

Department of Labor Issues Long-Awaited Fiduciary Rule



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THE NEW STANDARD REQUIRES BROKER-DEALERS PROVIDING ADVICE WITH RESPECT TO IRAS TO PUT THEIR CLIENT'S INTERESTS AHEAD OF THEIR OWN.

The U.S. Department of Labor released new rules on April 6 that materially enlarge the duties of a broker-dealer with respect to its clients' investments in individual retirement accounts (IRAs) and other applicable retirement plans. The new rules will begin to take effect during April 2017, with full implementation scheduled for 2018. The new rules are applicable to a broader group than broker-dealers and are generally applicable to advisers who provide investment advice with respect to retirement accounts, including advisers registered pursuant to the Investment Advisers Act of 1940, as amended (Advisers Act).

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Under prior rules, when a broker-dealer provided investment advice with respect to an IRA, the advice was required to satisfy a “suitability” standard. Under this standard, the broker-dealer’s duties to the client were limited, with the core requirements being that the broker-dealer (i) must know its client and the client’s financial situation and (ii) recommend products that are suitable for the client’s situation. This suitability standard did not address (i) conflicts of interest between the client and the broker-dealer (actual or perceived) or (ii) any financial benefit the broker-dealer might receive if the client purchased the investment that was recommended. Also, in practice, the suitability standard did not require the recommended investment to be of any particular quality.

The new rules require a broker-dealer who provides “investment advice” with respect to an IRA or other applicable plan and who receives any fee or other compensation (including commissions), directly or indirectly, to serve the broker’s client’s “best interests.” This new standard requires broker-dealers providing advice with respect to IRAs to put their client’s interests ahead of their own. A “best interests” standard also implies that the recommended investment should satisfy a quality standard. The new rule includes a definition of “investment advice,” and broker-dealers will need to educate their staffs as to what constitutes investment advice. One activity that is within the definition is providing advice with respect to the conversion of a 401(k) into a rollover IRA.

The new rules do include an exception that, to a certain extent, limits the “best interest” standard and the connected requirements with respect to fees and other compensation. The exception is being called the “BIC” exemption (or “BICE”) by market participants, which is short for “best interest contract exemption.” The BIC exemption permits broker-dealers to continue to rely on many current compensation and fee practices, as long as they meet specific conditions intended to ensure that the broker-dealers mitigate conflicts of interest and that they, and their registered representatives, provide investment advice that is in the best interests of their customers.

In order to align the adviser’s interests with those of the IRA (or other applicable plan) customer, the BIC exemption requires the broker-dealer to acknowledge fiduciary status for itself and its advisers. The broker-dealer and its advisers must adhere to basic standards of impartial conduct, including giving prudent advice that is in the customer’s best interest, avoiding misleading statements and receiving no more than reasonable compensation. The BIC exemption also requires broker-dealers to have policies and procedures designed to mitigate the potential harmful impacts of conflicts of interest and to disclose basic information about their conflicts of interest and the cost of their advice.

Because a BIC is an enforceable contract, the owner of an IRA (or the trustee of any other applicable plan) who is party to a BIC will have a breach of contract claim against the broker-dealer if the broker-dealer or its adviser breaks the standards required by the BIC.

The new rules will mean that the applicable fiduciary standards for a broker-dealer and a registered investment adviser, who are each providing investment advice to a retirement client, will be substantially similar or perhaps identical and will be similar to the standard historically applied to investment advisers registered pursuant to the Advisers Act.

Many market observers expect that broker-dealers will generally elect to enter into BICs with their retirement customers, perhaps as part of their standard account-opening documentation.