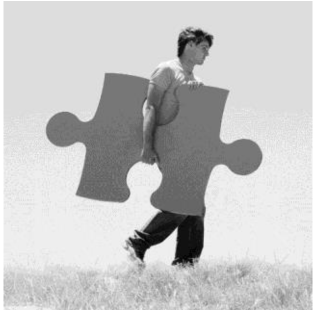
Client Alert

April 5, 2017



DOL Fiduciary Rule Delayed by 60 Days

Impartial Conduct Standards to Become Effective on June 9, 2017

Other Provisions Are Subject of Further Evaluation Prior to January 1, 2018 Implementation Date

Late in the day on April 4, 2017, the Department of Labor ("DOL") made publicly available its final rule, extending by 60 days the implementation of its fiduciary rule adopted in April 2016 (the "Fiduciary Rule"). The final rule is expected to be published in the Federal Register on April 7, 2017, and will become effective immediately upon publication, one business day before the Fiduciary Rule was scheduled to become applicable. The pre-publication text is available on the DOL website.[1]

Although the 60-day delay had been widely anticipated, the final rule includes some important provisions, which will impact market participants in the near future:

- There will be no delay beyond June 9, 2017 for the expanded definition of "fiduciary" set forth in the Fiduciary Rule.
- Fiduciaries will be required to comply with the Impartial Conduct Standards (summarized below) starting on June 9, 2017.
- DOL acknowledged that 60 days will likely be insufficient for it to conduct the review of the Fiduciary Rule ordered by President Trump. However, it anticipates completing that review prior to the scheduled implementation date for the remaining aspects of the Fiduciary Rule (January 1, 2018.)

Background

In April 2016, the DOL published the Fiduciary Rule, which became effective in June 2016. Implementation of the Fiduciary Rule was originally deferred to April 10, 2017, with many of the provisions not becoming applicable until January 1, 2018.[2]

On February 3, 2017, President Trump issued an executive memorandum directing DOL to further study the Fiduciary Rule and to take corrective action if it concludes that the rule harms retirement investors or has certain other adverse effects.

The Fiduciary Rule significantly expands the categories of persons who might be deemed "fiduciaries". Under the expanded definition, a single instance of providing advice to a retail retirement investor[3] regarding specific investments, investment strategies, or investment advisers could be sufficient to trigger fiduciary status. The expanded definition would likely sweep in most broker-dealers and many insurance agents.

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[1] *See* https://s3.amazonaws.com/public-inspection.federalregister.gov/2017-06914.pdf.
[2] *See* our prior Client Alerts: https://media2.mofo.com/documents/160407erisa.pdf; https://media2.mofo.com/documents/161031-dol-guidance-fiduciary-rule.pdf.
[3] There is an exception from the Fiduciary Rule for advice provided to retirement investors who are represented by independent, professional fiduciaries.

Persons and firms who are deemed fiduciaries must act in the best interest of their clients. Moreover, they are generally prohibited from engaging in transactions with clients that involve a conflict of interest or from receiving variable compensation, such as sales commissions. These requirements pose major challenges for many broker-dealers who regularly engage in principal transactions with their customers and who compensate their sales force on a commission basis.

Recognizing this dilemma, the DOL adopted with the Fiduciary Rule two new prohibited transaction exemptions ("PTEs")—the Best Interest Contract Exemption and the Principal Transactions Exemption.[4] These new PTEs would enable broker-dealers to continue to earn commissions on a wide range of securities transactions effected on an agency or riskless principal basis, and would have permitted them to continue to act as a principal with respect to a rather narrow range of investment products. However, both exemptions include detailed contractual and disclosure requirements, which have raised concerns about the difficulties of compliance and the risk of exposure to litigation.

Fundamental to the Fiduciary Rule is the requirement that all fiduciaries comply with the Impartial Conduct Standards. These standards require the fiduciary to:

- Act in the Best Interest of the retirement investor;
- Avoid excessive compensation; and
- Refrain from any false or misleading disclosures.

Acting in the "Best Interest" of the retirement investor requires the fiduciary to provide advice that reflects the care, skill, prudence, and diligence that a prudent person would use. The advice must be based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor and must be furnished without regard to the financial or other interests of the fiduciary.

Proposal to Delay the Implementation Date

In light of the Presidential memorandum directing the DOL to further study the effects of the Fiduciary Rule, on March 2, 2017, the DOL published a proposed rule extending the applicability date of the Fiduciary Rule by 60 days, from April 10, 2017, to June 9, 2017. The DOL received more than 193,000 letters commenting on this proposal. The comments covered a wide range of opinions on the need for delay as well as on the merits of the Fiduciary Rule itself.

Following its review of the comments, the DOL concluded that a delay in implementation was appropriate. However, the DOL stated that "*it is inappropriate to broadly delay application of the fiduciary definition and Impartial Conduct Standards for an extended period in disregard of the previous findings of ongoing injury to retirement investors.*" In this regard, the DOL noted that the principles set forth in the Impartial Conduct Standards were not the subject of substantial controversy.

The DOL stated that it would likely require more than 60 days to fully evaluate the detailed requirements of the Best Interest Contract Exemption and the Principal Transactions Exemption. It observed that, since these provisions were not scheduled to become applicable until January 1, 2018, it expected it could complete its review before that date. Accordingly, the DOL states in the final rule:

"Thus, the fiduciary definition in the rule (Fiduciary Rule or Rule) published on April 8, 2016, and Impartial Conduct Standards in these exemptions, are applicable on June 9, while compliance with the remaining conditions in these exemptions, such as requirements to make specific written disclosures and representations of fiduciary compliance in communications with investors, is not required until January 1, 2018."

[4] The DOL also amended a number of existing PTEs to make conforming changes.

Implications of the Final Rule

Financial institutions now have a clear mandate: On June 9, the expanded definition of fiduciary will go into effect, as will the requirement to comply with the Impartial Conduct Standards. Many financial institutions have taken the position that the principles set forth in the Impartial Conduct Standards are appropriate and have planned to implement them regardless of the status of the Fiduciary Rule. Now, all financial institutions whose conduct comes within the scope of the expanded definition of fiduciary will need to be prepared to implement the Impartial Conduct Standards. In many cases, this will require training of sales and supervisory personnel on the distinctions between the suitability standard and the best interest standard. In addition, it will require financial institutions to carefully consider their product mix and their internal compensation systems in order to ensure that they are not misaligned with the best interests of retail retirement investors.

Compliance with the more onerous requirements set forth in the Best Interest Contract Exemption and the Principal Transactions Exemption may be deferred, pending the DOL's continuing review of these provisions. Hopefully, that review will result in modifications to the PTEs that will make them less problematic, and provide more certainty as to how to apply them in specific circumstances. Broadening the scope of permitted principal transactions and eliminating the prohibition on class action waivers are among the changes most needed.

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