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It's not too late

**There's still time to roll back the fiduciary rule –
but a full U-turn may be unpopular**



COVER
STORY

The Fiduciary Rule Poll

Broker-dealers have spoken candidly about the industry-changing fiduciary rule. A majority think there is still time to roll it back and the SEC is the frontrunner to replace it

By John Crabb, Americas reporter

The US Department of Labor's (DoL) fiduciary standard rule has been befuddling the financial services industry for the past seven years. In its simplest form, it increases accountability for the brokers, planners and insurance agents that handle US retirement accounts. It introduces measures to ensure they act in the best interest of their clients rather than for their own financial gain.

And exactly what steps can be taken to best respond to the rule are also polarising, even though much of the market agrees with its basic principles. It is not solely the rule itself that is under fire, but the way that it has been implemented, and to an extent even the implementing agent itself.

In the words of the DoL, the rule states that:

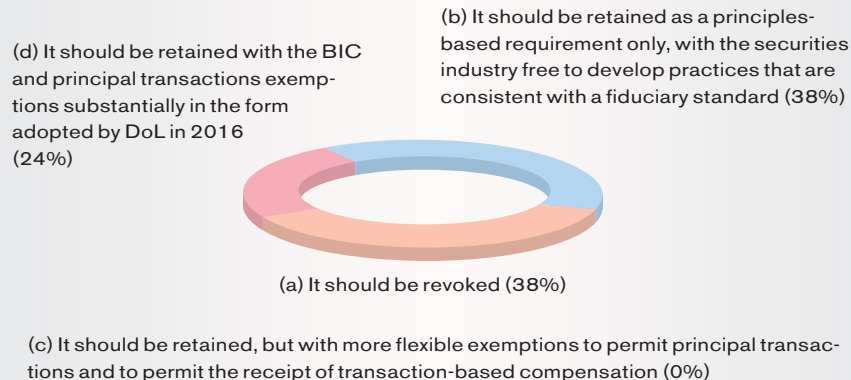
'Financial Institutions and Advisers must adhere to basic standards of impartial conduct. In particular, under this standards-based approach, the Adviser and Financial Institution must give prudent advice that is in the customer's best interest, avoid misleading statements, and receive no more than reasonable compensation.'

Recent suggestions by the Securities and Exchange Commission (SEC) that it is looking into a best interest standard that would be applied in a blanket fashion to the whole industry have gained momentum this year, and many have questioned the DoL's ability to enforce the rule once – or if – it does finally come fully into force.

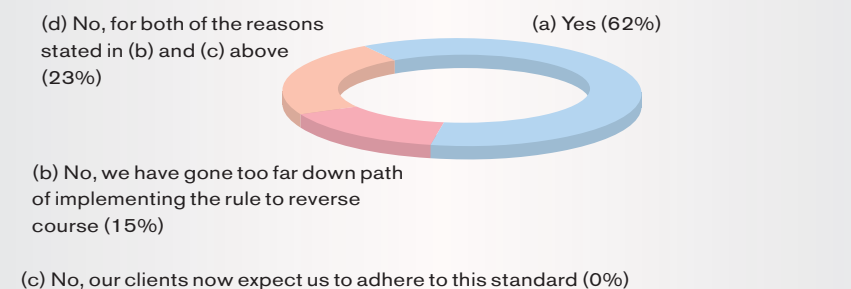
Originally intended to be phased in on April 10 this year, the rule was preemptively delayed by 60 days, and quietly rolled out on June 9. Following much deliberation however, full execution of the rule was delayed for another 18 months – until July 1 2019 – in August of this year. This followed a court case at the US District Court for the District of Minnesota where the DoL had filed a request for the delay. Only the bravest would bet against it being pushed back yet further when that date comes.

Lauded as a much-needed update to Employee Retirement Income Security Act of 1974 (Erisa), the legislation requires that any financial body that provides advice or works with retirement plans is automatically deemed a fiduciary – and therefore must strictly adhere

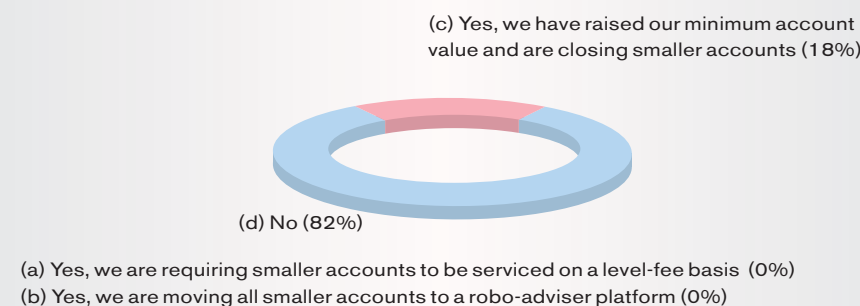
Q1. Under the DoL fiduciary rule, broker-dealers making investment recommendations are now deemed fiduciaries, although the future of the rule and the related best interest contract (BIC) and principal transactions Exemptions remains unclear. What do you believe should be the future of the fiduciary rule?



Q2. Do you think it is practicable to roll back the fiduciary standard required by the DoL rule?



Q3. Have you made any changes to your handling of smaller, retail retirement accounts?



to its imposed standards of impartial conduct. This redefinition will have an effect on much of the financial services industry, but will impact broker-dealers most of all, whose costs are likely to skyrocket.

With this in mind IFLR has surveyed the broker-dealer market on the fiduciary standard rule and its many facets. Perhaps the most striking statistic uncovered in the

research process is that nearly as many as two in three respondents believe, despite the advanced stages, that it would be practical to roll back the fiduciary standard required by the DoL rule.

What is not clear is exactly how this could be managed, and indeed if it even could or should at all. There would be abundant implications if it were to be rolled back, from

a regulatory, legal and market perspective. While some see a future without the rule, others suggest the current form should be changed to fit, while others think it is too late to make any widespread alterations.

“There have been so many firms that have taken on so much expense, and have gone so far to meet the requirements of the rule, that it is not really fair to them to roll it back,” says one broker at a US firm. “No matter what they do it can’t be fair to everybody at this

Sixty-two percent do not wish to see a fiduciary standard removed, with the qualification that it needs to be improved

point.”

“They have to try to find a solution that is going to serve the marketplace best without hurting the most firms out there either financially, or resource wise,” he adds.

Easier said than done. While other results in the survey tend to point to firms not taking actions to remediate the effects of the rule, it is widely reported that many firms have already taken sizeable steps to comply. The line of best fit remains uncertain, and this latest delay shows that no outcome is guaranteed.

An uncertain future

Under the terms of the fiduciary rule, broker-dealers that make investment recommendations are now deemed fiduciaries. Part of the initial proposal for the rule saw the introduction of the principal transactions exemption (PTE) which requires the completion of a best interest contract (BIC). The BIC is an extensive agreement between a retirement investor and advisers or financial institutions, which, if certain stipulations are met, means that brokers are allowed to earn the conflicted compensation that is banned under the new terms. The contract will act as the guarantee that the broker will act in the best interest of the client.

The future of the rule, the BIC and PTE remains unclear, (see question 1), and nearly 40% of respondents believe that it should be revoked, at least in its current form. This leaves around 60% who do not wish to see a fiduciary standard removed, but with the qualification that it needs to be improved.

Donna DiMaria, chief executive officer of broker-dealer Tessera Capital Partners, says that the intent is there, but that the rule does not meet its original goal, and is bad for smaller investors. “We have seen a lot of institutions telling small clients that they have to take their business elsewhere, or else they can go into an unmanaged portfolio,” she says. “That is very worrisome to me, especially being a small business owner myself.”

Another broker suggests that while convenient, the exemptions themselves are too complicated for most of the market to comply with. “A lot of firms are going to have to follow the BIC exemption,” he says. “You would think that an exemption would be easier than following the rule, but most firms can’t even figure out how to implement it.”

The rule, says DiMaria, was not properly thought through in terms of how it would be implemented on a practical basis.

“I understand that the idea is to have disclosures and to give investors an idea of any conflicts,” she explains. “[But] the rule’s suggestion that institutions or their fiduciaries sign off on a waiver saying that they agree with all of these specific requirements is really an impractical solution.”

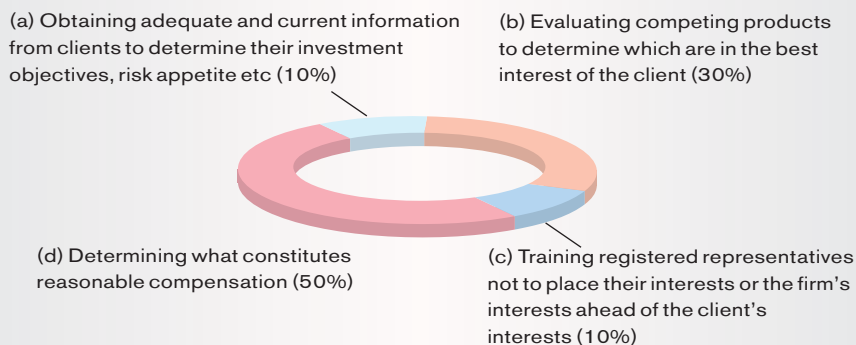
Nearly 40% of respondents believe that the rule should be retained as a principles-based requirement only, with the securities industry given a level of freedom to develop practices that are consistent with a fiduciary standard. Twenty-four percent think that it should be retained with the BIC and PTE in place.

Pass the buck

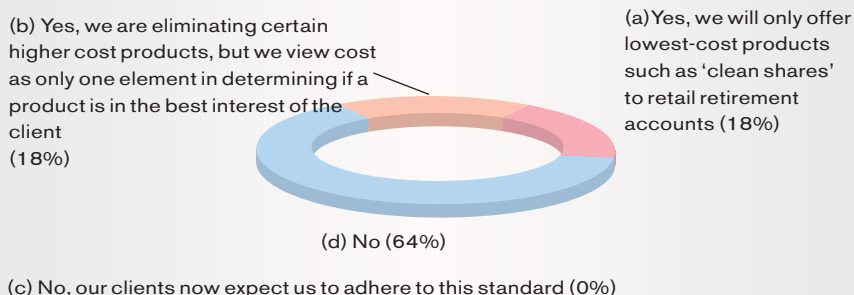
Revoking the rule might be a step too far, even for President Donald Trump who targeted it early into his term. His February 3 executive order instructed the DoL to review and attempt to rescind the fiduciary rule, the extent to which the subsequent delays to the Obama-era regulation come as a result of this is uncertain.

While revoking the rule could be an unlikely resolution, a striking 62% of respondents think that it would be practical to roll the rule back to an extent (see question 2). Based on conversations with the market, the

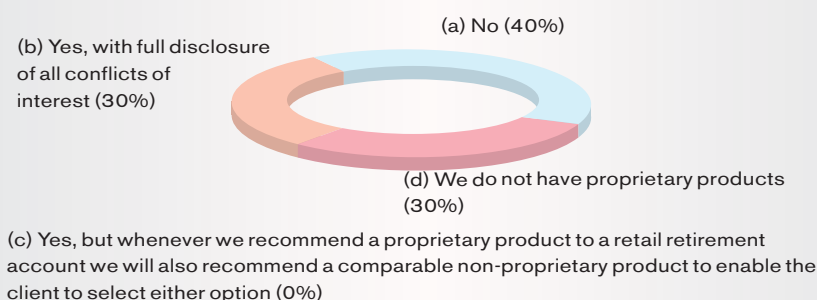
Q4. During the current transition period, compliance with the BIC and principal transactions exemptions only requires adherence to the impartial conduct standards. What is the most challenging aspect of complying with the impartial conduct standards?



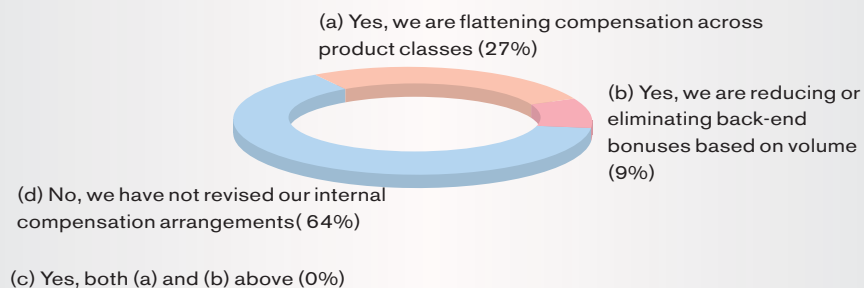
Q5. Have you made any changes in the product mix that you will make available to retail retirement accounts?



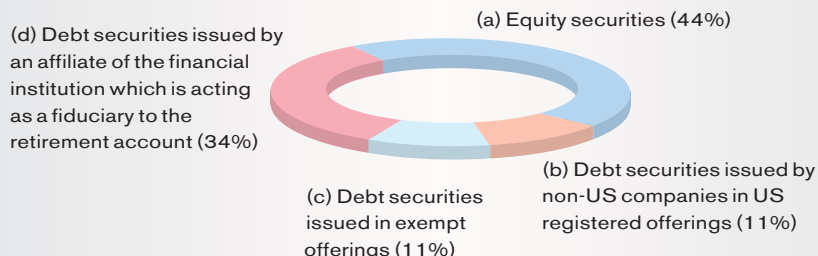
Q6. Will you sell proprietary products to retail retirement accounts?



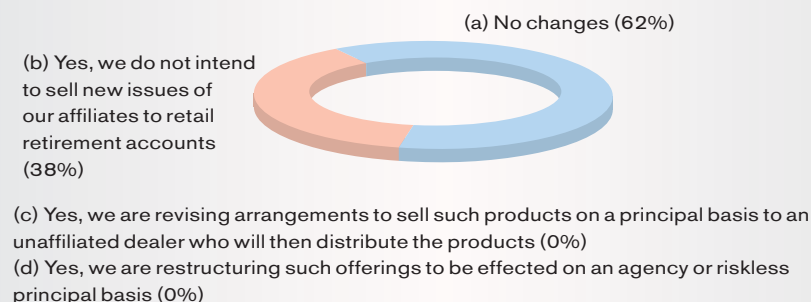
Q7. Have you revised your internal compensation arrangements to accommodate the fiduciary rule?



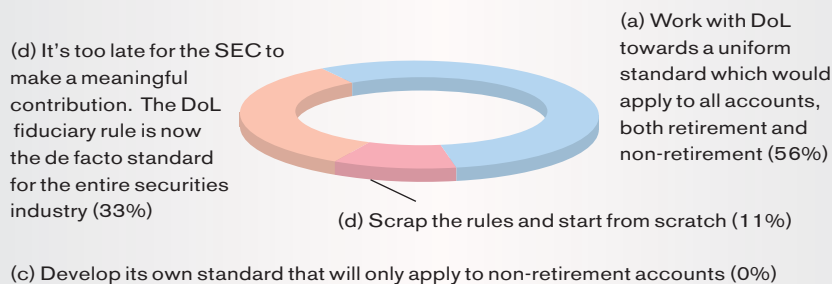
Q8. The principal transactions exemption is currently available for only limited categories of investment instruments. If those limitations were to be relaxed, what do you view as the most important to add to the list of instruments that may be sold under the principal transactions exemption?



Q9. Are you planning any changes in the arrangements through which you distribute new issues of your affiliates?



Q10. The SEC has recently indicated it is re-engaging on the question of a fiduciary standard for all broker-dealers. What do you think the SEC should do?



wrong authority to be implementing the rule at all. It really should be a best interest standard, you don't need to be a fiduciary to know what is not in the client's best interest," he says.

"I think it should be the SEC, Finra and the DoL working together to come up with an overriding best interest standard that encompasses the entire financial industry," he says. Fifty-six percent of survey respondents agree with him.

DiMaria agrees and is uncertain as to why the SEC did not handle the rule in the first place, introducing a consistent standard across all types of investments. "The intent was fine, but the fact that it only applied to a segment of the marketplace caused an uneven playing field, and businesses to exit-like is happening with a lot of small investors in the RIA [registered investment advisor] market," she says.

Keith Palzer, a wealth manager and strategy and operations business consultant at Navigant, who spoke on behalf of his clients, iterates that another reason it would be practical to do so is because a lot of firms when they looked at the fiduciary rule, decided to adopt fiduciary responsibility standards.

"Rolling back the rule wouldn't cause undue hardship because a number of firms have already decided that fee-only is the way to go," he says. "It makes sense for them for business reasons, and I think that that those firms will continue to approach it that way regardless of any roll back."

consensus on how best to roll back the rule at this stage would be to have the SEC draft a best interest standard, (see question 10) versus calling it a fiduciary standard that applies to the whole industry, and not just qualified accounts.

While a drastic move, an SEC best interest standard would apply to retirement accounts and non-retirement accounts alike, and would solve many of the problems that have arisen in terms of defining exactly what a fiduciary is. Newly-confirmed SEC chairman Jay Clayton announced his intention to tackle the problem of the fiduciary rule, to help bring

some much-needed clarity to the retirement sector.

Jeremy Reiland, an investment advisor at the Chamberlin Group, fully backs the decision by Clayton and the SEC. This is because the DoL only has authority over qualified accounts, which is only half of total market volume. The other half is non-qualified accounts which are technically exposed to no best interest standards. It really isn't all-encompassing, but it should be, he says.

"In my opinion, the DoL is the



All indicators point to a future where the DoL no longer carries the torch alone

In too deep

While the majority of respondents believe it would not be impractical to roll back the fiduciary standard required by the DoL rule, it must be accounted for that 38% disagree that it would, and a further third think that it is too late for the SEC to make a meaningful contribution.

These respondents suggested that not only have firms already gone too far in their means of implementing the rule to reverse it, and that their clients already expect them to meet the principle as standard in all of their actions.

“The process has taken over four years to develop and to implement in stages,” says the first broker. “We have already implemented the very first stage of it, and there doesn’t seem really to be a rational explanation as to why it should be rolled back, besides from the person sitting in the White House.”

One of the reasons that it may be too late to reverse the course of the rule is because it is the larger, more powerful firms that have already made inroads. “The problem with the early adopters is that many are big firms, and they have made a lot of changes to systems and processes. Any kind of changes now are going to cost them,” says DiMaria.

“If you think about the uneven playing field for different types of investor classes, the securities industry and these government agencies’ goal out there is to really protect *these* investor classes.”

At this stage it may be wise to accept that some form of fiduciary standard is going to be around, inevitability, and that to even suggest rolling it back entirely is out of touch.

Time and tide

The poll also shows that a number of firms appear reluctant to make wholesale changes to adapt to the fiduciary standard rule. Some suggest that they are waiting to see its final form (see questions 3, 5 and 7).

Slightly more than 80% of respondents have not made changes to the handling of smaller, retail retirement accounts, while 64%

have not made any changes in the product mix they will make available to retail retirement accounts or revised their internal compensation arrangements to accommodate the fiduciary rule.

It is more likely that smaller brokers are yet to make changes than their larger counterparts, who are closer to the front line when the time comes for enforcement by the DoL. Uncertainty regarding the rule’s future, if it were indefinitely delayed or rolled back, could also be factor here.

“We are dealing a lot with smaller investment advisers and a lot with private placements, and both markets have not been as pro-active as the bigger firms,” says the second broker.

“First of all investment advisers tend to think that this doesn’t apply to them at all because they are already fiduciaries, so I think you’ve got a bit of a delay there. If you are dealing with private placements, again I don’t think they really understand the implications of all of this.”

The fact that some firms would already class themselves as fiduciaries, and are in no rush to update fiduciary standard to clients, could also be harmful to the constituencies, because the first inclinations tends to be to consider not selling retirement plans at all. In this outcome, retirement plans would lose the opportunity to be in certain funds.

Referring specifically to the way that firms handle small retail retirement accounts (see question 5), Palzer also suggested that many firms are already operating to a fee only model.

“Each of them is set up to focus on bringing in clients at the family level, and the small accounts that come in with that are usually just family members who don’t have a lot of wealth yet,” he says. “For this reason it would not be overly burdensome to impose the same fee-only no-backdoor compensation model.”

Compensation has also been a talking point (see question 7). Like most of the respondents, DiMaria has made no changes regarding internal compensation arrangements, largely because most of her firm’s arrangements are based on the

The BIC exemption stipulations

1. recognise the fiduciary status of the retirement investor in writing;
2. meet certain impartial conduct standards;
 - a. give advice that is in the ‘best interest’ of the retirement investor;
 - b. charge no more than reasonable compensation; and
 - c. make no misleading statements about investment transactions, compensation, and conflicts of interest.
3. confirm that the financial institution and its advisers will work to comply with any process designed to prevent abuse of such impartial conduct standards;
4. provide a disclosure to confirm the non-use of incentives to act in a way not in the customer’s best interests; and
5. disclose all fees and compensation, as well as conflicts of interest, and ensure that investor is not paying the manager directly.

compensation that the managers they work for are earning.

“We haven’t really changed anything yet, because we haven’t seen any managers change anything yet, and we get a percentage of their fee, so it pretty much stays the same,” she says. “It is going to depend on what that final percentage is, and then we might have to change our percentage accordingly.”

Setting the standard

In line with this, another interesting data point (see question 4) centered on the most challenging aspect of complying with the impartial conduct standards – the obligations that the rule determines investment advice fiduciaries must adhere to in order to meet the exemptions.

Of the four options, half of the respondents suggested that determining what constitutes reasonable compensation was the most testing.

“The requirements of the rule, even though easy to articulate in words, mean that it is going to be very difficult to have a uniform standard of approach over time, because of how many different products and

Methodology

IFLR's Fiduciary Rule Poll was compiled with the help of the poll's sponsor firm, Morrison & Foerster.

With input and insight from partner Anna Pinedo and senior of counsel Hillel Cohn, poll questions were devised and targeted to best address the issues faced by broker-dealers and gain the market's views on the US Department of Labor's fiduciary rule.

Using recommended contacts from the editorial team and Morrison & Foerster, the poll was distributed to broker dealer firms across the continental United States.

Responses were obtained from a representative cross section of those firms. The poll provides the financial services industry with an anonymous forum to learn how broker-dealers are viewing, and adapting to the fiduciary rule.

To ease the concerns of the participants, anonymity was offered to all respondents that requested it. To that end IFLR will not name some of the firms that agreed to interviews.

Responses and comments were obtained via on and off the record telephone calls during September 2017. While the more structured responses to the poll questions provided interesting statistics, a real sense of broker-dealer's concerns emerged from their explanatory comments. The topics raised in those interviews formed the basis of the conclusions drawn out of the main body of IFLR's analysis.

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fee structures there are," says Palzer.

The abundant choice of products and funds, data providers and reporting services that each have their own specific taxonomies, means that you have to be very comfortable that you are being comprehensive in your analysis. "In today's world it is already so difficult to get a good sense of what similar products are," he says.

The struggle to define what is and what isn't classed as a proprietary product has also been widely discussed, and there have been suggestions that it should be reclassified as a principle-based requirement only.

As a true fiduciary, everything that the individual, adviser and firm should always be focused on seeing what is in the client's best interest rather than what is in the firm's interest for profit, says Reiland, who suggested that training was proving to be challenging.

"The firm should put the client's best interest first. It's difficult for a client to know the difference between broker-dealer firms and investment advisory firms, whose fiduciary responsibility per se, is completely different," he notes. "I feel the number one propriety is to have a best interest standard that focuses on the client's needs regardless if the advice is coming from an advisor who is licensed under a broker-dealer or registered investment advisory firm."

A problem of enforcement

Another problem that has been mooted is whether or not the DoL would even have the ability to enforce the rule if it were to avoid a class action provision. Compared to the number of employees at the SEC, an agency

itself under duress due to budgeting concerns, the DoL has a significantly fewer staff in its enforcement division.

Whether or not the DoL would be up to the task is arbitrary, as all indicators point to a future where it no longer carries the torch alone.

The market consensus is for a unified rule of best interest, with all the regulators, including the SEC, DoL, the US Commodity Futures Trading Commission and others, working together for an outcome that suits the whole industry.

What aspects a uniform best standard interest would keep of the fiduciary rule as seen in its current state, if any, is uncertain, but as it stands the rule is overly technical. During the Obama administration, those who devised the rule were trying to build on fiduciary principles outlined in Erisa, but it was overcomplicated.

"Rather than create hyper-technical exemptions from the prohibition, just for IRAs and 401k and the like," says Palzer. "It would make more sense from a market efficiency perspective and a uniformity of treatment perspective to have the federal agencies enunciate a few principles of conduct with respect to revenue shares and advice and then have the firms conform to that."

Whether the rule is repealed, or abandoned, or fiduciary based principles that have been applying to separately managed retirement accounts for years are applied across the whole industry, or the current form survives its most recent delay and is fully enacted, is not clear. There are many routes.

What is clear at this stage, is that it is going to be a rocky year and a half.

The next steps

IFLR speaks with Morrison & Foerster's Anna Pinedo and Hillel Cohn, who helped compile the questions, to discuss the results of the poll and the best course of action for the fiduciary rule

Despite its unpopularity, more respondents feel that the fiduciary rule should be retained than revoked. Why do you think that is?

Anna Pinedo

My view is that, at this point, many firms have committed a lot of resources to the fiduciary rule and compliance with it. They also may have planned their communications with clients when it comes to the rule and so may be reluctant to change course. They may think it is expensive to change course, and may believe that any messaging relating to a change of course of action would be a challenge. I also think it is reasonable to predict, given public statements, that the Securities and Exchange Commission [SEC] will in earnest work on a rule. It may be different in some ways from the existing Department of Labor [DoL] rule, but will be shaped around some kind of broader best interest rule. I think many firms view this as an inevitability of sorts.

Hillel Cohn

I would add that even in Congress now there appears to be a coalescing of views that some type of enhanced standard conduct is required for broker dealers. It just seems that we have gone too far down the road to do a 180 and completely eliminate the concept.

More than 60% of respondents feel that it would be practical to roll back the fiduciary standard required by the DoL rule, even if compliance is now at an advanced stage. Why do you think that the market is so certain that this can be done?

Cohn

I was a little bit surprised at that outcome of the poll, because it does seem inconsistent with the result of the first question. Congress could pass a bill which would basically put a full stop to the DoL rule and



Many of the more onerous provisions in the rules adopted by the DoL last year will be substantially revised, trimmed back or eliminated

effectively rescind it.

There is no question that there is a legal basis to reverse course. However, I think the practical factors that Anna just cited are going to argue strongly against a complete reversal or revocation of the rule.

Pinedo

I think when some clients talk about the rule, they still believe that there will be some kind of best interest rule or standard. But they find a lot of the prohibited transaction exemptions like the best interests contract agreement and all the paperwork and requirements that go with it very burdensome. Even though they may sort of grudgingly think that there will be a best interest standard or some of them may even support this, they find the DoL rule as currently constructed difficult to navigate, and burdensome from a document and compliance perspective. I think that, during this transition period, they certainly find it easier to function, but they find moving to the ultimate requirements as currently drafted or currently formulated to be challenging.

I would take away from responses, or this response compared to the prior one, that many people are just worried about specific parts of the DoL rule.

There has been a widespread call for the SEC to release a best interest standard that applies to the whole industry, including that which is covered by the current DoL rule. What are your thoughts on this?

Pinedo

I think people that we spoke to would heartily endorse that approach. There is a lot of concern about having different standards: many, many, many clients of broker-dealers have retirement accounts and non-retirement accounts. Trying to apply different standards of care in that context may not be very sensible and may create potential complications which will be eliminated by having a single standard that applies across the board.

What aspects of the current rule do you think this new look best interest standard would likely keep, if any, and what would it shed?

Pinedo

I think the SEC's request for information and the request that the DoL has put out are helpful in terms of giving a road map. One of the centrepieces of the regulation of conflicts sets a fiduciary standard for advisers: they have to disclose conflicts of interest and they seek informed written consent from clients to proceed, and clients are able to opt out.

Something along those lines, which is already part of the DoL rule, is the idea that conflicts of interest have to be clearly and prominently disclosed, and that there should be some contract or agreement between the broker-dealer and the customer. From the SEC's report that they were required to put out by Dodd-Frank in 2011, where they talked about how clearly it was a standard that was higher than the current suitability standard, it does require this consideration of alternative products and fee structures. It goes beyond what is part of the current suitability standard, and those are going to be some of the basics of what we see from the SEC.

Cohn

I think that is exactly right, and I think it is consistent with the SEC's fundamental charter which is basically to regulate through full disclosure rather than dictate what people should or should not invest in.

If a comprehensive roll-back were to happen, what would be the best way to go about it without there being a direct negative impact for the early adopters of the rule?

Cohn

It is difficult to believe there will be a complete roll-back. I think what Anna said is likely to be the outcome: there will be some kind of best interest standard – or something akin to a best interest standard – that survives and which is not going to be rolled back. Many of the more onerous provisions that are in the rules adopted by the DoL last year will be substantially revised, trimmed back or eliminated. For early adopters, I think compliance with a best interest standard will probably be something they are going to continue to live with and promote as demonstrating that their interests are consistent with those of their customers. The message is: we are looking out for your best interest Mr. Customer, we are not just salesmen who will sell you whatever we happen to have in our inventory.

There has been little change to the way that smaller, retail retirement accounts have been handled. Respondents have overwhelmingly made no move to change in this regard: what is the benefit of this?

Cohn

I think it is hard to know. There certainly has been a lot of talk in the industry about changes that are likely to come about if this rule is fully implemented, and this may simply reflect people waiting to see what the final shape of the rule is going to be. It may also be people saying: 'well let's see how it works and if it is too difficult or too expensive to comply for the smaller accounts then we will deal with it at that time'.



When some clients talk about the rule, they still believe that there will be some kind of best interest rule or standard

Overall, the poll suggests that there has been little in the way of changes made so far, including in internal compensation arrangements and product mix offerings. Do you think that this is because the market is already expecting that the rule will be further delayed or rolled back entirely or another reason?

Pinedo

There is certainly a lot of hesitation to dramatically change business models. There were a lot of smaller firms that were waiting to see what some of the larger wirehouse firms did, and they were waiting to see what would happen with the rule generally.

Determining what constitutes reasonable compensation has been expressed to be the most challenging aspect of complying with impartial conduct standards. What makes this so difficult?

Cohn

This struck me as an interesting outcome to the poll. I think determining the reasonableness of compensation with respect to a particular product at the firm level is probably not all that difficult. However, I think the internal compensation arrangements are much more challenging in that you basically have systems which were designed to promote sales which now have to be revisited. This is going to be true even if only the impartial conduct standard survives – the systems have to be revisited to make sure that they could not incentivise brokers to push products that are not in the interest of the retail client. My sense is that there is a lot of work to do in that particular area, which may be why this item was flagged as the most challenging aspect of the impartial conduct standards.

Opinion is split on whether to sell proprietary products to retail retirement accounts following the rule's enforcement. Why do you think that this question saw mixed results?

Pinedo

I think that market participants don't know clearly what a proprietary product is. We have been struggling ourselves with trying to understand what the parameters are in identifying a proprietary product.

Cohn

The definition in the DoL rule is less than clear with respect to what would constitute a proprietary product. There are also some internal inconsistencies in the rule as to how proprietary products would be treated. The scope of what constitutes a proprietary product and the consequences of determining that a particular product is proprietary is an area that clearly, at a minimum, needs some guidance from whichever authority is going to administer the new standard. That's assuming there is a different category of treatment for proprietary products.

How does the market want that principle transaction exemption to be relaxed?

Cohn

There are many categories of securities that are excluded from the current principal transaction exemption. This would really be disruptive to capital markets as they currently operate. I don't think, from the industry side that there is much debate about the need to significantly expand the scope of products that could be sold under some kind of exemption on a principal basis, or that it is going to be a very important part of any rule going forward.

Pinedo

I have heard lots of clients complain. I am sure there isn't any reason why securities issued by a foreign issuer shouldn't be allowed to be included

Finally, what is your key takeaway from this poll?

Pinedo

I think that it is probably that most people agree to an extent that some standard, be it best interest or fiduciary, is likely to be around. Depending on where you are situated it is probably regarded as almost a necessity or maybe an inevitability.

Cohn

The most surprising thing to me was the relative lack of steps taken to prepare for the rule. I would have thought there would have been more pro-active activity than apparently there has been.