Aon Advisor Solutions

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Conflicts of Interest in Qualified Accounts

Part 2 – The Department of Labor Fiduciary Rule Loses its Bite

By: Joel M. Wertman

In Part 1 of this Series, we reviewed the status of the pending Department of Labor's (DOL) new fiduciary rule pertaining to investment advice under the Employee Retirement Income Security Act of 1974 (ERISA) and lamented the changing landscape and uncertainty surrounding the rule in the initial weeks following the election of President Trump. If anything, those initial weeks of the Trump presidency served as mere foreshadowing to a dramatically shifting world as the contours of the DOL rule have twisted, turned, flipped and flopped.

April 10, 2017 was the original inception date for the DOL's fiduciary rule. Instead, on April 4, 2017, the DOL issued its final rule postponing implementation of any portion of the rule until June 9, 2017, with the most involved provisions being delayed yet further. On June 9th, the rule became effective in its now abbreviated capacity solely with respect to the implementation of an impartial conduct standard. Most crucially, the expanded definition of who is a "fiduciary" became applicable on that date. However, the more onerous requirements such as the Best Interest Contract Exemption (BICE) were delayed until January 1, 2018. At least, that's what where we stood in June 2017.

Not surprisingly at this point, the one consistency with the DOL fiduciary rule has been that it remains ever changing and ever delayed. It's become a virtual impossibility to predict the final incarnation of the rule or the reaction by the financial services industry and governing bodies. Here is a glimpse into what has happened since the initial delay was put in place and where we could be heading in the near future.

The Trump Effect and the Involvement of Congress

A clear guidepost to where the rule was and is heading came in the form of comments by Labor Secretary Alexander Acosta in the days before the new fiduciary rule officially became effective on June 9, 2017. Roughly three weeks prior, Secretary Acosta announced a temporary enforcement policy related to the new fiduciary rule and various prohibited transaction exemptions. Generally speaking, the DOL indicated that it will not pursue regulatory matters against fiduciaries who work in good faith to comply with the fiduciary rule and the applicable exemptions. However, this temporary enforcement policy was to expire on January 1, 2018.

During this interim period, advisors must provide "best interest" advice. Essentially, they must only meet a professional standard of care based on the interests of the investor rather than on the competing financial interest of the advisor. Moreover, the advisor cannot make misleading statements about transactions, compensation or conflicts of interest. An advisor also cannot charge more than reasonable compensation.

The next step was the DOL's July 6, 2017 Request for Information, which was made in response to a directive by President Trump to further explore the potential ramifications of the rule on the financial services industry. After this brief pause for information gathering, the DOL proposed an 18-month delay on August 9, 2017. This proposal was to extend the transition period as well as the applicability date of the BICE. Proponents of the new rule had trumpeted the BICE as the true "teeth" as it would require advisors to acknowledge their fiduciary duty to the customer, adhere to impartial conduct standards, implement policies and procedures reasonably and prudently designed to prevent violations of the impartial conduct standards, refrain from giving or using incentives to act contrary to the customer's best interest, and fairly disclose the fees, compensation, and material conflicts of interest associated with their recommendations, among other things.

The DOL moved very quickly. Only nineteen days later, on August 28, 2017, the Office of Management and Budget approved the DOL recommendation and concluded that it was consistent with change. Notably, reviews of this type often take at least ninety days. However, this review was completed in less than three weeks. There were very practical real-world reasons for the swiftness of the approval. First, the DOL wanted to move quickly on review of these measures. Second, there was an interest in quelling the markets and giving some certainty about the deadlines. On the other hand, naysayers argue that the quick approval was unjustified and merely demonstrates a predetermined outcome.

The new eighteen month delay pushes the deadline for full compliance with the rule until July 1, 2019. This delay will give the DOL additional time to conduct its review and, potentially, for the Securities and Exchange Commission (SEC) to weigh in.

The hesitancy to move forward with full implementation exhibits a desire to avoid confusion with the final version of the rule particularly since Congress may have an enormous impact. In this regard, in September 2017, the House of Representatives proposed a spending bill which contained a provision to eliminate the DOL fiduciary rule. This spending bill for 2018 fiscal operations of the government included a rider stating that the fiduciary rule "shall have no force or effect."

Several other pieces of legislation in the House and Senate have been designed to stop the DOL rule. For instance, Representative Ann Wagner of Missouri introduced a bill in late September 2017 that would eliminate the DOL fiduciary rule and establish a more general best interests investment standard.

Amidst the congressional maneuvering, the DOL set a fifteen day comment to expire on September 15, 2017 related to the proposed eighteen month delay from January 1, 2018 to July 1, 2019. Opponents and proponents weighed in, but commentators largely believe that the eighteen month delay will be implemented. Principally, coordination amongst financial regulators on a uniform fiduciary standard of care seems to be a driving force behind further delay.

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What's the SEC doing?

Casual observers of the DOL rule have probably wondered why the SEC has not been the leading voice on this issue. The SEC has explored a potential uniform standard at various times in prior years. Most recently, it sought comment on June 30, 2017 regarding standards of conduct for investment advisors and broker-dealers. In its request, the SEC acknowledged the June 9, 2017 applicability of the DOL rule and welcomed the DOL's invitation to engage constructively on this issue to seek "clarity, consistency and coordination." The SEC also remarked that this comment was part of its ongoing analysis of standards of conduct.

Four potential options exist for the SEC. First, the existing structure can be maintained. Second, enhanced disclosures could be required to mitigate investor confusion. Third, a best interests standard could be developed for broker-dealers. Fourth, a uniform standard of conduct could be developed for both broker-dealers and investment advisors. To assist in its evaluation, the SEC sought comment on 17 categories with numerous subtopics. Of particular note, the SEC sought comment related to confusion by retail investors about standards of conduct; identifying conflicts of interest; experiences thus far in complying with the DOL rule; benefits of possibly having different standards; and implementation, to include whether incremental steps would be preferable.

While extensive comments have been received by the SEC, the position papers by the Public Investors Arbitration Bar Association (PIABA) and the Securities Industry and Financial Markets Association (SIFMA) illustrate the dramatic variance in viewpoints.

PIABA's commentary roundly criticizes the industry for creating confusion amongst retail customers about standard of care as well as the insufficiency of FINRA Rule 2111 (suitability) as PIABA believes that the "reasonable basis" standard allows for conflicts of interest. PIABA argues that a higher standard of care is needed as it believes investors lose between $57 million to $117 million each day due to conflicted investment advice. Accordingly, PIABA argues that a uniform standard is necessary to protect vulnerable investors from conflicted advice. They believe that investment advisers and broker-dealers must adhere to the same standard as inconsistent standards generate confusion. PIABA suggests that the SEC adopt a standard "no less stringent than that adopted by the DOL."

On the other hand, SIFMA supports the development of a best interests standard for broker-dealers and, in particular, favors the current status of the DOL impartial conduct standards regarding advice being in the customer's best interest; reasonable compensation; and avoiding materially misleading statements. SIFMA views the additional duties and responsibilities such as the BICE as onerous due to the attendant warranties, written disclosure requirements and costs. SIFMA suggests an updated FINRA Rule 2111 (suitability) to include duty of loyalty, duty of care, enhanced upfront disclosures (but no continuing duty after the recommendation), and "reasonable diligence" as the standard for making a recommendation.

In late September, SEC Chairman Jay Clayton stressed the SEC was working with the DOL and pushing towards a fiduciary rule. The financial services industry will certainly keep a watchful eye on the SEC's expanding role in this debate.

Are other regulators involved?

Not content to wait, the State of Nevada became the first to impose fiduciary obligations on broker-dealers and investment advisers as matter of statutory law. On June 2, 2017, Nevada amended its financial planners statute to remove the current exemption for broker-dealers, investment advisors, and their representatives from the definition of "financial planner" which thereby imposes a fiduciary duty on these entities and persons in connection with their advice provided to clients. These changes went into effect on July 1, 2017.

Meanwhile, several other states already hold broker-dealers to a fiduciary standard: California, Missouri, South Carolina and South Dakota. However, these are not statutory requirements imposed by the state legislatures. Rather, the fiduciary standard in these states has been established through the courts. Other states, whether by statute or court decision, could conceivably impose similar obligations if the DOL rule is further weakened or revoked.

The concern with states taking the lead on this issue is that multistate brokers and financial advisors faced ever daunting tasks in dealing with different state regulations, each defining who is a "fiduciary" in different terms. Leaving fifty different state legislatures and fifty different court systems to establish the prevailing laws for fifty different states renders a uniform standard a virtual impossibility.

Next Steps

What happens next is certainly the paramount question. Compliance departments have spent large sums of money and expended countless hours preparing for a DOL fiduciary rule which may never be fully implemented as originally anticipated. The only certainty has been uncertainty. The winds of change are blowing, particularly with the SEC's increased interest and recognition of a fiduciary rule as being an agency priority. At this point, the industry's only option is to continue to dutifully comply with the now effective DOL impartial conduct standards while keeping a watchful eye on the SEC, DOL and state regulatory bodies to determine what additional obligations are on the horizon.

Comments suggestions or inquiries are welcome and should be directed to:
mary.pat.fischer@aon.com

Aon Risk Services Northeast, Inc.
199 Water Street New York, NY 10038 • (800) 243-5117

Joel M. Wertman
Joel M. Wertman is a partner in the Winget, Spadafora & Schwartzberg's Philadelphia office. He focuses his practice on disputes in the securities, insurance and real estate industries. He has represented clients in a wide range of litigation matters that include public customer disputes in state court, federal court and arbitration, as well as employment disputes seeking monetary and injunctive relief in state and federal courts. He also represents clients in regulatory enforcement matters initiated by the SEC, FINRA and state regulatory bodies. He may be reached at Wertman.j@wssllp.com.

X-12899-1017