Wealth Management Systems Inc.

The Fiduciary Standard in 2015: What's Different This Time?

Nearly eight years after the near-collapse of Wall Street began, authorities are still grappling with the question of what constitutes a fiduciary standard -- guidelines that define the obligations financial services professionals have to their clients -- and how to protect investors from situations where their "best interests" may collide with those of their adviser.

The new proposal intends to expand the scope of what constitutes investment advice in order to broaden the range of fiduciary protections for investors.

The latest attempt at revamping the ponderous fiduciary standard rules were unveiled recently by the U.S. Department of Labor (DOL). The initiative has gained the support of the White House and the Securities and Exchange Commission (SEC), which has issued its own call to action with regard to imposing higher standards on brokers, requiring them to put their clients' interests first.

The fiduciary standard issue was intended to be resolved by the Dodd-Frank Act, Wall Street reform legislation passed into law in 2010 in the wake of the financial crisis. But then-attempts at a resolution faced stiff opposition from Congress, whose only action was to require the SEC to conduct a study and issue a report. The matter has been sidelined for the past few years.

A "Double Standard"

Under current law there are two standards that financial professionals are held to -- the suitability standard, which applies generally to brokers and the fiduciary standard, which applies generally to registered investment advisers. The suitability standard is a flexible arrangement in which brokers are only required to recommend investments that are "suitable" for clients, based on factors such as the clients' investment objective, age, and tolerance for risk. Because of its loose interpretation, the suitability standard can lead to conflicts of interest: When given the choice between two "suitable" investments, a broker can choose the one that offers the higher compensation. With the fiduciary standard, advisers are required to put their clients' interests first, even if that means receiving lower or no compensation on a transaction.

Proposed Changes

While the DOL's overall goal is the same as in 2010 -- to require retirement investment advice to be in the clients' best interest, be that the plan sponsor, plan participant, or beneficiary -- the new proposal intends to expand the scope of what constitutes investment advice in order to broaden the range of fiduciary protections for investors.

As a result, the DOL expects its rules to significantly expand the number of advisers and brokers who will be considered fiduciaries in the context of investment advice.

Along with the wider application of the fiduciary standard would come a new, lengthy list of prohibited transaction exemptions designed to allow new fiduciary advisers to continue to receive commissions, 12b(1) fees, and other widely practiced forms of compensation -- so long as proper disclosures are made.[1]

In addition, the guidelines would establish a new type of contract for advisers/brokers and their clients, which could be used when an adviser wants to recommend a type of product or investment strategy (such as an individual retirement account rollover) that he or she feels is in the client's best interest -- but which also could result in additional compensation for the adviser. Under the new rules, an adviser and client could enter into this type of formal contract without requiring prior approval from the DOL. Once the contract is signed it would give the adviser the ability to enact transactions that would otherwise be prohibited by ERISA.[1]

The DOL expects the "prohibited transaction exemption" feature to be widely used in the IRA segment of the retirement market. Commenting on the process, Labor Secretary Thomas Perez stated, "If the broker or adviser doesn't have any conflicts of interest with respect to a given piece of advice, he or she doesn't need an exception simply for recommending a rollover. But if they are getting a commission or other payments that give them a personal financial interest in the outcome of the advice, this exception will force them to commit to give advice that is prudent and puts the customer first, and has reasonable fees. They can't mislead the customer and they have to be upfront about their conflict, but when that hurdle is met, the transaction can move ahead."[1]

What's at Stake?

For its part, the White House supports the DOL's new rules, and issued a report asserting that the current suitability rule results in a 1% drop in returns on retirement investments each year, resulting in total losses for affected investors approaching $17 billion annually.[2]

A Protracted Process

Regarding the timing of any final resolution, the outlook is murky at best. With a 75-day comment period and public hearing, and with controversy mounting within the industry about the potential legal liability posed by the "best interest" contracts, Labor Secretary Perez is not putting any specifics on the timing of the initiative. While a different standard may be on the horizon, it is, at this time, a distant prospect.

[1]PLANSPONSOR.com, "Broad Strokes of New Fiduciary Rule Outlined by DOL," April 14, 2015.

[2]Forbes, "DOL Issues Proposed Fiduciary Rule, 2015 Version," April 14, 2015.

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