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Brace for Impact

How the changing definition of fiduciary might change your practice

IN MY LAST COLUMN, I discussed how the Department of Labor (DoL) has proposed changing the definition of fiduciary. If the proposed regulations were finalized in their current form, brokers currently advising 401(k) plan sponsors and participants in a non-fiduciary capacity would undoubtedly need to change their service model and redefine their role as plan advisers. To avoid fiduciary status, they would effectively be forced to furnish written disclaimers to plan clients, stating that they are not providing impartial advice, as contemplated under the proposed DoL guidance.

If he failed to provide any disclaimer, a broker could be viewed as an "investment advice fiduciary" and any variable compensation, such as 12b-1 fees, received by the broker would trigger a non-exempt prohibited transaction under the Employee Retirement Income Security Act (ERISA). The penalties for a prohibited transaction generally include a right of rescission by the plan client, a "first tier" 15%-per-year excise tax and a "second tier" 100% excise tax, and a 20% civil penalty on any amounts recovered through DoL action.

Alternatively, a broker serving as a plan fiduciary could avoid these penalties by becoming a dual-registered investment adviser. This action would enable him to charge an asset-based fee (such as a wrap fee), eliminating the problems associated with variable compensation.

Potential Impact on Other Providers

The proposed regulations, by their terms, would impact platform providers directly. To comply with the proposed safe harbor, they would need to disclose in writing that they are not providing impartial investment advice. This may have a substantial impact on platform providers that deliver advisory services regarding the selection of plan investment alternatives, especially those delivering such services in exchange for any type of direct or indirect compensation. Like brokers, platform providers offering advisory services could provide non-conflicted advice by adopting an asset-based fee, although this change would similarly require the provider to become registered as an investment adviser.

Similarly, third-party administrators (TPAs) that also provide advisory services in exchange for variable compensation would need to either provide the required disclaimers, or register as investment advisers in order to provide their advisory services for a level fee in a non-conflicted manner.

New Fiduciary Standard for Brokers under the Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was enacted on July 21, 2010, is expected to impact the standard of conduct of those financial advisers who provide their services as registered representatives of broker/dealers. Although these rules under the Dodd-Frank Act are unrelated to the DoL's regulatory initiative to broaden the "fiduciary" definition under ERISA, they are expected to have an impact on the standard of care that brokers must adhere to when advising their clients, including retirement plan clients.

The Dodd-Frank Act required the U.S. Securities and Exchange Commission (SEC) to conduct a study of the different standards of conduct that apply to broker/dealers and investment advisers by January 2011. The SEC is authorized to issue regulations that will impose on broker/dealers the same fiduciary standard that applies to investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Under the Advisers Act, investment advisers have a fiduciary duty to act solely in the *best interests* of the client and to make full and fair disclosures of all material facts, including conflicts-related disclosures.

However, under current law, brokers generally are subject only to a duty of "suitability," which requires the broker to recommend investments that are suitable for the specific investor. The recommended investment does not have to be in the best interests of the client. Many brokers who advise plan clients do so in a non-fiduciary capacity, so they are not subject to ERISA's fiduciary standards under current DoL regulations. Thus, non-fiduciary advisers can make recommendations that are conflicted, skewed to investments that generate higher fees, without any restriction under ERISA or the Advisers Act.

Depending on how the SEC decides to exercise its rule-making authority under the Dodd-Frank Act, brokers who advise plan clients may be significantly affected and may be subject to new conflicts-related disclosure requirements. These changes would be in addition to any future regulatory changes imposed by the DoL concerning when and how a broker could be viewed as providing fiduciary "investment advice" for ERISA purposes.