Fi360 UPDATE

DOL Fiduciary Rule Transition Period Extended as the SEC Prepares to Issue Its Own Rule
Where things stand and what to expect next

LATEST DEVELOPMENTS AND OUTLOOK FOR THE DOL FIDUCIARY RULE

The Department of Labor has imposed an 18-month delay (from Jan. 1, 2018 to July 1, 2019) of the final applicability date of the limited portion of the fiduciary rule that is not yet in force. The delay extends the transition period the DOL established to allow firms extra time to prepare for specific requirements of the three major Prohibited Transaction Exemptions (PTEs) associated with the fiduciary rule: the Best Interest Contract Exemption (BICE), Principal Transaction Exemption, and PTE 84-24, which applies to advisory transactions involving insurance and annuity contracts and mutual fund shares. The transition period is the time between the rule's first applicability date (June 9, 2017) and the final applicability date, which is now proposed to be July 1, 2019.

The delay also provides time for the DOL to prepare responses to questions President Trump directed it to address at the beginning of this year and to formulate proposed changes to the rule. It seems clear that the net effect of this review will be elimination of the contract requirement associated with BICE, and perhaps all of the rule requirements deferred during the transition period.

The DOL has indicated that it is considering one or more new "streamlined" PTEs, without stating what those might be. Based on various comments from the Department, certain types of products that are designed to avoid compensation conflicts and do not pose special risks to investors, such as "clean" mutual fund shares, may be targeted for favorable regulatory treatment under a new streamlined PTE.

Despite the intense media focus on the latest rule delay, all firms providing advice on retirement accounts must recognize that the core provisions of the rule became applicable on June 9, 2017 and remain in full force. The expanded definition of who is accountable as an investment advice fiduciary, the definitions and requirements regarding non-fiduciary forms of communications (also known as carve-outs), and the requirement under the three PTEs mentioned above for firms to establish and follow Impartial Conduct Standards (ICS) are in place. These provisions are not involved in the delay and we foresee little chance that they will be rolled back in future DOL rulemaking.

Most firms have expended considerable resources to conform to the expanded fiduciary definition and associated responsibilities that have been in place for nearly six months. Those firms that don't yet adhere to the rule are at risk. Not only has the DOL expressed its intention to enforce these obligations if firms are not making a good faith effort to comply, but ERISA accounts (unlike Individual Retirement Accounts) are subject to private rights of action. A private right of action permits a party to sue based on a violation of the law (in this instance, for fiduciary breaches of ERISA), in contrast to a violation of a client agreement.

With respect to IRAs, fiduciary advisors who do not provide impartial advice as required by the rule would violate the prohibited transaction rules of the Tax Code and become exposed to a prohibited transaction excise tax. Even if the DOL ultimately proposes to do away with the contract requirement of BICE, which seems certain, there is compliance risk in violating the rule in the IRA space.

IRAs are at the intersection of retirement saving and personal wealth management; as such, they are subject to overlapping DOL and SEC regulatory jurisdiction. During the Obama administration, DOL officials expressed frustration with the SEC for failing to engage in fiduciary rulemaking. Under the Trump administration, SEC officials blame the DOL's previous leaders for moving ahead without them. Now the SEC and DOL appear to be working together to bring fiduciary rulemaking at the agencies into alignment.

GROWING LIKELIHOOD OF SEC FIDUCIARY RULEMAKING AND WHAT AN SEC FIDUCIARY RULE MIGHT LOOK LIKE

Since being sworn into office in May, SEC Chair Jay Clayton has repeatedly said that the SEC will move forward with its own fiduciary rule and called it a high priority. He went so far as to boldly predict that we would see a rule proposal in 2017. That hasn't happened, but based upon public statements and our recent interactions with SEC officials, we now believe that the SEC will release a proposal in 2018.

Financial firms that have dually registered advisors are caught between a rock and a hard place when it comes to current fiduciary standards. The DOL rule now requires robust and consistent fiduciary accountability for advice rendered in retirement accounts. The SEC requires strong fiduciary accountability for those who are registered investment advisors but has allowed non-registered broker-dealer representatives to give virtually indistinguishable forms of advice without registering as RIAs and without fiduciary accountability. This inconsistency in the space subject to SEC oversight means that an advisor must act in a fiduciary capacity when giving advice about retirement accounts for a client but can switch hats to provide non-fiduciary advice on non-retirement assets for that same client. It is inexplicable to clients as to why this drop-off in accountability makes any sense. This is especially true in the case of an IRA that was previously advised under a suitability standard and now must be advised in a fiduciary capacity due to the DOL rule – it creates an awkward client experience to say the least.

The current situation is untenable for the SEC because it is untenable in the marketplace. The most efficient and effective way for the SEC to handle the situation is to coordinate with the DOL during the DOL rule transition period. That way, the DOL can tweak its rule to align with what the SEC decides to propose.

HOW MIGHT THIS SCENARIO PLAY OUT?

Let's assume the SEC formulates and releases a proposed fiduciary rule by mid-2018. That would be somewhat slower than what Chair Clayton has said he expects to happen but is also more realistic because it would include time for Trump's two nominees to fill Commission vacancies (Hester Peirce and Robert Jackson) to be confirmed and get up to speed. Following release of the proposed rule, there would be a required public comment period (probably 90 days), refinements made to the rule, re-proposal, another comment period and then a final rule. All told, that would take roughly 18-months (the same duration as the DOL Rule transition period) with the SEC and DOL working on parallel rule-making tracks.

Following adoption, there would likely be an additional transition period before the compliance requirements take effect. That would bring the whole process to 24 months, meaning the SEC's fiduciary rule could be fully in place by the end of 2019.

For this to happen, both agencies would need to be motivated to act, aligned on guiding principles, and realistic about what can be accomplished without undue risk of successful litigation by either fiduciary rule advocates or opponents. We think all three of these conditions can plausibly be satisfied.

Going way out on a limb to prognosticate about what we think might be in a proposed fiduciary rule from the SEC based upon what we have heard from regulators and our marketplace insights, here are a few key features we would expect.

- DOL's definition of fiduciary will be adopted by the SEC with little or no change because firms are already adapting to it and it will be very difficult to weaken without running afoul of statutory requirements of ERISA that place a priority on protecting retirement assets. The SEC, in contrast, has a multiple mission that includes encouraging capital formation in addition to protecting investors.

- No new private right of action will be created, which means the contract requirement of BICE in the DOL rule will go away (as already expected) and the SEC would regain primary enforcement power over IRAs.

- A carve-out will be provided to make it clear that self-directed brokerage accounts (where the client does not seek or receive personalized advice) does not entail fiduciary responsibility for trade facilitation. Special provisions will be needed to be clear about the dividing line between fiduciary and non-fiduciary activities in call centers.

- Strict controls will be crafted to address "hat-switching." Informed client consent will be required. One senior SEC official described this as something tantamount to having actual hats, one embroidered with the word "FIDUCIARY" and the other with "SALESPERSON" that the advisor/broker would have to appropriately don if they want to change the nature of the relationship.

- Truthful and proactive "holding-out" obligations will be included. Use of terms like "advisor" or "consultant" will require fiduciary accountability.

- Adherence to Impartial Conduct Standards (drawn from the DOL rule concept) will be required for fiduciary relationships.

- The SEC will coordinate its rulemaking with state insurance commissioners, who are working on a model rule that would require a 'best interest' standard for annuity transactions. It is unclear at this early stage how well that project will harmonize with securities laws and ERISA's much higher standard of conduct.

Our assessment is bold but based upon careful analysis of regulatory, marketplace and practical realities. The timing and details of what will happen are an educated guess at this point, but we want to make sure you have the benefit of our best thinking on the subject.

Our guidance has consistently been to recognize that, beyond the regulatory imperative to act, competitive forces and client-centric considerations argue for embedding fiduciary practices in the culture and operational structure of every advisory firm. That advice has proven to be sound.

Since 1999, Fi360 has been at the forefront of educating, equipping and supporting investment fiduciaries. We are committed to helping advisors achieve fiduciary excellence on behalf of their clients. Regardless of what the future of fiduciary regulation may entail, advisors who embrace and apply Fi360's Prudent Practices® are well prepared to serve clients' best interests and excel in the marketplace.