EDUCATION

In the Know: A Q&A on the Latest DOL Fiduciary Rule & SEC Proposal Developments

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To say activity in Washington is being closely followed would be an understatement, with the consensus view that the Department of Labor's Fiduciary Rule is all but officially vacated, and a recent proposal from the Securities and Exchange Commission (SEC) is in the middle of a 90-day comment period. Yaqub Ahmed, senior vice president and head of Defined Contribution – US at Franklin Templeton, leads a discussion on the latest developments with attorney Michael Hadley, partner with Davis and Harman LLP. They outline the SEC proposal and how it might impact financial advisors and their clients.

The US Department of Labor's (DOL's) proposal to expand the scope of persons deemed to be a fiduciary has faced a number of challenges. The intent of the DOL Rule was to ensure financial advisors put their clients' interests above their own financial interests.

Amid ongoing court challenges, the "DOL Rule" faced a deadline of April 30, 2018, to request a rehearing of the Fifth Circuit's recent decision to vacate the DOL Fiduciary Rule in its entirety. The DOL did not make the request by the deadline, but still has time to file a petition known as a "writ of certiorari" with the Supreme Court to review the lower court decision.

AARP, the nation's largest nonprofit, nonpartisan organization dedicated to empowering people 50 and older, along with the attorneys general of California, Oregon and New York, twice filed separate motions to intervene, seeking a rehearing "en banc" by the Fifth Circuit. That means *all* the judges of the court would hear the case, not just the three in the earlier ruling. A three-judge panel denied both requests, so the Fifth Circuit's "mandate" will revert to the law that existed prior to the DOL Fiduciary Rule.

Meanwhile, on April 18, the Securities and Exchange Commission (SEC) issued a comprehensive set of proposed rules regulating the standard of conduct for broker-dealers, referred to as "Regulation Best Interest."

For more context on these issues, I've invited Michael Hadley, partner with Davis and Harman LLP to answer some commonly asked questions on the recent activity.

So Where Does the DOL Rule Stand Now?

Hadley: Here is the current situation. As of June 4, 2018, the Fifth Circuit Court of Appeals has issued an opinion that renders all of the regulatory changes issued in 2016 to the Fiduciary Rule null and void. The DOL can still petition the Supreme Court for review by June 13.

It is important to remember that the fiduciary rules in the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code still exist—it is still a fiduciary act to provide investment advice for a direct or indirect fee to an ERISA plan or an individual retirement account (IRA).

And, one who is a fiduciary may not engage in what is called a “prohibited transaction” with respect to an ERISA plan or IRA, including receiving transaction-based compensation, unless an exemption applies. What has been declared null and void by the court is DOL’s expansion of the activities that are considered fiduciary investment advice, and the related new and amended exemptions issued at the same time.

What is considered a “conflict of interest” under the SEC proposal?

Hadley: The concept of a “conflict of interest” comes up a number of times in the SEC proposal. It is relevant to the new disclosures that broker-dealer and registered investment adviser firms would need to create, and relevant to the new best interest standard of care that would be imposed on broker-dealers.

But let’s focus on the part of the proposal that would require:

- A broker-dealer must establish, maintain and enforce written policies and procedures reasonably designed to identify and at a minimum disclose or eliminate all material conflicts of interest.
- In addition, with respect to “financial incentives,” a broker-dealer must establish, maintain and enforce written policies and procedures reasonably designed to identify and at a minimum disclose and mitigate, or eliminate, all material conflicts of interest arising from these financial incentives. In other words, the proposal would create an obligation on the broker-dealer to mitigate conflicts from financial incentives.

Thus, the SEC proposal focuses on both “material conflicts of interest” and a subset of conflicts that arise out of “financial incentives.” A material conflict of interest is a conflict of interest that “a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested.”

With respect to “financial incentives,” the SEC states that this would include (but is not necessarily limited to): “Compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold; employee compensation or employment incentives (*e.g.,* quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); compensation practices involving third-parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third-parties (*e.g.,* sub-accounting or administrative services provided to a mutual fund); receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third-party; sales of proprietary products or services, or products of affiliates; and transactions that would be effected by the broker-dealer (or an affiliate thereof) in a principal capacity.”

What are the similarities and differences between the SEC’s proposal and the DOL Rule?

Hadley: The SEC’s proposal shares many similarities with the DOL Fiduciary Rule, but there are also a number of differences. The SEC repeatedly states its belief that its proposal would be well-integrated with the DOL’s Fiduciary Rule, including the requirements under the Best Interest Contract Exemption. The SEC’s proposal focuses on broker-dealers and the “associated persons” of broker-dealers and, to a lesser extent, investment advisers registered under the Investment Advisers Act of 1940.

The SEC proposal is composed of the following parts:

- A proposal to require that broker-dealers act in a customer’s “best interest” when making recommendations to retail customers.
- A proposal to lay out, in a single interpretative release, the elements of an investment adviser’s fiduciary duty to its clients. The SEC describes this proposed release as reaffirming and, in some cases, clarifying this duty, which has largely developed through court cases interpreting the anti-fraud provision of the Investment Advisers Act.
- A new “relationship summary” disclosure requirement that would, in a document of no more than four pages, lay out the basics of the firm’s services, standards of conduct, fees and costs, conflicts of interest and certain other information. This new disclosure requirement would apply to both broker-dealers and

investment advisers.
- A proposal to limit the ability of broker-dealers and their associated persons from using the term “adviser” or “advisor” as part of their name or title, unless such broker-dealers are registered as investment advisers.
- A proposal to require broker-dealers and investment advisers to prominently disclose the firm’s registration status with the SEC (i.e., as a broker-dealer and/or investment adviser).

So where does the SEC proposal go from here?

Hadley: There is a 90-day comment period for the SEC proposal, starting from the date of official publication on May 9—meaning the industry has until August 7 to file comments. It’s important to remember that this is only a proposal, which could change significantly before finalization. We expect robust comments from many stakeholders, even if, ultimately, there is broad support for the thrust of the proposal. It is also important to keep in mind that the SEC’s proposal builds on a variety of existing duties and obligations already imposed on broker-dealers under SEC and FINRA rules. In fact, many of the elements of the new best-interest standard would be viewed by FINRA as already required under its “suitability” standard for recommendations. Nonetheless, this new proposal would be a significant enhancement of the duties owed to retail securities customers, including with respect to retirement plans and accounts.

The industry is watching the progress on both the SEC proposal and DOL Rule closely. With so much up in the air, it seems likely there won’t be meaningful changes to the way firms do business until the future becomes clearer.

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