Change in Administration Presents Opportunity to Revisit DOL Fiduciary Rule

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In 2016, regulatory developments introduced fundamental changes in the legal standards that govern the relationship of broker-dealers with their customers. Although the changes are not applicable until April 10, 2017, most in the industry have already been preparing for compliance. The new regulations appear likely to increase costs and risks and could drive a rapid evolution in the brokerage industry, encouraging consolidation of broker-dealer firms and also limiting the range of financial products offered to investors. These unintended consequences, along with promises by members of the new administration and the Republican-controlled Congress of significant deregulation in the financial sector, present the possibility that the new regulations will be reconsidered before they become applicable.

DOL Fiduciary Rule

In April 2016, the Department of Labor (DOL) issued a final regulation that expanded the scope of who is considered a "fiduciary" of employee benefit plans, individual retirement accounts (IRAs), and other accounts and arrangements subject to the Employee Retirement Income Security Act of 1974 (ERISA) or Section 4975 of the Internal Revenue Code (the Code). Known as the fiduciary rule, it expands the ERISA definition of a fiduciary (one who "renders investment advice for a fee or other compensation, direct or indirect") to include anyone making a "recommendation" or a "communication ... reasonably viewed as a suggestion" as to certain decisions regarding investments and related strategies and policies. Consequently, any broker-dealer would be a "fiduciary" if it communicates in such a manner with an IRA owner or other retail customer that is a retirement investor within the rule's scope. (See our November 8, 2016, client alert "Department of Labor Issues Guidance on Conflicts of Interest Rule" and our April 25, 2016, client alert "Labor Department Redefines 'Fiduciary' for ERISA and Internal Revenue Code Purposes.")

The DOL issued its fiduciary rule before the Securities and Exchange Commission (SEC) had taken any action, as authorized by the Dodd-Frank Act, to assess the effectiveness of the standards of care applicable to broker-dealers and investment advisers and to issue rules that could potentially require broker-dealers to adhere to the same fiduciary standard that applies to investment advisers under the Investment Advisers Act of 1940, as amended. Under current law, any broker-dealer providing investment advice that is solely "incidental" to its broker-dealer business activities and for which it receives no "special compensation" is excluded from regulation under the Advisers Act. Instead, broker-dealers are subject to the suitability standards of the Financial Industry Regulatory Authority (FINRA) pursuant to Rule 2111. Operating under the suitability standard, broker-dealers commonly receive transaction-based compensation (such as brokerage commissions) and 12b-1 fees (mutual fund marketing or distribution fees) and participate in revenue-sharing arrangements with advisers and other providers of services to mutual funds.

A broker-dealer that is a fiduciary to a retirement plan investor under the DOL's new rule and receives compensation through commissions, 12b-1 fees or revenue sharing would, absent an exemption, be engaging in a nonexempt prohibited transaction under ERISA and Section 4975 of the Code. The "best interest contract exemption" (BICE) would permit a broker-dealer to receive these forms of compensation if it adheres to certain requirements and, with respect to plans not covered by ERISA, enters into a written contract (referred to as a "best interest contract" or BIC) with its customer essentially including such requirements. The BIC must include provisions specifying that the

broker-dealer is acting as fiduciary under ERISA or the Code with respect to any investment advice provided under the contract and that the broker-dealer will:

- adhere to "impartial conduct standards" by providing advice that is in the investor's best interests, charging no more than reasonable compensation and refraining from making materially misleading statements;
- implement policies and procedures that specifically identify and document material conflicts of interest and include measures reasonably and prudently designed to prevent such conflicts from causing violations of its impartial conduct standards; and
- not use incentives for investment personnel that are intended or would reasonably be expected to cause its representatives to make recommendations that are not in an investor's best interests.

The broker-dealer also would be required to provide a set of clear and prominent disclosures regarding various aspects of the relationship, including the standard of care owed to the investor, the compensation to be earned directly from the investor and indirectly through third-party payments, material conflicts of interest, and the investor's right to obtain a copy of the policies and procedures described above. The BIC cannot contain any exculpatory provision or limitation of liability for breach, nor can it contain any waiver or qualification of a right to bring or participate in a class action or other representative action.

The standards of conduct will apply as of April 10, 2017. However, most of the BICE's procedural conditions will not apply during an initial transition period that runs until January 1, 2018. During this transition period, no written contract will be required.

As an alternative to BICE, the new DOL regulation provides a more streamlined variant commonly known as "BICE lite." BICE lite would cover certain investment recommendations, most prominently including rolling assets from a plan into an IRA or switching assets from a commission-based account to a fee-based account. Unlike BICE, BICE lite does not require a broker-dealer to enter into a written contract with each applicable retirement investor and does not prohibit any waiver of a private right of action. However, BICE lite does not allow the commissions and other transaction-based fees permitted under the full BICE.

To operate under BICE lite, a broker-dealer may receive only a "level fee" that is disclosed in advance to the investor. This is a fee or compensation that is fixed at a percentage of the value of the assets under management or set fee that does not differ based on any particular investment recommended. Level fees do not include commissions or other transaction-based fees and do not include any payments from third parties, such as 12b-1 fees or revenue-sharing payments. Moreover, any recommendations under compensation structures that are limited to proprietary products would not fall under BICE lite. Under BICE lite, a broker-dealer must acknowledge in writing to the retirement investor that it is acting as fiduciary under ERISA or the Code with respect to any investment advice and must adhere to the "impartial conduct standards" described above.

Prospects for the Rule and Brokerage Industry

Despite uncertainty over how President Donald Trump may attempt to deregulate the sector, many brokerage firms have already begun to restructure their business and operations to meet the BICE or BICE lite standard, or have taken other steps aimed at complying with the new rules. Some brokerage firms have eliminated commissions and third-party payments and moved to a flat fee-based system. Mutual fund sponsors have responded by planning to issue a new "T Share" class that would bear a uniform front-end load and trailing 12b-1 fee. The uniform sales charges, across all fund categories, would represent an attempt to eliminate the conflict of interest and other concerns as to whether compensation is "reasonable" inherent in the current structure where one fund may provide a broker a higher commission than another. On December 15, 2016, the SEC's Division of Investment Management released guidance that would streamline the manner in which funds could disclose newly established share classes (including the T Share class) and sales load variations that would apply uniformly to investors that purchase shares through a given intermediary.

Members of the new administration (such as Anthony Scaramucci, in his November 1, 2016, op-ed in *The Wall Street Journal*, "Your 401(k) Doesn't Need a Federal Babysitter") have suggested that the unintended consequences of the DOL's fiduciary rule make it counterproductive. In September 2016, House Financial Services Committee Chairman Jeb Hensarling, R-Texas, introduced his financial reform bill, the Financial CHOICE Act, which would repeal the fiduciary rule and prohibit the DOL from passing another such rule until the SEC has promulgated a new rule, as authorized by the Dodd-Frank Act, governing the standard of conduct applicable to broker-dealers. On January 6, 2017, Rep. Joe Wilson, R-S.C., introduced the Protecting American Families' Retirement Advice Act, which would delay effectiveness of the DOL fiduciary rule for two years, for the stated purpose of "giving Congress and the new administration adequate time to re-evaluate the new regulation." Republicans in Congress also are considering additional methods to delay the effectiveness of the rule through procedural means, including through the appropriations process. However, even if

the fiduciary rule were to be delayed or repealed, for better or worse, some of the changes that it catalyzed in the industry may now be irreversible.

Ideally, any reconsideration under the new administration of the rules governing the relationship of broker-dealers with their customers will recognize the value of investor choice, financial product innovation and economic efficiency, and will seek to integrate these objectives with the imperative of investor protection. The new administration may wish to re-examine some of the conclusions that the DOL reached in its cost-benefit analysis. For example, the DOL projects the harm that IRA holders can expect to suffer over the next 20 years due to underperformance as a result of conflicted advice at 50 to 100 basis points per year, but the analysis does not quantify the harm that IRA owners may suffer as a result of the unintended consequences of the fiduciary rule.

The BICE requirements may limit the range of financial products available to retirement investors. The requirement that any compensation be "reasonable" may discourage broker-dealers from offering innovative products that may be appropriate for the IRAs of some investors but can only be provided at higher rates of compensation due to steeper costs and lower volumes associated with those products. A lack of comparable products in the market may put the broker-dealer at risk of being unable to establish that its compensation is reasonable under the applicable standards. Because reliance on the BICE would allow the customer to participate in a class action, if an account underperforms (even as a result of benign causes) and a plaintiffs' attorney were to initiate a class action, this risk would be particularly acute.

The DOL decided that "disclosing conflicts alone would fail to adequately mitigate the conflicts or remedy the harm." Nevertheless, it may be useful to reconsider whether the objectives of the "reasonable compensation" standard could be accomplished with less risk of unintended consequences through enhanced disclosure of the structure, sources and rates of compensation for the applicable investment.

Institutions subject to the fiduciary rule face substantial costs and disruption to comply with many of its requirements and, in particular, to operate under the BICE. Smaller firms that do not wish to pursue a level fee model may no longer be viable unless they are absorbed by larger institutions that are able to deploy infrastructure and systems of a scale more likely to meet the procedural and compliance burdens. Consolidation of brokerage firms as a result of these factors (which, as reflected in recent press reports, is already underway) would narrow the range of firms available to investors.

The potential impacts of overlapping regulatory jurisdiction on economic efficiency in the markets for investment products and services also may be an appropriate subject for re-examination. The fiduciary rule encompasses areas that already are covered by the securities regulators, including the SEC and FINRA. Different standards and compliance systems may apply to an IRA and a taxable account held by the same customer with the same broker, even if there is no other reason for the different treatment, and may force investments into a taxable account (or a separate account at a different institution), even if contrary to the customer's best interests.

The DOL acknowledged that it received commentary to the effect that "subjecting SEC-regulated ... broker-dealers to a special set of ERISA rules for ... IRAs could lead to additional costs and complexities for individuals who may have several different types of accounts at the same financial institution some of which may be subject only to the SEC rules, and others of which may be subject to both SEC rules and new regulatory requirements under ERISA." However, the DOL observed that ERISA and the Code cover some types of investment advice that are not within the scope of the federal securities laws and that, in issuing the new regulations, it believes that it has taken care to honor the text and purposes of ERISA and the Code, including the "special emphasis on the elimination and mitigation of conflicts of interest."

This observation by the DOL is consistent with the axiom that regulations must be designed to fulfill the purposes of the governing statutes. But the need for reform — via regulation and perhaps even legislation — presented by the inconsistencies, overlap and potential for unintended results in the existing rules is, arguably, equally important. This new year may be a good time for reform to begin.