the authority and scope of the Labor Department's power. However, the department seems to be of the mindset that this rule will reinforce better practices and procedures to protect investors saving for retirement, rather than harm them in the long run. As the Labor Department states, "While many [advisors] do act in their customers' best interest, not everyone is legally obligated to do so and some do not." This rule reinforces that idea with a way for consumers to now hold their advisors accountable for that piece of bad investment advice.

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