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PPLI

A New Day for Private Placement Life Insurance Planning in Delaware

Fiduciary Standard Expanding to Brokerage, Rollover Advice

by Donald W. Nicholson, Sr.

As the second oldest regulated industry in the U.S.,[1] bankers have long been accustomed to fiduciary accounts, which are a staple of bank trust departments. However, trust departments are about to get some company. And the fiduciary standard is also likely to undergo some changes in the way it is applied and to whom, thanks to Congress and a couple of federal agencies.

In recent years, Capitol Hill and federal regulators – principally the Department of Labor (DOL) and the Securities and Exchange Commission (SEC) – have begun expanding fiduciary coverage to stockbrokers and certain pension providers. While the new initiatives do not directly impact banking regulation – at least for now – it's helpful to be aware of fiduciary trends in a related part of the financial services industry.

For example, my independent wealth management/financial planning firm is registered with the SEC but my firm is subject to two somewhat different standards of fiduciary care. Under current SEC requirements, registered investment advisers (RIAs) are subject to a fiduciary duty with twin duties of loyalty and care.[2] For the most part, under the duty of loyalty the SEC emphasizes disclosure as a means of managing conflicts of interest. Under the duty of care, there also is an implied suitability requirement that the SEC was going to formalize under a 1994 rule proposal. However, it was never adopted.[3]

As a related part of my practice, I am also subject to an older, and more highly prescriptive fiduciary duty under Delaware trust law through my management of clients' trust account portfolios. Delaware trust law also contains twin duties of loyalty and care, the latter term often referred to as the "Prudent Man" standard of care under trust laws as well as the Employee Retirement Income Security Act of 1974 (ERISA). Under Delaware law, the duty of loyalty prohibits self-dealing, or acting in a way that compensates the fiduciary advisor over the interests of the trust beneficiaries.[4] Under the duty of care, every kind of investment is eligible for inclusion in a trust portfolio, limited only by the duty of loyalty prohibiting self-dealing, and the Prudent Man Rule that requires that a fiduciary "shall act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use…"[5] In similar fashion, the SEC does not prescribe limits on the kinds of investments in an advisory account, only that the portfolio meets the implied suitability requirements.

Broker-dealer reps, too, have a form of fiduciary duty, but only in special circumstances. The duty of loyalty is largely a facts-driven review in a court or arbitration forum to determine whether the broker was in a position

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of trust and confidence in the customer relationship, or held discretionary authority over customer assets. Interestingly, a broker's suitability requirement is more articulated under rules promulgated by the Financial Industry Regulatory Authority (FINRA) than is the implied requirement for investment advisers. In the last several years, FINRA also added to the list of specific factors for determining suitability of a broker's investment recommendations.[6] Ironically, because all of these same factors are traditionally followed by RIAs, they are now more in alignment in terms of following an appropriate due diligence process.[7]

Since nearly nine out of 10 brokers are also dually registered as investment adviser reps, they may often "switch hats" by acting as an RIA fiduciary to a customer's advisory account and as a non-fiduciary broker (in most instances) servicing the customer's brokerage account. This has caused considerable confusion among investors, as documented in various studies. Moreover, most investors do not understand the difference between a suitability standard (essentially a half loaf), and the twin duties that comprise the traditional fiduciary standard.

The investor confusion problem has been exacerbated by the fact that most financial intermediaries are subject to a functional test, and not a 'holding out' test, in determining fiduciary status. In other words, anyone can use a title such as 'financial advisor' or 'wealth manager,' terms that imply acting in a position of trust and utmost good faith to the client, but using fiduciary-like titles does not always correlate with a legal obligation to act in the client's best interest. In some ways it's no different from consumer labeling in other industries. Right now consumer groups are pushing the Food and Drug Administration to ban the use of "natural" on food labels, which they claim is misleading.

The problem with misleading titles in the industry probably isn't going to go away, although there are wedges here and there in regulation.

The original investment adviser statute prohibited then, and still does today, use of the term "investment counselor" unless registered with the SEC. It was protected in response to legitimate investment advisers who wanted to halt stockbrokers using the term to imply fiduciary status. Over the decades that term has fallen into disuse and the organization supporting the 1940 prohibition since changed its named from the Investment Counselors Association of America to the Investment Adviser Association. In 1987 the SEC also developed guidance that prohibited holding out as a financial planner unless registered with the SEC as an investment adviser. In 2005 the SEC adopted a rule that allowed brokers to accept fees for their investment advice without being subject to the fiduciary requirements of the Investment Advisers Act of 1940 (Advisers Act). However, acknowledging complaints from financial planning groups, the rule prohibited the use of the term "financial planner" unless registered under the Advisers Act. A court later threw out the rule for other reasons.

In the wake of the 2008 financial crisis, among other things the Obama Administration pushed for reform in this area by proposing that brokers be subject to a fiduciary standard based on a functional approach, i.e. the test being whether they provide retail investment advice. The end result was provisions in the 2010 Dodd-Frank reform act requiring a study of the different standards for brokers and advisers providing retail investment advice, and authorizing the SEC to adopt a uniform fiduciary standard for both brokers and advisers.

It was not until March 2015 that SEC Chair Mary Jo White announced that she would support a uniform fiduciary standard for both groups. A proposed rule has been placed on the rulemaking calendar for October of this year, but these schedules are often pushed back. Still, it appears that a common fiduciary standard is in the works for retail investment advice. Banks have a broad exemption from this requirement except for mutual fund advisers.

This leaves us with the DOL's fiduciary initiative, which was first begun in 2010, halted in 2011 by stringent industry opposition, and then resumed in April 2015 with a revised proposal. Called the "conflict of interest" rule, the DOL's proposal would discard a 40-year-old, cumbersome, five-point test to determine functional fiduciary status under ERISA. The latest proposal would replace it with a more streamlined definition that would bring in thousands of securities and insurance brokers who were previously exempt. Not only would they and their firms be fiduciaries for the first time, but fiduciary coverage would be expanded to include rollover advice on plan distributions to participants and IRA advice as well.

In terms of a 'holding out' standard, there also is one change proposed by the DOL. Where an ERISA service provider could claim to be a fiduciary under the current five-part test, the DOL has noted that in enforcement cases the courts have rejected a holding out test, looking only at whether defendants have met all five prongs of the functional test. Under the proposed rule, this would no longer be the case, since representing oneself as a fiduciary would trigger status as an ERISA fiduciary.

The debate over the rule has raged on for five years -- now going on six -- with opponents asserting industry compliance costs six times the DOL's estimate. The DOL in turn points to economic benefits of at least $17 billion a year to investors by eliminating the costs of conflicted advice, a claim that opponents argue is flawed.

At the same time, in responding to industry and bipartisan pressure from Congress, the DOL has conceded a few points to critics claiming the Department wanted to ban commissions by permitting incentive compensation to be received by brokers for their investment advice. In the past, ERISA fiduciaries were permitted to charge only "level-fee" advice to discourage firms from "steering" clients to investments with higher payoffs to the firm and agent. In exchange the proposed DOL exemptions from prohibited transaction rules under ERISA would, among other

things, require the incentive commission to be reasonable, add several new disclosure requirements related to investment costs, and mandate a duty of prudence for the first time with respect to advice on plan rollovers and IRA accounts.

Earlier, I mentioned that the Advisers Act and Delaware trust law have no restrictions on investment products. However, the Department of Labor's duty of loyalty standard departs from current trust law by restricting the use of investment products in conflicted advice arrangements to conventional and more liquid investments like mutual funds. Industry opponents complained that this was a throwback to 19th century trust law, in which state legislatures sometimes banned riskier investments from trust portfolios.

To-date the DOL rule proposal has survived numerous oversight hearings in Congress, legislative attempts to derail the rule, and has now been forwarded to the Office of Management and Budget for one last review before being released to the public in final form. The rule is also likely to undergo a legal challenge in court and a possible Hail Mary pass by Congress under a little-used law allowing final congressional review of major agency rules, leaving some uncertainty over its final fate.

If the DOL rule survives these final hurdles, as most observers believe, we will see dramatic changes to the contours and boundaries of the fiduciary standard under securities and pension law. On the other hand, fiduciary purists do see a slight downside, albeit far less than opponents. Supporters of the DOL rule see a potential for some dilution in the duty of loyalty if brokers and insurance producers are able to receive commission compensation that is counter to the "sole interest" standard under ERISA, which requires fiduciaries to act 'solely' in the interest of the beneficiary. Nor is it clear whether a final SEC rule governing fiduciary conduct of brokers and advisers will be aligned more closely with the existing Advisers Act requirements or with FINRA's lower, commercial standard of good faith and fair dealing between equal parties.

The changes brewing in these two agencies will likely take many years to incorporate into the best practices of financial intermediaries. But over the long-term, if implemented, these upgraded market conduct standards are likely to replace the sales culture still embedded in many firms with a fiduciary, best-interest standard that is more closely aligned, albeit imperfectly, with the standard applied to fiduciary accounts at banks.

In the meantime, it's worth watching these developments by the banking community. Over time, it's possible that the DOL and SEC rules will have a ripple effect on other quarters of the industry.

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1- Insurance was the first regulated sector of the financial services industry when New Hampshire appointed the first insurance commissioner in the country in 1851. See New Hampshire Insurance Department website, History, (2015), available at http://www.nh.gov/insurance/aboutus/index.htm . The Office of the Comptroller of the Currency, the first national bank regulator, was created by Congress in 1863 as a bureau of the U.S. Department of the Treasury. See OCC website, History: 150 years of the OCC (2013), OCC, available at http://www.occ.gov/about/what-we-do/history/index-history.html.

2- See staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers ("2011 SEC Study"), January 2011, available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

3- SEC, Suitability of Investment Advice Provided by Investments Advisers, IA Release No. 1406 (Mar. 16, 1994), proposing a rule under Advisers Act sec. 206(4) antifraud provisions requiring advisers to give clients only suitable advice.

4- For example, in Delaware a trustee "owes the [trust] beneficiaries the duty of loyalty and must exclude all self interests." Gans v. MDR Liquidating Corp., No 9630, 1991 WL 114514.

5- Del. Code Ann. Tit. 12, §3302(a). Available at http://delcode.delaware.gov/title12/c033/.

6- See FINRA Rule 2111. Suitability requirements differ for institutional and retail customers of a broker-dealer. The broker's duty is satisfied with respect to institutional customers if s/he has a reasonable basis to believe that the institutional customer is capable of an independent evaluation of investment risks. However, when recommending investments to a retail customer, the broker is generally required to assess nine customer-specific factors such as age, liquidity needs, investment time horizon, and risk tolerance.

7- The nine factors listed in Rule 2111 are: 1) age; 2) other investments; 3) financial situation and needs (including annual income and liquid net worth); 4) tax status; 5) investment objectives; 6) investment experience; 7) time horizon; 8) liquidity needs; and 9) risk tolerance.