WHO YOU CALLIN' A FIDUCIARY???

Spotlight On Talent: David Amster

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By David Amster
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The United States Department of Labor ("DOL") recently finalized rules that require financial institutions that offer retirement advice to address conflicts of interest ("COIs") that arise as a result of offering such advice (the "Fiduciary Rule"). The effective date is April 10, 2017. As one would expect with any new rule of this magnitude, there are potential minefields everywhere – not the least of which is the fact that the DOLs own website reflects materially inaccurate information about its own rule.

HISTORY

The SEC has historically held broker-dealers and investment advisors to very different fundamental standards by which they are obligated to treat their customers. Broker-dealers are required to ensure that a recommendation is merely "suitable" for the particular client to whom the recommendation was made and that a customer receives the "best execution" possible for any resulting transactions. Suitability is simply a reasonable basis to believe that a recommendation is appropriate in light of, among other things, the client's financial resources and market sophistication. Best execution generally (there are many subtleties to this concept that are beyond the scope of this bulletin) translates to "best price available." Now let's compare those standards with those under which investment advisors are obligated to operate. Under the law, investment advisors have a "fiduciary duty" to act in the best interest of their clients. A fiduciary has a legal and ethical responsibility to act in ways that put the client first and to faithfully elevate the customer's interests above his or her own. Despite many years of steadily growing resentment within the investment advisor community, the SEC has never acted to level the playing field. The DOL, however, recently moved to harmonize investment advice standards – albeit in the limited areas within which it believes it has jurisdiction – by enacting its Fiduciary Rule.

SCOPE

The DOL asserts a responsibility "to protect, educate and empower retirement investors ("Protected Clients") as they face important choices in saving for retirement in their IRAs and employee benefit plans." Under the Fiduciary Rule, all who provide retirement advice to Protected Clients (e.g., broker-dealers, investment advisors, banks) must abide by a fiduciary standard that squarely put the customer's best interest before the advisor's profit and must either prohibit payments that give rise to COIs or comply with one or more protective exemptions, otherwise known as Prohibited Transaction Exemptions ("PTEs"). So, for the first time, broker-dealers and their salespeople who provide investment advice to Protected Clients will have a fiduciary responsibility to those counterparties.

A fiduciary obligation is triggered by the existence of a "recommendation." The DOL, like FINRA, roughly defines a recommendation as a communication that would reasonably be viewed by the recipient as a suggestion to either transact or not transact and that is subject to a commission or fee. The DOL also contends that the more individualized the advice, the more likely that the advice will qualify as a recommendation. Certain communications are excluded from qualifying as recommendations. Educational material that informs underlying participants and beneficiaries of plans that are managed by independent fiduciaries (e.g., material that reflects what investment options are available, hypothetical asset allocation models) does not qualify as a recommendation. The educational exclusion, however, does not extend to similar material that is provided directly to IRA owners, primarily because an independent fiduciary typically does not exist in the context of an IRA. An additional exclusion applies to "general communications" such as newsletters, public commentary via the media, remarks at widely-attended conferences or speeches, marketing materials, general market data and broadly disseminated research reports. Furthermore, so-called "hire me" communications that market oneself or one's services is not fiduciary investment advice provided that such communications do not include an investment recommendation. To be clear, the Fiduciary Rule essentially shuts down the ability of a financial institution and it representatives from receiving any compensation (either commissions or fees) from Protected Clients on the basis of a recommended transaction – that is unless the financial institution employs a PTE.

PTEs

PTEs permit a fiduciary to receive compensation that is derived from a transaction that is recommended to a Protected Client. Two prominent PTEs are the Best Interest Contract Exemption ("BICE") and the Principal Transactions Exemption. The BICE is designed to mitigate conflicts of interest that may impede an advisor's ability to offer investment advice that is in the best interest of a Protected Client. The BICE must be executed in writing at the time of account opening. A valid BICE must:

1. acknowledge the fiduciary status of itself and its representatives and commit to certain basic standards of impartial conduct (e.g., providing prudent advice that is in the client's best interest, avoiding misleading statements and receiving no more than reasonable compensation);
2. state that it has policies and procedures designed to mitigate the negative impact of COIs;
3. disclose basic information that summarizes existing COIs; and
4. disclose the cost of its advice.

To use a BICE, the financial institution's website must also reflect a description of the firm's business model, material COIs that are associated with its business model, a summary of the firm's policies and procedures that have been implemented to mitigate any such COIs and its

compensation and incentive arrangements with its representatives. Another PTE, the Principal Transaction Exemption, permits a fiduciary to use its own inventory to trade certain recommended debt securities and other investments with Protected Clients. To do so, however, the financial institution must adhere to the same standards as those that are required for a valid BICE. Absent further guidance from the DOL, BICE users may face significant exposure due to the lack of clarity that surrounds certain BICE elements. For instance, according to the impartial conduct standards, compensation for advice given to Protected Clients must be "reasonable." Since the DOL does not define this term, one can only speculate as to how they might ultimately enforce that provision. That's an awfully uncomfortable position to be in given that the DOL firmly places the responsibility of proving compliance with the impartial conduct standards at the feet of those fiduciaries who seek to rely on a BICE.

COUNTERPARTY EXCLUSIONS

The Fiduciary Rule allows for certain counterparty exclusions or carve-outs. The most prominent exclusion applies to recommendations given to an experienced independent plan or IRA fiduciary such as a bank, insurance carrier, registered broker-dealer or any other fiduciary that manages at least $50 Million in total assets. Investment advice provided to such counterparties does not trigger a fiduciary obligation and does not require the use of a PTE to overcome the general prohibition against receiving recommendation-based compensation from Protected Clients.

For the sake of brevity, this bulletin does not address every specific aspect of the Fiduciary Rule. And that's why CRC is here. CRC will help you navigate through the regulatory maze. Should you have any questions regarding the Fiduciary Rule or any other regulatory enigmas, mysteries or head-scratchers, please call me at 917-568-6470 or e-mail me at damster@compliance-risk.com.

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David Amster is responsible for CRC's business development, client relationship management and for supervising the execution of strategic engagements.

David joined CRC in September 2016 from CRT Capital Group LLC, where he served for more than 15 years as Managing Director and Chief Compliance Officer.

David's Wall Street career began at Salomon Brothers, Inc., the free-wheeling broker-dealer of Liar's Poker fame. As the Syndicate Desk Coordinator for the Salomon's Private Investment Department, David first learned the business from the sales and trading perspective and was immersed in the results-oriented culture of a high-energy trading floor. David then headed to FINRA where, as a Field Examiner, he led comprehensive on-site reviews of the books, records and operations of bulge bracket dealers.

David earned his BA in Economics from Binghamton University and his MBA in Finance from Fordham University's Gabelli School of Business.

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