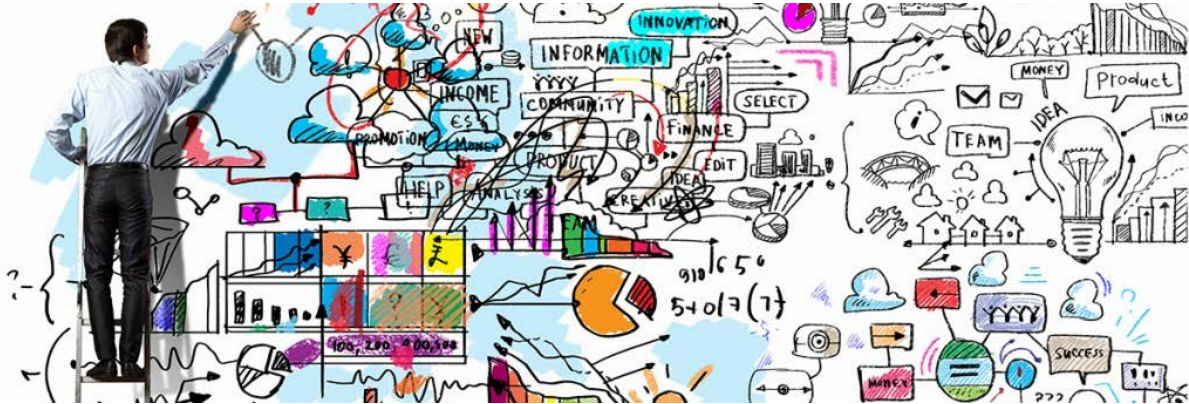


CONFUSED BY THE CLARITY THE STATE OF THE FIDUCIARY RULE

by Louis S Harvey

September 8, 2017



It is certainly clear that the DoL Fiduciary Rule ("Rule") will materially change the investment business over the next ten years but what is unclear to me is what those changes will be. As I read and hear definitive statements about what will and will not happen, I fail to understand how so many informed people could possibly be so confident about so many things.

This article is about the state of affairs and why I am so confused by the clarity others have expressed.

There are four major centers of influence that will define the final Rule.

There is the current administration that will dictate what administrative actions or inactions will be taken by the DoL, SEC, IRS, Department of Justice, etc. But the composition of these areas of current administration could change as other administration areas have.

In 2020 the entire administration could change. A likely delay of the Rule's implementation for more years could herald another administration that could either be much more supportive or much less supportive of the Rule.

The courts have supported the Rule thus far but there is the very real possibility that higher courts could strike down the Best Interest Contract Exemption ("BICE") contained in the Rule.

A least likely influence is that the Congress will find common ground to halt or modify the Rule.

Despite all these centers of influence in play, there are certain aspects of the Rule that are already in place and "Cast in Stone" so that changing them is almost out of the question. There are other aspects that are simply "Unknowable" at this point since the relevant centers of influence have not weighed in on them. There are also aspects of the Rule that are not yet in effect but are "Likely to be Implemented". Then there are those that are "Unlikely to Remain" as part of a final Rule.

The most important aspects of the Rule have been put into these categories to help explain my confusion, and maybe yours.

Cast in Stone

The aspects of the Rule that have already been implemented are by far the most difficult to change or to reverse. These include the aspects that were implemented on or before June 9th, 2017:

- The Definition of the Term “Fiduciary”; Conflict of Interest Rule-Retirement Investment Advice. This revised definition specifies who is a fiduciary, what Fiduciary Acts (See Appendix) are and what constitutes a breach (Conflicts of Interest¹).

The activities that are now “Cast in Stone” as Fiduciary Acts as of June 9th 2017 are summarized in the following table:

Checklist of Ten Types of Recommendations Defined as Fiduciary Acts	
1	The advisability of acquiring, holding, disposing of, or exchanging securities or other investment property
2	Investment policies or strategies
3	Portfolio composition
4	Selection of other persons to provide investment advice
5	Investment management services
6	Selection of investment account arrangements (e.g., brokerage versus advisory)
7	Other management of securities or investment property
8	Whether, in what amount and in what form rollovers, transfers, or distributions from a plan or IRA should be made
9	To what destination should a rollover, transfer, or distribution from the plan or IRA be made
10	How securities or other investment property should be invested after being rolled over, transferred, or distributed from the plan or IRA

The most far reaching impact of the June 9th Fiduciary Acts are probably the effects on rollovers. As it stands today, a rollover is required to be in a client’s best interest but meeting such a standard is not a familiar process and BICE provides guidance only for level fee arrangements. It is therefore necessary to create a process to show that a client’s best interests are served by the rollover. This may be challenging when the cost of the rollover alternative is substantially higher than the cost of not rolling over.

¹ According to the Department of Labor, “Many investment professionals, consultants, brokers, insurance agents and other advisers operate within compensation structures that are misaligned with their customers’ interests and often create strong incentives to steer customers into particular investment products.

- Once defined as a Fiduciary Act, standards must be maintained that comport with the universally accepted Prudent Expert Rule².
- Furthermore, retirement regulations prohibit all conflicts of interests unless the prohibition is waived by an exemption, for which specific conditions must be met.
- Laws and regulations that remain unchanged such as statutory exemptions defined in the Pension Protection Act of 2006 (408g exemption). These exemptions have the full force and power of being derived through the constitutional process of making laws.

Unknowable

A number of material questions have been raised but not yet answered about the survivability of the Best Interest Contract Exemption. These aspects are generally the consequences of the regulatory process, actions taken and promises made. By describing the answers to these questions as “Unknowable” it also means that there is a reasonable likelihood for those answers to either favor or oppose the BICE:

- What aspects of the Rule will the courts ultimately uphold and which will be struck down?
- What enforcement will be in place when the No Enforcement Policy³ for various aspects of the Rule eventually expires?
- What the consequences will be of failing to meet the “Working Diligently” requirement of the No Enforcement Policy?
- Will plaintiffs and courts recognize the No Enforcement policy or will private action be based on regulations already passed and thereby limiting the usefulness of this policy?
- Will the SEC make changes based on the Dodd-Frank Act⁴, and will they augment, replace or contradict the DoL Fiduciary Rule?
- How will arbitration panels act until all exemptions are fully implemented?
- What are the final exemptions and what conditions will be required for each?
- Who will be in charge of the DoL Fiduciary Rule at the EBSA (department previously headed by the architect of the Rule, Phyllis Borzi)?

² Fiduciaries must act in the interests of clients with the care, skill, prudence and diligence under the prevailing circumstances that a prudent expert acting in a like capacity and familiar with such matters would act.

³ On May 2nd, 2017 the DoL issued Field assistance Bulletin No. 2017-02 which in essence states that, “...during the phased implementation period ending on January 1, 2018, the Department will not pursue claims against fiduciaries who are working diligently and in good faith to comply with the fiduciary duty rule and exemptions, or treat those fiduciaries as being in violation of the fiduciary duty rule and exemptions.” The DoL goes on to say “This Bulletin is an expression of EBSA’s temporary enforcement policy; and it does not address the rights or obligations of other parties.” Revisions that extend this policy to July 1st, 2019 are being considered.

⁴ Section 913 of the Dodd Frank Act empowers the SEC to make new rules to harmonize advisor regulations.

Likely to be Implemented

Certain aspects of the Rule are likely since they are favored by the current administration. They are likely only if the Rule is fully implemented during the tenure of this administration as it is composed today. If not fully implemented, changes in department heads can reverse the likelihood:

- The No Enforcement Policy of selected provisions, subject to “Working Diligently” to comply with the best interest requirement, reasonable compensation and misleading statement aspects of the existing Rule
- Some form of additional exemptions that waives prohibitions to conflicts of interest
- Compensation through existing arrangements, subject to conditions that are yet to be defined
- Other alternatives to BICE that are better aligned with certain business models

Unlikely to Remain

Elimination or changes to the following aspects of BICE have been promised or implied by the current administration. Full implementation of final exemptions must take place under the current administration for these to be eliminated or changed:

- Right to class action for all retirement investors
- Required warrantees and supporting procedures
- Disclosure requirements as defined in the current version of BICE
- Limitations on compensation for pre-existing and future business
- Written contract requirement

Conclusion

Faced with these uncertainties, what would a prudent expert do? I don’t know, but here is what I advise:

- Stop trying to find the *right* answer... no one knows

The best answer is:

- Limit expenditures to aspects that are “Cast in Stone”
- Hedge against the “Unknowable” aspects with contingency plans
- Assess progress with aspects that are “Likely to be Implemented” and make any improvements that represent minimal disruption and cost
- Stop all spending on aspects that are “Unlikely to Remain”
- Pay attention to all aspects and keep them all in focus, not just those that are in the latest headline, tweet or study.

FREQUENTLY ASKED QUESTIONS

This report puts a wide range of issues into perspective and raises a number of questions. This section is intended to give more depth to several of these issues and answer questions that may have been raised.

What aspects of the Rule were “Set in Stone” on June 9th, 2017?

In its announcement on April 4th, 2017 of a 60-day extension of the applicability dates of the fiduciary rule and related exemptions, the DoL noted regarding the revised June 9th date...

“The fiduciary definition in the Fiduciary Rule published on April 8, 2016, and impartial conduct standards in these exemptions, are applicable on June 9, while compliance with the remaining conditions in these exemptions, such as requirements to make specific written disclosures and representations of fiduciary compliance in communications with investors, is not required until Jan. 1, 2018.”

“Under the terms of the extension, advisers to retirement investors will be treated as fiduciaries and have an obligation to give advice that adheres to “impartial conduct standards” beginning on June 9 rather than on April 10, 2017, as originally scheduled. These fiduciary standards require advisers to adhere to a best interest standard when making investment recommendations, charge no more than reasonable compensation for their services and refrain from making misleading statements”.

Source: <https://www.dol.gov/newsroom/releases/ebsa/ebsa20170404>

What does “Working Diligently” actually entail?

In its Field assistance Bulletin No. 2017-02 (“FAB 2017-02”) the DoL announced its No Enforcement Policy and that *“fiduciaries who are working diligently and in good faith to comply with the fiduciary duty rule and exemptions”* would be granted relief.

The April 4th announcement made reference to what was expected during the “transition period”. Fiduciaries need to *“adhere only to the impartial conduct standards (including the best interest standard), as conditions of the exemptions during the transition period”*

There is no further guidance as to what must be done or shown to establish that the promised relief would be granted. This makes relief uncertain, considering that the DoL has also announced that the referenced exemptions are subject to change and new exemptions could be added.

A reasonable response of FAB 2017-02 would be to assess and then assume the most likely conclusion. Any evidence of work done to comply with the current version of BICE should be well documented in the event that relief is withheld at a future date.

What will happen to the BICE changes that have already been developed?

Changes fall into one or more of four broad categories that have different dispositions.

- Improve Business: Improvements may include lower costs, automation, marketing advantage and intangibles.
- Commitments Made: Reversing public statements and promises made to clients could have serious negative effects. Efforts need to be made to minimize any potential harm.
- High Cost of Reverting: New practices and systems that have already been implemented may involve high risk, disruption and expenditure to undo. It is possible to seek efficiencies that reduce the burdens without reverting to the previous practices and systems.
- High Cost of Continuing: In cases where significant future costs or risks are anticipated, the decision to abort is clear, given the enormous instability that has evolved.

Separating changes into these four categories can lead to a clear course of action.

What aspects of the Rule are covered by the No Enforcement Policy?

In its FAB 2017-03, the DoL promises relief for violation of BICE, Principal Transaction Exemption or limitations on the use of Arbitration.

"...the Department of Labor will not pursue a claim against any fiduciary based on failure to satisfy the BIC Exemption or the Principal Transactions Exemption, or treat any fiduciary as being in violation of either of these exemptions, if the sole failure of the fiduciary to comply with either the BIC Exemption or the Principal Transactions Exemption, is a failure to comply with the Arbitration Limitation in Section II(f)(2) and/or Section II(g)(5) of the exemptions."

Source: <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2017-03>

Why is further delay likely?

As long as supporters and opponents of the Rule see a reasonable path to achieving their conflicting goals, it will be difficult to avoid further delays. The precedent having been set, both supporters and opponents will demand a postponement of any aspect with which they disagree. Denial of a delay at this point would produce an outcry that would force the delay.

What forms of compensation are affected by the Rule?

Any compensation that is paid by, reduces the retirement investor holdings or influence the advice that is given is covered by the Rule. This includes all fees, expenses, commissions, salaries, incentives and non-cash compensation received by the person who performs a Fiduciary Act.

What court cases are pending that can materially change the future of the Rule?

The National Association for Fixed Annuities vs. DOL and Secretary Thomas Perez: The DoL rule's definition of reasonable compensation is too vague, and the inclusion of fixed-indexed annuities in the BICE is "arbitrary and capricious" and "contrary to law."

U.S. Chamber of Commerce vs. DOL and Secretary Thomas Perez: The DoL has "improperly exceeded" its authority by creating this rule, is in violation of ERISA and other rules, and that it has "unlawfully created a private right of action."

The American Council of Life Insurers/National Association of Insurance and Financial Advisors vs. DOL and Secretary Thomas Perez: The DoL rule "unlawfully and arbitrarily imposes fiduciary duties on commercial sales relationships and communications that are not fiduciary in nature."

Indexed Annuity Leadership Council vs. DOL and Secretary Thomas Perez: The fiduciary rule and the BICE are "arbitrary and capricious" and exceed the DoL's statutory authority.

Market Synergy Group vs. DOL and Secretary Thomas Perez and Assistant Secretary Phyllis Borzi: The DoL rule inflicts "severe and irreparable harm" and its actions "violate applicable law and procedure."

Thrivent Financial for Lutherans vs. Acosta: The DoL exceeded its statutory authority by attempting, with its new fiduciary rule, to force all disputes into federal court rather than allowing for alternative dispute resolution methods.

What is the greatest effect that BICE will have on the industry?

If BICE survives, it will transform the way pricing is done. The combination of fiduciary risk, best interest requirement, compensation limitations and the burden of disclosures will eventually outweigh the convenience of bundling advisor compensation with other associated products and services.

Advisors will demand a dizzying array of prices to fit each situation encountered. What is even more complex are the changes that follow as clients naturally begin to act like consumers and demand discounts and price reductions. All this will make it impractical for product and service providers to manage. Distributors will be forced to step in and manage the pricing.

Distributor control of pricing will ultimately change the way business is conducted and transform the relationship of manufacturers and distributors as distributors create higher markups and lower core product pricing.

Will there ever be strong enforcement of BICE?

Very likely. The new definition gives a concrete basis to prosecute so regulators expect to see increased enforcement from private sources. Courts and arbitration panels will render judgement on losses where a fiduciary breach can be shown.

This form of enforcement can be expected to remain dormant until there is a major market correction.

How do you explain what is going on to a client?

The government seeks to oversee the advisor/client relationship and there is a struggle going on between the pro-government and free market factions.

Pro-government factions seek to have legal contracts, identical methods, controlled compensation, warranties, and extensive public disclosures.

The free market factions seek to rely on the self-interest of clients and advisors to maintain a fair and orderly process.

APPENDIX

Fiduciaries and Fiduciary Acts

The definition that went into full effect on June 9th, 2017 revised ERISA 3(21):

(1) Such person provides to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner the following types of advice for a fee or other compensation, direct or indirect:

(i) A recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, or a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA;

(ii) A recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., brokerage versus advisory); or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer, or distribution should be made;