ERISA Rule Update: October 2017

It is our intention to bring to light a brief review and current state of the Department of Labor's (DOL) Rule. Sadly, we have no definitive answer on where the Rule will ultimately end up, but we can prepare you and provide insight on what is going on before Congress.

What We Know

As it stands today, the process is clear: on July 1, 2019 the DOL's regulatory change takes full effect, expanding the definition of fiduciary investment advice, holding service providers and plan sponsors accountable to the regulations included in ERISA and applying to IRAs. There are various bills that have been presented as well as comments that have been submitted. Bills and comments cover both sides of this issue, for the rule and against. The Society does not have a side on this issue, with the exception of believing and practicing in a manner, as members subscribing to the Professional Code of Ethics, which does require we place our client's interest above our own.

The fiduciary obligation means that advisors and service providers subject to the rule must act in the best interests of their clients. In the event of a conflict of interest, the advisor and service provider must meet certain exemptions or avoid offering fiduciary advice.

However, as of June 9, 2017 with a further transition period for many BIC provisions and revisions to PTE 84-24, advisors must hold themselves to the impartial conduct standards. To meet this standard an advisor must:

- Give advice with the best interest standard of care (prudence and loyalty);
- Charge no more than reasonable compensation; and
- Make no misleading statements regarding investments, compensation, and conflicts of interest.

Fundamental Change

Many service providers have made or have begun making internal changes in order to meet the Rule, while some are procrastinating and others have decided to fight against the Rule. As of this time, there are 33 bills that have comments regarding this Rule, both for and against, including total repeal. The Financial Choice Act, approved by the House Financial Services Committee on May 4, both overhauls the Dodd-Frank Act and repeals the DOL Fiduciary Rule.

To date, legal challenges to the Rule have not been successful. It is reasonable to predict that the existing legal challenges will continue at district court and appellate levels. Conversely, it is reasonable to predict that further delay of implementation of the Rule could result in lawsuits seeking to enforce the Rule, likely through a lawsuit brought pursuant to the Administrative Procedures Act.

The Wagner Bill[1]

One bill that appears to have the most merit has been drafted by Rep. Ann Wagner (R-MO); it seeks to kill the fiduciary rule and instead impose a best interest standard on broker-dealers' investment recommendations. Rep. Ann Wagner introduced legislation on Sept. 27 that would repeal the DOL's fiduciary rule and create a new standard of conduct for brokers and dealers. Rep. Wagner has had her sights set on rolling back the fiduciary regulation since 2015, when she first introduced legislation to repeal the regulation. Rep. Wagner's Protecting Advice for Small Savers (PASS) Act of 2017 would:

- Repeal the fiduciary rule;
- Create a best interest standard for broker-dealers;
- Require broker-dealers to disclose compensation they receive and any conflict of interest that exists;
- Limit the SEC's rulemaking authority under Section 913 of Dodd-Frank;
- Prevent the Treasury and Labor departments from promulgating fiduciary regulations on broker-dealers under ERISA; and
- Preempt state laws, avoiding a patchwork of standards.

Interesting observation from the bill:

> The standard of conduct when providing a recommendation, which would be in addition to adhering to a duty of care and duty of loyalty, is that the recommendation be in the client's best interest and:
>
> a. Reflect reasonable due diligence, and
> b. Reflect the reasonable care, skill, and prudence that would be exercised based on a customer's investment profile.

Much of the bill has the same topics such as misrepresentations, conflicts, etc. However, the wording that is used and meaning, "reflect reasonable due diligence" is different from "best interest" that is used in the DOL Rule. Reasonable due diligence is defined as a reference to FINRA Rule 2111,[2] which is a suitability standard.

The definition of the best interest standard expands on the suitability standard by providing advice that, at the time of the recommendation reflects: the care, skill, prudence, and diligence under the 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, based on the investment objectives, risk tolerance, financial circumstances and needs of the retirement investor, without regard to the financial or other interests of the advisor, financial institution or any affiliate, related entity, or other party. It is also one of the three elements of the impartial conduct standards. Therefore, the difference is the best interest standard is intended to mirror the duties of prudence and loyalty, as applied in the context of fiduciary investment advice under §404(a)(1)(A) and (B) of ERISA. Thus, the ``best interest'' standard is rooted in the longstanding trust-law duties of prudence and loyalty adopted in §404 of ERISA and in the cases interpreting those standards.[3]

The Securities and Exchange Commission

In addition, the Securities and Exchange Commission (SEC) Chairman Jay Clayton hopes that his agency can "properly tailor" an approach that will best address issues related to those the DOL's fiduciary rule concerns. Some of Mr. Clayton's observations from the SEC point of view include:

- Increasing compliance resources and efforts (e.g., disclosure, documentation, and training, in particular regarding costs and rollover recommendations);
- Increasing the use of robo-advice;
- Reevaluating and changing the types of products and accounts (and related fees) offered to retirement investors, focusing particularly on products or accounts that would address the compliance requirements driven by the Best Interest Contract Exemption (e.g., shifting some or all of their retirement accounts to level-fee advisory accounts).
- "Clean Shares" that do not have any sales loads, charges, or other asset-based fees for sales or distribution (thus allowing brokers to set their own commissions that would be paid directly by investors); and
- "T-Shares" — or "Transaction Shares" — that have uniform sales charges across all fund categories.

The SEC intends to work closely and constructively with the DOL to implement appropriate standards of conduct for financial professionals who provide advice to retail investors.

State-Specific Fiduciary Standards

To add another party to this conversation, states have also chimed in on this issue by drafting their own fiduciary standards. Nevada was the first state to draft a state-specific fiduciary standard on advisors doing business there. However, there is some question on the legality of state oversight of ERISA plans. There is one association that has filed with the Nevada Securities Administrator, Ms. Diane Foley, a legal opinion rendered by the law firm of Trucker Huss. The legal opinion reviews application of ERISA's preemption provisions[4] to the recently enacted Nevada law. The new law imposes a state-based fiduciary standard on broker-dealers, broker-dealer sales representatives, and most investment advisors licensed under state or federal law who meet the definition of "financial planner" under Nevada law.

Where Does this Leave an Advisor

We can review and interpret the bills and comment letters for days or until July 1, 2019. Reality is we are now, today, bound by impartial conduct standards for both employer-sponsored retirement plans and IRAs. The question is, how do we apply those standards in practice? One answer is, not only through your actions, but you must prove you have complied with the impartial conduct standards. You must have written processes and procedures in place and diligently document your process and procedures to comply with the standard for each client interaction. If you currently have written processes and procedures in place, review them to assure they are updated to reflect the impartial conduct standards. Generally your objective is to:

- Thoroughly review and verify all material facts that relate to any investment recommendation, at this point considering going beyond suitability.[5]
- Fully understand how the specific product will fit as a solution and if it is the best alternative for the client at that time.[6]
- Become an expert in your area regarding the products and services you are properly licensed to sell (including licensing requirements to provide tax and/or legal advice). It is important to note, as a fiduciary, ERISA's prudence standard obligates a fiduciary who lacks expertise on a particular matter to seek the assistance of an expert in order to fulfill the fiduciary obligation.

This process, as documented, would be considered by an independent party on behalf of an individual contemplating a purchase. The test of prudence is focused on the written process by which a fiduciary has reached certain recommendations.

To satisfy this process your procedures should, at the least:

- Utilize methods to gather, investigate and evaluate all material client information.
- Have a process to retain and/or recommend other professional advisors in areas where you are not an expert or not licensed.
- Use methods for analyzing various product solutions taking into account a reasonable compensation for services provided.
- Any recommendation provided would show your use of independent judgment for any product solution.

---

[1] Protecting Advice for Small Savers (PASS) Act of 2017.

[2] 2111. Suitability (a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time

horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

[3] Federal Register / Vol. 81, No. 68 / Friday, April 8, 2016 / Rules and Regulations.

[4] ERISA §502.

[5] Duty of Prudence, ERISA §404(a)(1)(B).

[6] *Ibid*.