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Symposium Note: Blank Check in the Criminal Justice System

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DEPARTMENT OF LABOR FIDUCIARY RULE – EXPANSION OF FIDUCIARY DUTIES

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The U.S. Department of Labor (DOL) has expanded the “investment advice fiduciary” definition under the Employee Retirement Income Security Act of 1974.¹ On April 6, 2016, the DOL issued its final rule (Fiduciary Rule) imposing fiduciary duties upon those who provide investment advice for compensation—direct or indirect—as to the purchase or sale of securities or other investments within a plan or individual retirement account qualified under the Employee Retirement Income Security Act of 1974.² According to the Executive Summary, the Fiduciary Rule “aims to require advisers and their firms to give advice that is in the best interest of their customers, without prohibiting common compensation arrangements under conditions designed to ensure the adviser is acting in accordance with fiduciary norms and basic standards of fair dealing.”³ Further, according to the Executive Summary, the DOL concluded (after a multi-year study that began in 2009) that IRA holders receiving conflicted investment advice may see their investments underperform by an average of 0.5 to 1% per year.⁴ This could result in a cost to IRA investors between \$95 billion and \$189 billion over the next 10 years in the mutual fund segment alone.⁵

Prior to the adoption of the Fiduciary Rule, many advisers of tax qualified accounts included insurance companies and their producers and broker-dealers and their sales representatives. These advisers of tax qualified accounts have not traditionally owed fiduciary duties to those they advise or to those they sell securities and investments. Before the Fiduciary Rule, only registered investment advisers acting pursuant to the Investment Advisers Act of 1940 and registered with the U.S. Securities and Exchange Commission or licensed with state securities commissions owed fiduciary duties to their customers as a matter of law.⁶ Upon the effective date of the Fiduciary Rule, April 10, 2017, broker-dealers and insurance companies will owe fiduciary duties to their customers in connection with the sale of investment products in tax qualified accounts.

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1. 29 C.F.R. § 2510.3-21 (1974).
2. *Id.*
3. *Id.*
4. *Id.*
5. *Id.*
6. 15 U.S.C. § 80b-1–80b-21; 3 C.C.R. 704-1:51-4.8-IA.

The DOL's adoption of the Fiduciary Rule was unquestionably controversial. During the comment period following the DOL's release of the proposed Fiduciary Rule in early 2015, Commissioner Daniel M. Gallagher of the U.S. Securities and Exchange Commission issued a scathing comment letter to DOL Secretary Thomas E. Perez.⁷ Commissioner Gallagher predicted that broker-dealers utilizing a commission-based fee structure would find it so difficult to comply with the "labyrinth of prohibitions and exemptions" of the Fiduciary Rule that they would no longer continue to service lower-valued accounts.⁸ According to Commissioner Gallagher, this is bad government policy, will affirmatively harm those it claims to help, and proves the "nanny-state is alive and well."⁹

Now that the fiduciary standards will apply to all types of advisers when providing recommendations concerning tax qualified accounts, current methods of compensation for insurance producers and broker-dealers will be prohibited if they are not in the best interest of the investor. Generally, fiduciaries are prohibited from receiving compensation from third parties in connection with transactions involving the plans and IRAs.¹⁰ For example, the sale of variable annuities and indexed annuities into a qualified account would not be permitted as these types of investments provide the seller with compensation from the insurance company.¹¹ However, the Fiduciary Rule provides an exemption to conflicting payment structures or "prohibited transactions" that allows the fiduciary to continue to provide advice and make otherwise prohibited sales. The exemption is known as the Best Interest Contract Exemption (BICE).

In order to satisfy BICE, the fiduciary must agree to provide investment advice that is in the best interest of the investor, acknowledge its fiduciary status, receive only reasonable compensation, disclose all potential conflicts of interest, and provide a detailed breakdown of his collected commission.¹² As reflected in many commentaries, the meaning of these requirements for the exemption, and what constitutes actual compliance, is not altogether clear.

The additional compliance obligations will certainly come at a cost. Some fiduciaries may elect to eliminate small investors as the cost to comply might be too great as suggested by Commissioner Gallagher. It remains to be seen what fallout the Fiduciary Rule will have on both the industry and investors. What is clear is that investment professionals and

7. Letter from Daniel M. Gallagher, Comm'r, Sec. & Exch. Comm'n, to Thomas E. Perez, Sec'y, Dep't of Labor (July 21, 2015), <https://www.sec.gov/news/speech/2015/gallagher-dol-comment-ttr-7-21-15.pdf>.

8. *Id.*

9. *Id.*

10. Best Interest Contract Exemption; Correction, 81 Fed. Reg. 44773, 44775 (July 11, 2016) (to be codified at 29 C.F.R. pt. 2550).

11. *Id.*

12. *Id.*

their lawyers and advisers will spend substantial time and money sorting out this new overlay of law governing retirement plans and IRAs.