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RETIREMENT SERVICES

GAME CHANGER, PART II

THE FOUR FIDUCIARY STANDARDS OF CARE

The Department of Labor’s Conflict of Interest Proposal creates a new fiduciary standard of care applicable only when advisors take advantage of certain prohibited transaction exemptions. If made effective, the “Best Interest Contract” standard will become the fourth standard of care with which advisors must comply, alongside suitability, common law fiduciary rules, and ERISA fiduciary rules.

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There is a movement afoot in the U.S. to simplify the standards of care applicable to interactions between financial advisors and their clients. There is also resistance to this movement. The Dodd-Frank Act mandated that the Securities and Exchange Commission (SEC) study the feasibility of a uniform fiduciary standard due to the confusion observed among investors about the roles and responsibilities of advisors. But due to limitations inherent to today's statutes, the Department of Labor (DOL) chose to create a new standard of care as part of its Conflict of Interest Proposal ("Proposal") in order to find a path to mitigating what it sees as a retirement investment system prone to conflicts of interest. The new fiduciary standard imbedded in the Proposal is best understood in the context of the debate over a uniform fiduciary standard.

Part I of this series of articles on the Conflict of Interest Proposal discussed the updated regulation defining "fiduciary," the basic structure of the Proposal, and some of its implications. This Part II discusses the four fiduciary standards of care that will apply if the Proposal becomes effective. Part III will zero in on the Best Interest Contract (BIC) Prohibited Transaction Exemption (PTE) that is the centerpiece of the DOL's strategy for bringing ERISA-style fiduciary accountability to the IRA marketplace. Part IV will discuss the relative merits of the DOL's Proposal as put forth by various interested parties—including the White House and the DOL.

INTRODUCTION

There are three standards of care applicable today to interactions between financial advisors and their clients, and the DOL's Conflict of Interest Proposal[1] adds a fourth that might be described as either "IRA fiduciary" or "Best Interest Contract fiduciary."

The three current standards of care are:

1. **Suitability**: brokers who sell securities must ensure the securities are "suitable" for the clients to whom they are recommended. This is the lowest standard of care. While it offers significant protections for investors and is based on fair dealing, it includes no loyalty requirement, and is therefore the least protective. Brokers, in other words, do not have to sell products that are *best* for their clients, only products that are *suitable*. Conflicts of interest are permitted and need not necessarily be disclosed since they are assumed to be a part of the seller-buyer relationship.
2. **Common law fiduciary**: centuries of fiduciary rules and case law make up the "common law of trust"[2] that governs most fiduciary interactions in the U.S. (and globally, in many cases). Registered Investment Advisers (RIAs) are generally bound by a fiduciary standard of care that might be defined as "client first." Conflicts of interest are permitted so long as they are disclosed.

[1] A new regulation and a package of prohibited transaction exemptions proposed by the Department of Labor on April 14, 2015 aimed at mitigating perceived negative effects from conflicts of interest based on variable and indirect compensation. Click here to visit the Proposal landing page at dol.gov.

[2] See especially the Uniform Prudent Investor Act, which is part of the Uniform Trust Code.

3. **ERISA fiduciary**: ERISA is the strictest of the fiduciary standards and probably the most protective of investors. It can be described as a "client only" standard that prohibits an advisor from even considering his or her own interests. Conflicts of interest are prohibited, whether disclosed or not, unless an exemption applies.

The Best Interest Contract PTE of the DOL's Proposal would add a fourth standard of care that applies only to those using the BIC PTE or those other PTEs which are part of the Proposal and share the BIC's "best interest" standard of care:

4. **BIC Fiduciary**. There is no official name, but "BIC fiduciary" or "IRA fiduciary" covers it reasonably well. The BIC PTE creates a "best interest contract" standard of care that has similarities to both ERISA and common law, but is clearly different from both.

The purpose of this article is to highlight key differences among the four standards of care and to explore the implications of adding the fourth standard.

THE DECADE-LONG BATTLE OVER TRANSPARENCY AND THE UNIFORM FIDUCIARY STANDARD

Our current watershed time in the retirement industry — a time of professionalization and a movement toward a fiduciary service model — began roughly a decade ago with a series of scandals that, combined with the 2000-2002 bear market, left investors with a distrust of the financial services industry and led to a sense in Washington that Something Must be Done. The late-day trading and market timing scandals involved sophisticated, institutional investors profiting from trades placed under circumstances in which the profits came at the expense of rank and file mutual fund investors. A variety of new rules and a desire to improve transparency took root in Washington.

The DOL's Three Transparency Initiatives

As part of the impetus to improve transparency and reduce the harm caused by conflicts of interest, the Department of Labor in 2007 announced a series of three transparency initiatives: new disclosures on Schedules A and C of the Form 5500, disclosures for fiduciaries (408b-2)[3], and disclosures for plan participants (404a-5)[4].

[3] 29 CFR 2550.408b-2, the DOL's regulation on how to qualify for the prohibited transaction exemption allowing service providers to provide services and get paid for doing so.

[4] 29 CFR 2550.404a-5, the DOL's regulation on disclosures to participants in participant-directed plans that the DOL viewed as implied by the prudence and loyalty provisions of ERISA.

The 2010 Fiduciary Definition Proposal

The DOL was not finished after the completion of the three transparency initiatives. In 2010 they proposed a redefinition of the term "fiduciary" to update the existing 40-year-old rule[5]. The stated intent was to broaden the net to cause more advisors to be treated as fiduciaries, since the DOL can regulate fiduciaries but not, for the most part, non-fiduciaries. The rule met with significant opposition, was withdrawn, and was finally re-proposed in dramatically revised form as part of the Conflicts of Interest Proposal published on April 14, 2015.

PPA

During this time, Congress continued to show interest in transparency and conflicts of interest in the financial industry. In 2006 the Pension Protection Act provided a new "fiduciary adviser" PTE, the intent of which was to expand access to advice but to do so in a manner protective of investors.

Dodd-Frank

In 2010, the Dodd-Frank Act included an interesting provision[6]: the SEC was ordered to study the question of whether advisors should be held to a uniform fiduciary standard of care for all types of investors. The SEC, as required, published a report[7] in January 2011 in which it suggested the adoption of a "uniform" standard. Here is an excerpt from the report [emphasis added]:

> In the study, the staff notes that investment advisers and broker-dealers are regulated extensively under different regulatory regimes. But, many retail investors do not understand and are confused by the roles played by investment advisers and broker-dealers. The study finds that "**many investors are also confused by the standards of care that apply to investment advisers and broker-dealers**" when providing personalized investment advice about securities.
>
> The study further states that "**retail investors should not have to parse through legal distinctions to determine" the type of advice they are entitled to receive**. "Instead, retail customers should be protected uniformly when receiving personalized investment advice about securities regardless of whether they choose to work with an investment adviser or a broker-dealer."

In its financial report for fiscal year 2014, the SEC lists the fiduciary standard as one of its goals. SEC Commissioner Mary Jo White has stated publicly that she is committed to a fiduciary rule and that it is a "very high priority."[8]

5 29 CFR 2510.3-21(c), definition of "fiduciary"
6 Section 913
7 "Study on Investment Advisers and Broker Dealers," January 2011.
8 At the SIFMA annual conference in late 2014.

The Non-Uniform Uniform Fiduciary Standard

Because Dodd-Frank mandated that any uniform fiduciary standard could not eliminate commissions as a way of doing business, the SEC's proposed standard would have levied different requirements on brokers versus RIAs. RIAs are required to monitor investments they recommend, but brokers would not share this requirement. Thus, while the standard of care for initial purchases or recommendations would be the same for both brokers and RIAs, the ongoing standard of care would be different.

Because the proposal created a non-uniform standard of care, many opposed it. But interest remains in the notion of a uniform fiduciary standard and the extension, generally, of a fiduciary standard of care to all financial advisors in all account types when advice is given, though naturally many remain opposed.

Revised Fiduciary Standards of Care as the Culmination of the Transparency Movement

The DOL's 2015 Conflict of Interest Proposal is the latest step — and perhaps the most significant — in a long-running effort to improve transparency and reduce conflicts of interest in the financial services industry. But instead of simplifying the landscape via a uniform standard of care, statutory constraints forced the DOL to create a fourth standard of care (or wait for Congress to act). The result is a system of rules that would be more complex than either the existing rules or a uniform fiduciary standard as proposed by the SEC. This is not an indictment of the Proposal, simply an acknowledgement that adding a fourth standard does add to the complexity of the regulatory scheme.

Unlike the SEC's proposed uniform standard, which would apply a fiduciary standard of care to all account types with respect to which an advisor provides fiduciary advice, the DOL's Proposal affects a subset of the financial marketplace we can describe as Retirement Investors[9] — in particular the $7 trillion IRA marketplace. The Proposal would bring ERISA-style fiduciary accountability to IRAs, retirement plan participants, and fiduciaries of certain small retirement plans.

We can therefore understand the DOL's Proposal in the context of a decade-long movement to improve transparency and reduce conflicts of interest. Determining the future of fiduciary standards of care is one of the final steps in this movement.

[9] As defined in the Proposal: IRAs; certain retirement plan fiduciaries and participants.

UNDERSTANDING THE FOUR STANDARDS OF CARE

Suitability

Suitability might be described as a "fair dealing" standard. In an educational document for investors entitled "Suitability: What Investors Need to Know," available on the FINRA website, the opening sentence says:

> "FINRA's suitability rule (FINRA Rule 2111) is based on a fundamental FINRA requirement that brokerage firms and their associated persons (sometimes referred to as brokers, financial advisers or financial consultants) **deal fairly with their customers**."

The Rule itself defines suitability as follows:

> "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."[10]

> "Implicit in all…relationships with customers…is the fundamental responsibility for fair dealing…The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct."

So suitability is similar to a fiduciary standard of care in some ways, but variable compensation is permitted. Due diligence is required, but not to ensure an investment is in a client's best interest, but merely to ensure the broker knows enough about the client to form a reasonable belief that the investment is suitable.

The "Eye Single" of ERISA Exclusive Purpose

ERISA is frequently cited as the most stringent standard of care in the financial services marketplace, with reason. The exclusive purpose rule of ERISA Sections 404(a)(1)(A) and 403(c)(1) require that plan assets "shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan."[11] ERISA's prohibited transaction rules prohibit virtually every kind of transaction among the plan and parties in interest and fiduciaries unless a specific exemption is available and the conditions of that exemption are met.

A landmark case examining the loyalty standard of ERISA described the duty of fiduciaries as follows: "…their decisions must be made with an eye single to the interests of the participants

[10] FINRA Rule 2111(a).

[11] ERISA §403(c)(1)

and beneficiaries."[12] Whereas common law fiduciaries such as RIAs serving taxable investment accounts must follow a "client first" standard, whereby the RIA may consider his or her own interests so long as the client's interests come first. ERISA, by contrast, is "client only"—the advisor's interests are generally not a permissible consideration.

The Common Law Duty of Loyalty: "Client First"

ERISA is easy to summarize because it is self-contained and relatively unambiguous. Common law, on the other hand, consists of centuries of laws, rules, and court cases. But for our purposes a few points about common law loyalty are most pertinent, in particular the treatment of conflicts of interest such as variable compensation.

The Uniform Trust Code (UTC) is a model act that most states have adopted, in whole or in modified form. Unlike under ERISA, under most states' UTC variants, many conflicts are explicitly permitted, such as:

- Investing in the fiduciary's own mutual funds, CDs, or other investment products
- Receiving compensation from transactions involving the trust so long as the terms are fair.

RIAs, similarly, are permitted to receive variable compensation. A financial planner acting as an RIA can charge a fee for financial planning, recommend the purchase of a whole life insurance policy as part of the plan, then sell the policy to the client for a commission so long as the conflict is disclosed and the client's interests are put first. For this reason, the common law fiduciary standard of care might be described as "client first" even though the actual language used in the UTC and the Uniform Prudent Investor Act (UPIA) is similar to that of ERISA. From Section 5 of the UPIA: "A trustee shall invest and manage the trust assets solely in the interests of the beneficiaries."

The Loyalty and Prudence Standards of the BIC PTE vs. ERISA

The DOL adapted language from ERISA to create the BIC standard:

> When providing investment advice to the Retirement Investor regarding the Asset, the Adviser and Financial Institution will provide investment advice that is in the Best Interest of the Retirement Investor (i.e., advice that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise 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 Adviser, Financial Institution or any Affiliate, Related Entity, or other party)**…

[12] *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir. 1982), cert denied, 459 US 1069 (1982)

A plain reading of the "without regard to" language of the BIC standard suggests that the DOL intends for the BIC PTE standard of care to resemble ERISA's "eye single" to the needs of participants, not the "client first" common law standard. And by incorporating the "without regard" language into the standard itself, the "eye single" interpretation of ERISA—which is not part of the common law, which would otherwise apply—has been wired into the new rule.

Compare the BIC language above to the language of ERISA Section 404(a)(1):

> "…a fiduciary shall discharge his duties with respect to a plan **solely in the interest of the participants and beneficiaries** and--
>
> (A) for the **exclusive purpose** of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man 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…"

ERISA's "solely in the interest of" is very similar to "without regard to the financial or other interests of the Adviser." The prudence language is nearly identical, with the BIC version simply being specific to the circumstance of investment advice. Clearly, the DOL intended for the BIC standard of care to be as similar as possible to that of ERISA.

However, ERISA does not apply to IRAs. Therefore it is common law fiduciary rules, to a large extent, which will determine how courts view breaches of duty. The DOL acknowledges this to a degree, but states in the preamble to the BIC PTE:

> "The best interest standard set forth in this exemption is based on longstanding concepts derived from ERISA and the law of trusts…the Department would expect the standard to be interpreted in light of forty years of judicial experience with ERISA's fiduciary standards and hundreds more with the duties imposed on trustees under the common law of trusts."

In other words, this is a hybrid standard of care patterned after ERISA but subject to common law notions of prudence and loyalty, in addition to the specific terms of the exemption. It is not an ERISA standard; it is not strictly a common law standard; it is something new.

The following table highlights the key features of each standard of care.

THE FOUR FIDUCIARY STANDARDS OF CARE UNDER THE DOL's CONFLICT OF INTEREST PROPOSAL

	Suitability	Common Law Fiduciary	BIC Fiduciary	ERISA Fiduciary
Fiduciary?	No	Yes	Yes	Yes
Standard for considering clients' needs	Recommendations must be for products that are **suitable**, but need not be in the clients' best interests	"**client first**"; Client needs must be the first consideration. Advisors may consider their own self-interest so long as client needs come first.	"**best interest**"; Defined in terms similar to ERISA's Prudent Man Rule (but not identical); a hybrid of "client first" and Exclusive Purpose	**Exclusive Purpose**; Clients' best interests are the sole permissible consideration; the most stringent of the standards of care
Conflicts of Interest (including variable compensation)	Permitted. Minimal disclosure needed. The presumption is that this is a seller-purchaser relationship and an element of *caveat emptor* applies	Permitted if disclosed	Permitted if disclosed, but with significant constraints stated or implied in the exemption	Not permitted unless an exemption is available and you meet its terms
Consequences of breach	Potential action by FINRA; contractual liability	Potential action by SEC or state; contractual liability	Contractual liability; potential action by IRS if they develop an enforcement program; IRS excise tax for PT	Personal liability of fiduciaries under ERISA §409; penalties under §502; lawsuits; action by DOL; PT penalties and excise tax
Governing regulators and laws	FINRA; FINRA rules; securities law and SEC rules	SEC; securities law and SEC rules; state rules; common law	DOL sets the rules, IRS is responsible for enforcing; IRC §4975 and the BIC PTE; common law	DOL; ERISA
Is it more rules-based or more principles-based?	Rules-based. There are principles-based aspects but broker regulation and enforcement are heavily rules-based	Principles-based; principles are drawn from centuries of law and case law	Rules-based, though the DOL describes it as principles-based. The Impartial Conduct Standards are principles-based; the bulk of the BIC PTE is quite prescriptive	Principles-based. The ERISA fiduciary provisions are relatively short and guidance is relatively sparse compared, for example, to the IRC/IRS rules on plan qualification

HOW THE PROPOSALS WOULD AFFECT STANDARDS OF CARE

Suitability Stays

It is important to note that fiduciary standards of care only apply when one is a fiduciary. Under all current or likely proposals, there will always be non-fiduciaries regulated under non-fiduciary standards of care — there would just be fewer of them. The primary non-fiduciary standard of care in the financial services industry today is the suitability standard.

The 2011 SEC Uniform Fiduciary Standard Proposal

If the SEC enacted this proposal, for any given transaction, a broker or advisor would be subject to one of the following standards:

1. **Suitability**. Would apply to non-fiduciary brokers.
2. **Common law fiduciary**. The standard of care would not be entirely uniform, as noted below. The standard would apply to all account types whenever an advisor provides advice that triggers fiduciary status.
    a. **RIA fiduciary**. Registered investment advisors would be subject to a "client first" standard of care with an obligation to monitor recommended investments.
    b. **Broker fiduciary**. Registered representatives of broker-dealers would be subject to a "client first" standard of care only with respect to the initial sale of a security. There would be no duty to monitor.
3. **ERISA fiduciary**. ERISA would continue to apply with respect to plans covered by ERISA.

The 2015 DOL Conflicts of Interest Proposal

If the Proposal were to become effective it would be added to the current regulatory landscape as follows:

1. **Suitability**. Would still apply to non-fiduciary brokers.
2. **Common law fiduciary**. The current "client first" fiduciary standard would continue to apply with respect to all account types when fiduciary advice is given.
3. **ERISA fiduciary**. ERISA would continue to apply with respect to plans covered by ERISA.
4. **BIC fiduciary**. The BIC PTE standards would apply to advice to retirement investors when compensation is variable.

What If We Had Both?

The two proposals are not mutually exclusive. We could end up with a "uniform" fiduciary standard applicable under SEC rules and a separate "best interest contract" fiduciary standard applicable for advice to Retirement Investors. The resulting standard of care landscape would presumably look like this:

1. **Suitability**. Would apply to non-fiduciary brokers.
2. **Common law fiduciary**. The SEC "uniform" standard would apply.
    a. **RIA fiduciary**. "Client first" with monitoring.
    b. **Broker fiduciary**. "Client first" without monitoring.
3. **ERISA fiduciary**. ERISA would continue to apply with respect to plans covered by ERISA.
4. **BIC fiduciary**. The BIC PTE standards would apply to advice to retirement investors when compensation is variable.

RAMIFICATIONS

It is too soon to predict with anything approaching certainty what the consequences of the Best Interest Contract fiduciary standard will be. But we may draw the following conclusions based on a plain reading of the Proposal:

1. There will be a substantial compliance burden on advisors doing business in the IRA marketplace with relatively few exceptions.
2. The overall compliance burden for both RIAs and broker-dealers will go up by the simple mathematics of having four standards instead of three, with four separate sets of rules and regulators.
3. Variable compensation in IRAs will be significantly riskier than it is today. It could be inferred from the terms of the Best Interest Contract PTE that the difficulty and uncertainty of compliance will be viewed as an effective prohibition on variable compensation by some firms.

It might also be inferred that, if investors are confused today with respect to the obligations of their advisors, the addition of a fourth standard of care is not likely to un-confuse them.

Finally, an obvious consequence of the rule is that, if the Administration is correct in its apparent assertion that variable compensation is objectively bad for our society[13], society will be better off with the BIC PTE than without. No opinion is offered in this regard. Part four of this "game changer" series of articles will attempt to objectively examine the merits of the Proposal.

[13] See the report released by the President's Council of Economic Advisors on February 23, 2015.

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