Aon Advisor Solutions

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# Conflicts of Interest in Qualified Accounts

## Part 1 – The (Almost) Arrival of the Department of Labor Fiduciary Rule

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As those in the financial services industry are well aware, April 10, 2017 was to bring to an end months of high drama and anticipation with the implementation of the Department of Labor's (DOL) new fiduciary rule pertaining to investment advice under the Employee Retirement Income Security Act of 1974 (ERISA). To paraphrase an 18th century Scottish poet, the best laid plans of mice and men go often askew. The world has dramatically shifted since the DOL introduced its new rule in April 2016. In particular, potential seismic changes have been underway since the inauguration of President Trump.

Through a series of twists and turns, the financial services industry has finally landed on an extended delay of the expanded application of the fiduciary standard until June 9, 2017. Most crucially, the expanded definition of who is a "fiduciary" becomes applicable on that date. A transition period will be in effect from June 9, 2017 through January 1, 2018. During the Transition Period, fiduciaries will only be required to comply with the "Impartial Conduct Standards" and not the other conditions of such exemptions, such as the affirmative disclosure requirements. The Impartial Conduct Standards require that fiduciary advisers make recommendations that are in the customer's best interest, receive only reasonable compensation, and not make materially misleading statements. This delay permits additional examination of the rule's impact and evaluation of possible further changes to the conflict of interest rule and related exemptions. Moreover, most of the requirements for the pivotal Best Interest Contact Exemption have been further delayed until at least January 1, 2018.

In this ever changing landscape, it has become difficult, if not foolhardy, to predict the final outcome of this rule. Indeed, the Rule is barely recognizable from its April 2016 rendering to today's version. Here is a glimpse into where we have been, where we are now, and where we might be going.

As most in the financial services industry understand, the DOL's initial proposal of an expanded fiduciary standard would have resulted in sweeping changes. In particular, the new regulation greatly augmented the definition of who is acting as a "fiduciary" under ERISA. Generally speaking, the fiduciary standard now applies to individuals in the financial services industry who receive compensation for providing advice that is individualized or specifically directed to participants, owners and sponsors of "covered retirement plans." This obviously begs the question as to what's a covered retirement plan? The IRA rollover marketplace has certainly been the most high profile aspect given its prominence in employee retirement planning. The new rule would apply to not only recommendations related to IRA rollovers but also what investment to purchase or sell.

Isolating the rule's requirements to the IRA rollover marketplace is both a gross oversimplification of the rule's reach, not to mention a failure to appreciate the many nuanced areas upon which the rule touches. Indeed, "covered" retirement plans extend to employee benefit plans, health savings accounts, Archer Medical Savings accounts, and Coverdell education savings accounts. However, the Rule's reach is not without its boundaries as it was not designed to impact assets without an investment component such as health insurance policies, disability policies and term life policies. This article will not explore the depths of application under the rule but those in the financial services industry are wise to be wary of the rule's broad reach.

Arguably the new requirement which drew the greatest attention was the Best Interest Contract Exemption. With this provision the DOL set an expectation for "prudent advice" wherein the fiduciary is required to act with care, skill, prudence and diligence under circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. More simply stated, advisors would need 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 interests, and fairly disclose the fees, compensation, and material conflicts of interest associated with their recommendations, among other things.

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Proponents of the rule have argued that Best Interest Contract Exemption provides greater protections for customers against advisors selling high commission products as well as assuring that retirement advisors are working in the best interests of the client. Critics of the industry at large also argue that the current "suitability" standard costs clients too much in commissions and leaves them vulnerable to being sold investments that are not in their best interest. On the other side of the coin, detractors of the rule argue that forcing all firms to act as fiduciaries will inflate the cost of investment advice beyond the reach of those with small accounts.

In this context, President Trump took the Oath of Office on January 20, 2017. Two weeks later, the executive office sent a memo to the Department of Labor directing it to conduct a new cost benefit analysis of the rule and directed the DOL to rescind or revise the rule if the DOL determined that the rule causes harm to investors or the industry.

On February 9, 2017, the DOL sent a proposal to delay the fiduciary rule for review by the Office of Management and Budget (OMB). On February 27, 2017, the OMB completed its review of the rule delay request and determined that the rule is "economically significant." Notably, the aforementioned executive memo from President Trump had directed the DOL to review the delay request from a "cost benefit" standpoint. Accordingly, some commentators believed that the OMB was signaling that the significant cost benefit issues with the fiduciary rule existed which would afford the DOL ample justification to delay the rule. (That ultimately seems to have been the case.) With OMB's approval, the proposed rule was returned to the Department of Labor for publication in the Federal Register.

On March 2, 2017, the proposed rule was published in the Federal Register, which included a proposal to extend the applicability dates by an additional sixty (60) days. This would make June 9, 2017 the new compliance date. There had been whispers that the DOL would request a 180 day delay. The comment period on this proposal ended March 17, 2017 and the DOL had specifically requested comment on whether the benefits of a sixty day delay justified its cost, the length of the delay, whether it should delay applicability of all, or only part, of the final rule's provisions and exemption conditions, and the cost and regulatory impact analysis related to the delay.

On April 4, 2017, the DOL issued its final rule postponing applicably of the conflict of interest rule and related exemptions until June 9, 2017. In a certain sense, the Rule was bifurcated from its prior iteration. As of June 9, 2017, the more general rules about who is a fiduciary and the duty to act in a client's best interest become effective. However, the more involved requirements of the best interest contract and related exemptions have been delayed until at least 2018. In particular, the duties to declare fiduciary status and disclose conflicts of interests will be delayed.

The question now becomes what should firms plan to do next. Many broker/dealers appear to be moving forward. As one prominent example, Merrill Lynch announced last fall that it would no longer offer new, commission based IRAs starting in 2017. Other broker/dealers are likely to follow similar directives in an effort to mitigate risk.

While the expanded fiduciary standard and concurrent heightened duties arrive on June 9th, the provisions enforcing those fiduciary obligations are currently shelved until 2018. Moreover, the rule remains subject to ongoing scrutiny and possible additional changes. Nonetheless, the age of heightened care for financial advisory services has certainly arrived. For those who may litigate a customer case under this standard in the near future, the playing field has shifted. Where it shifts next is a story that continues to be written.

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