THE DEPARTMENT OF LABOR'S FIDUCIARY RULE: PROTECTING INVESTORS AND MARKETS.

By: Robert Botkin

Gary is you average, hard-working American. He graduated from college, found a good paying job in the hospitality industry and, thanks to his company's pension plan, there is a good sum of money put away for his retirement. Now Gary is a great when it comes to people, but not so great when it comes to navigating his retirement options and strategies. Gary is changing employers and must decide whether to roll his assets into an IRA, leave his assets in his former employer's plan if it allows, move his assets into his new employers plan if it allows, or just cash out. Before consulting a professional about the matter, Gary does some of his own research. He walks into a retail investment firm and the advisor pursuades him to rolls his funds into an IRA. Theo is the Broker-Dealer at the investment firm and recommends that Gary start his plan with a list of mutual funds, fixed indexed annuities, and variable annuities. Theo knows these are probably not the best investment for Gary, but its suitable, plus Theo gets a nice kickback.

Under the Department of Labor's (DOL) old Employee Retirement Income Security Act of 1974 (ERISA) rules, Theo falls outside of the definition of a fiduciary, and therefore, this kickback is not only legal, but it is common practice. In an effort to curb these practices, the DOL's new ERISA rules expand the definition of a fiduciary and creates a new method of exempting certain prohibited transactions.[1] The prohibited transactions relate mainly to the

[1] ERISA Definition of the Term ''Fiduciary'' and Conflict of Interest Rule, 81 Fed Reg 20946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pt. 2509, 2510, 2550); Best Interest Contract Exemption 81 Fed Reg 21002 (Apr. 8, 2016) (to be codified at 29 C.F.R. pt. 2550).

method that fiduciaries receive compensation.[2] For a fiduciary to receive commission based compensation, they must comply with the requirements for a Best Interest Contract Exemption (BIC exemption) that requires extensive disclosure about possible conflicts of interest.[3]

This paper looks to delve into the rule and comprehensively analyze the possible costs to the industry and benefits to investors. Part I of this paper will highlight the changes in the fiduciary rule and the DOL's support for such changes. Part II will analyze the BIC exemption and why the DOL took this route for exempting certain transactions. Part III will give an overview of the pushback and concern from the industry about the negative effect of the rules' implementation. Part IV will attempt to reconcile the consequences of new rules and make suggestions to minimize the negative externalities.

I. <u>DOL Fiduciary Rule</u>

On April 8, 2016, the DOL published the final rule that modified the existing regulation of conflicts of interest in the market for retirement investment advice under ERISA.[4] It is important to understand the scope of the ERISA rules. Title I of ERISA covers and protects employee benefit plans, imposing an obligation on persons who engage in activities related to the plan as fiduciaries.[5] The fiduciary standard under this Title imposes a duty of loyalty and

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[2] Definition of the Term "Fiduciary", 81 Fed Reg 20946, 20953 ("Prohibited transactions include sales and exchanges between plans and parties with certain connections to the plan such as fiduciaries, other service providers, and employers of the plan's participants. They also specifically include self-dealing and other conflicted transactions involving plan fiduciaries.")
[3] *Id*. at 20992 ("[T]he Department notes that other remunerations (e.g., commissions or revenue sharing), beyond the fixed assets under management fee, received by the adviser or affiliates as a result of investments made pursuant to recommendations or instances of the self-valuation of the assets upon which the fixed management fee was based would potentially raise prohibited transaction issues and therefore require use of the Best Interest Contract Exemption or other prohibited transaction exemptions.")
[4] *Id*.
[5] Chamber of Commerce of the United States v. Hugler, No. 3:16-cv-1476-M, 2017 U.S. Dist. LEXIS 17619 at *5 (N.D. Tex. Feb. 8, 2017).

prudence upon the fiduciaries.[6] Title II establishes rules for the tax treatment of IRA's and other plans subject to the Internal Revenue Code.[7] Under both Titles advisors are subject to the Prohibited Transaction rules and their exemptions. However while still titled fiduciaries, Title II does not create a private right of action and due to its lack of state law preemption, advisors are not subject to the fiduciary duties of loyalty and prudence as Title I advisors.[8] The fiduciary claims against advisors under this Title generally fall under state law.[9]

The two changes covered by this paper consist of 1) a new definition of Fiduciary under ERISA and the Code and 2) the creation of the Best Interest Contract Exemption. The theory behind these changes is that their implementation will "limit or mitigate conflicts of interest and thereby improve retirement security."[10]

a. *Expansion of the Fiduciary Standard*

Registered Investment Advisors and Broker-Dealers are the two groups that generally provide investment advice to retirees. Outside of ERISA, these groups of professionals have different standards in regards to the duty owed to their client in the general course of business. Under the Investment Advisors Act of 1940, Investment Advisors are held to a fiduciary

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6 *Id*. at *6.
7 *Id*. at *7.
8 *Id*.
9 *See* Mandelbaum v. Fiserv, Inc., 787 F. Supp. 2d 1226, 1237 (D. Colo. 2011).
10 ERISA Definition of the Term ''Fiduciary'' and Conflict of Interest Rule, 81 Fed Reg 20946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pt. 2509, 2510, 2550).

standard, however, this is not the same as the fiduciary responsibility under ERISA.[11] Broker-dealer are subject to the suitability standards under FINRA guidelines.[12]

To be deemed a fiduciary under the 1975 ERISA definition, one must satisfy a five-part test. A fiduciary is

> "(1)a person [that] renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property, (2) on *a regular basis*, (3) pursuant to a mutual agreement, arrangement or understandings, with the plan or a plan fiduciary, (4) the *advice will serve as the primary basis* for investment decisions with respect to plan assets, and (5) the advice will be individualized based on the particular needs of the plan."[13]

The 1975 rule was promulgated prior to the widespread use of participant directed 401(k) plans, complex investment options for IRAs, and the now common practice of rolling over of plan assets from fiduciary-protected plans to IRAs.[14] Due to the changing landscape of the retirement investment products, certain one-time transactions like rolling assets into an IRA, fall outside the scope of the rule.[15] These one-time transactions fail to satisfy the "regular basis" element of the test. The DOL was concerned of this gap because rollover investments are often "the most important financial decision that many customers make in their lifetime."[16] Furthermore, in the fine print disclosures of the contract, advisors would commonly avoid

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[11]SEC v. Capital Gains Research Bureau 375 U.S. 180, 194 (1963) (Investment Advisors owe "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients." However, the Investment Advisors Act of 1940 provides no private right of action.)

[12] Benjamin P. Edwards, *Fiduciary Duty And Investment Advice: Will A Uniform Fiduciary Duty Make A Material Difference?*, 14 JOURNAL OF BUSINESS & SECURITIES LAW 104, 110 (2014).

[13] Best Interest Contract Exemption 81 Fed Reg 21002, 21005 (Apr. 8, 2016) (to be codified at 29 C.F.R. pt. 2550) (emphasis added).

[14] DEPARTMENT OF LABOR, REGULATING ADVICE MARKETS: REGULATORY IMPACT ANALYSIS FOR FINAL RULE AND EXEMPTIONS at *4 (Apr. 2016).

[15] *Id*.

[16] *Id*. at *201.

fiduciary duties by stating: "investment advice is not intended to be the primary basis for decisions."[17]

The new rule replaced this five-part test with the goal of broadening the definition. The new rule defines a fiduciary as anyone who "renders investment advice[,]" and receives compensation, directly or indirectly.[18] "Investment advice" is intended to be read broadly to include any communications that are likely to be considered a suggestion to take, or refrain from taking, a particular action.[19] The main take away from the changes in the rule is the broad imposition of a fiduciary duty. For the purposes of Title II, this new rule merely expands the range of fiduciaries subject to the prohibited transaction rules, but the rule does not necessarily burden them with the fiduciary duties set out in Title I. While this new rule does have some implications on Title I advisors, the main thrust of the rule is aimed at Title II advisors of IRAs and other non-Title I plans.

b. DOL findings to support the rule.

The DOL sought to cast a wider net among investment professionals, consultants, and advisors playing a role in IRA investments who operate in a manner to circumvent ERISA's fiduciary standard. ERISA prohibits fiduciaries from engaging in prohibited transactions due to adverse risks posed by conflicts of interest.[20] The prohibited transaction rules are a general

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[17] Richard Veres, Understanding the New Fiduciary Rule and It's Impact to Retirement Plan Sponsors, Highland Consulting Associates (Fed. 28, 2017), https://www.highlandusa.net/blog/the-fiduciary-rule-impact-to-retirement-plan-sponsors-and-important-questions-to-ask-your-consultant.

[18] [18] ERISA Definition of the Term ''Fiduciary'' and Conflict of Interest Rule, 81 Fed Reg 20946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pt. 2509, 2510, 2550).

[19] *Vanguard*, REGULATORY BRIEF: THE DOL FIDUCIARY RULE: WHAT IT MEANS TO FINANCIAL ADVISORS *1 (Aug. 2016), https://advisors.vanguard.com/iwe/pdf/FA665902.pdf

[20] *See generally*, ERISA Definition *supra note* 18.

prohibition on all use of beneficiary's funds for the gain of someone other than the beneficiary.[21] ERISA provides a series of exemptions to this general prohibition, so long as certain criteria are met. [22]

Due to Investment Advisors circumventing the 1975 ERISA fiduciary rules, the new rules seek to provide a definition that better reflects the statutory purpose of ERISA and better protects investors.[23] The Department proposed a BIC exemption blanket exemption rather than a highly prescriptive set of transaction specific exemption in an effort to increase flexibility.[24] This section will dive into the economic assessment provided by the DOL and the Council of Economic Advisors (CAE) to outline the justification for broadening the fiduciary standard.

The CAE begins the study by highlighting the rise in the IRA market from 2% of the total retirement assets in 1978 to just under 30% in 2013.[25] In 2012, Americans rolled over more than $300 billion to IRAs and from 2012 to 2020 $2.4 trillion cumulatively is expected.[26] The shifting paradigm toward individual controlled IRAs and away from traditional pension plans has "coincided with an explosion in the investment options and trading platforms available."[27] The rise in complexity led to an increasing reliance on financial advice, and over half of IRA holders have a retirement strategy created with the help of a professional advisor.[28]

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[21] *See Id*.
[22] *See Id*.
[23] *Id*.
[24] Best Interest Contract Exemption, 81 Fed Reg 21002, 21005 (Apr. 8, 2016) (to be codified at 29 C.F.R. pt. 2550).
[25] Council of Economic Advisers, Exec. Office of the President, The Effect of Conflicted Advice on Retirement Savings at *5 (Feb. 2015).
[26] *Id*. DEPARTMENT OF LABOR, REGULATING ADVICE MARKETS: REGULATORY IMPACT ANALYSIS FOR FINAL RULE AND EXEMPTIONS at *3 (Apr. 2016).
[27] Council of Economic Advisers, *supra note* 25, at *5.
[28] *Id*.

Professional advisors refers to both Registered Investment Advisors, which give holistic investment advice, and Broker-Dealers, which give incidental advice.[29] Distinguishing between these two can be tricky, especially for investors because advisers can switch between roles, known as dual hatting.[30] As discussed previously, RIAs are subject to a fiduciary duty of care and loyalty, and Broker-Dealers are subject to a suitability standard.[31] Consumers are often unaware of these different standards, and even if aware, they are unable to determine which standard is applicable due to dual hatting.[32] Multiple studies from the Consumer Financial Protection Bureau, Government Accountability Office (GAO), and Securities and Exchange Commission (SEC) find that a majority of households' report satisfaction with their advisors, but express confusion about the different titles, legal obligations, and consumer protections that exist.[33] This confusion increasing the ability for abuse. Not only is the IRA assets largest for elderly households, but this demographic is most vulnerable to potential abuses.[34]

When Advisors receive conflicted payments[35], there are often misaligned interests for the advisor and the advisee. The GAO found that advisors frequently encourage rollover IRAs

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[29] *Id*. at *6.
[30] *Id*.
[31] *See* DEPARTMENT OF LABOR, *infra* note 14, at *12.
[32] Council of Economic Advisers, s*upra* note 27, at*6.
[33] *Id.* at *7 (*citing* CONSUMER FINANCIAL PROTECTION BUREAU, SENIOR DESIGNATIONS FOR FINANCIAL ADVISERS: REDUCING CONSUMER CONFUSION AND RISKS (2013), http://files.consumerfinance.gov/f/201304_CFPB_OlderAmericans_Report.pdf; GOVERNMENT ACCOUNTABILITY OFFICE, 401(K) PLANS: IMPROVED REGULATION COULD BETTER PROTECT PARTICIPANTS FROM CONFLICTS OF INTEREST (2011), http://www.gao.gov/assets/320/315369.html; SECURITIES AND EXCHANGE COMMISSION*,* STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS (2011), http://www.sec.gov/news/studies/2011/913studyfinal.pdf
[34] Council of Economic Advisers, s*upra* note 27, at *7.
[35] Conflicted Payments are payments to the advisor for actions taken by the advisee, whether that be in the form of a revenue-sharing arrangements, front-end loads, back-end loads, or other forms of payments that are disconnected with the performance of the investment.

without knowing the participant's financial situation because of a $5950 to $8900 earning difference if the participant invests in an IRA instead of the employer's plan.[36] This incentive for rollovers helps explain why 80% of the funds flowing into IRAs from 1998 to 2007 were from rollovers.[37]

Conflicted investment advice results in adverse outcomes for the advisee when compared with accounts not receiving conflicted advice. In the analysis of the effects of conflicted advice, the CAE's study focuses on mutual fund assets for two reasons: (1) mutual funds account for $3.5 trillion or about half of IRA assets and (2) due to existence of high-quality empirical studies specifically on the issue of conflicting interests. [38]

When looking at conflicted investment advice in the mutual fund industry, there is a significant difference, both statistically and economically, in the investment returns based on whether a fund is sold through an intermediary or directly to the investor. The annual returns for domestic equity funds and bond funds sold through an intermediary underperformed fund sold directly by 77 and 90 basis points\, respectively.[39] Bifurcating funds sold through an intermediary into two categories, actively and passively managed, the performance further stratifies.[40] Actively managed funds underperform passively managed funds by 112 to 132 basis points per year.[41] These studies are informative to understand that there is a difference in returns when a

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[36] Council of Economic Advisers, s*upra* note 27, at *13.
[37] GOVERNMENT ACCOUNTABILITY OFFICE, 401(K) PLANS: IMPROVED REGULATION COULD BETTER PROTECT PARTICIPANTS FROM CONFLICTS OF INTEREST (2011), http://www.gao.gov/assets/320/315369.html;
[38] Council of Economic Advisers, s*upra* note 27, at *8.
[39] *Id*. at *11.
[40] *Id*.
[41] Diane Del Guercio & Jonathan Reuter, *Mutual Fund Performance and the Incentive to Generate Alpha*, 69 THE JOURNAL OF FINANCE 1673, 1679 (2014) ('The fact that the vast majority of the assets in the broker-sold segment are invested in underperforming actively managed funds is likely to reflect an agency conflict between brokers and their clients.")

third party is involved, but these studies do not account for the fact that those directly purchasing funds may be risk seeking and/or more experienced investors.[42]

Another empirical study held constant for investors that would seek an adviser when available, and also holding constant for risk tolerance.[43] The control group for this study relied soley on the default investments in the absence of an advisor.[44] The experimental group, who received conflicted investment advice, underperformed the control by 298 basis points because "brokers significantly increased annual fees, significantly decreased annual after-fee returns, and slightly increased risk taking relative to the [default] portfolio."[45] Even after controlling for various investor traits, the difference was nevertheless about 125 basis points.[46] Additionally, conflicted advisors do not steer clients away from excessive trading and conflicted payments increased the losses on mistimed investments.[47]

Funds that offered unusually higher payments to advisors received larger inflows of capital compared with those offering unusually low payments.[48] Also, higher revenue sharing payments lead to greater inflows.[49] If performance is similar these facts alone do not necessarily sound the alarms for regulatory action, but the study further found that there is an inverse correlation between payments and performance.[50] The difference in performance was about 113 basis points of annual performance.[51] A different study determined the sensitivity of conflicted

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[42] Council of Economic Advisers, s*upra* note 27, at *11.
[43] *Id*.
[44] *Id*.
[45] *Id*.
[46] *Id*. at *12.
[47] *Id*.
[48] *Id*. at *14.
[49] *Id*
[50] *Id*
[51] *Id*.

payments upon the inflow of capital into the fund.[52] For a 50-basis point increase in adviser fees, there is a corresponding 1702 basis point increase in the allocation of capital into the fund.[53] Therefore, the funds that offer higher payments to advisors not only receive more capital, but significantly underperform those funds with lower payments.

The CAE attempts to identify the dollar figure amount of assets within IRAs that have some type of load payment.[54] The conservative estimate at $1.05 trillion includes only the value of mutual funds in IRAs with some type of load payment.[55] The middle estimate of $1.66 trillion includes the previous mutual fund figure, but adds annuities that often include load payments.[56] The high-end estimate of $3.26 trillion includes all advised assets, conflicted and non-conflicted, to give an overview of the entire scope of the IRA advised asset market.[57] Speculating on the total losses to retirement savers, assuming a 168 basis point underperformance of conflicted mutual funds, the CAE concludes that the cost of conflicted advise is around $17 billion.[58] While the assumed underperformance number is malleable due to the study's focus on mutual funds, for this paper we will assume a conservative underperformance value of 100 basis points or $10 billion cost of conflict.[59] This conservative estimate reflects the 100 basis point difference between IRAs and 401(k) due to administrative costs, holding constant annual performance.[60] The DOL's expansion of the fiduciary standard is intended to force a larger amount of advisors to comply with the BIC Exemption, its solution of the conflicted payments problem.

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[52] *Id*
[53] *See* DEPARTMENT OF LABOR, *infra* note 14, at *12.
[54] *Id*. at *19.
[55] *Id*.
[56] *Id*.
[57] *Id*.
[58] *Id*.
[59] *Id*. at *17.
[60] *Id*.

II. BIC Exemption

The BIC exception has created tension for the new rule's implementation, due to its allegedly high cost of compliance. As discussed in the overview of ERISA, Title II does not impose a duty of loyalty and prudence upon fiduciaries, like in Title I.[61] Title II advisors are still subject to the prohibited transactions rules and must find an exemption to complete such transactions.[62] The main purpose of the BIC exemption is to impose fiduciary duties on Title II advisors of IRAs and non-ERISA plans.

For the purposes of a BIC exemption it is important to distinguish between two types of compensation: level-fee based and commission based. Reading the final rule in the Federal Register can be confusing due to a Level-Fee Fiduciary exception to the BIC exemption.[63] This exemption to the exemption means that "the ongoing receipt of compensation based on a fixed percentage of the value of the assets under management . . . does not, in and of itself, violate the prohibited transaction rules or require compliance with an exemption.[64] Therefore, the BIC exemption is targeted mainly at commission based fee structures.

To qualify for BICE, a Financial Institution must:

1. Acknowledge fiduciary status with respect to investment advice to the Retirement Investor;
2. Adhere to Impartial Conduct Standards requiring them to:
    a. Give advice that is in the Retirement Investor's Best Interest (i.e., prudent advice that is based on the investment

[61] *See infra* note 14.
[62] The prohibited transaction rules are a unique part of securities law. The rules are a general prohibition on all forms of compensation, unless there is an exemption. Whereas, all other areas of securities law are a general allowance activity, unless there is a prohibition.
[63] Best Interest Contract Exemption 81 Fed Reg 21002, 21003 (Apr. 8, 2016) (to be codified at 29 C.F.R. pt. 2550).
[64] DEPARTMENT OF LABOR, CONFLICT OF INTEREST FAQS at *5 (Oct. 27, 2016), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf

objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to financial or other interests of the Adviser, Financial Institution, or their Affiliates, Related Entities or other parties);

   b. Charge no more than reasonable compensation; and
   c. Make no misleading statements about investment transactions, compensation, and conflicts of interest;

3. Implement policies and procedures reasonably and prudently designed to prevent violations of the Impartial Conduct Standards;
4. Refrain from giving or using incentives for Advisers to act contrary to the customer's best interest; and
5. Fairly disclose the fees, compensation, and Material Conflicts of Interest associated with their recommendations. [65]

This BIC exemption is the DOL's back-end way of imposing fiduciary duties upon advisors that did not previously have such responsibility. Forcing the parties to enter a contract with enforceable rights and obligations circumventing the state law preemption limitations of Title II. Because Title II does not preempt state law, forcing parties to enter a contract acknowledging a fiduciary relationship would be dispositive in imposing state law fiduciary duties.[66]

The contract must describe material conflicts of interest in connection with the fees received.[67] Also, financial institutions must maintain a website that is freely accessible to the public and update it at least quarterly with: a discussion of institutions business model and the material conflicts associated with such model, a schedule of typical account or contract fees, a model contract or other model notice of contractual terms and certain disclosures required under

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[65] Best Interest Contract Exemption, *supra* note 63, at 21003.
[66] *See* Mandelbaum, 787 F. Supp. 2d 1226, 1237 (D. Colo. 2011); *See also* Gregory A. Hicks, *Defining the Scope of Broker and Dealer Duties—Some Problems in Adjudicating the Responsibilities of Securities and Commodities Professionals*, 39 DEPAUL L. REV. 709, 709 (1990) (noting "uncertain significance of the fiduciary label often attached to these [brokers and dealers], and an accompanying uncertainty about the legal duties which the fiduciary label implies"
[67] Best Interest Contract Exemption, *supra* note 63, at 21007.

BICE, a written description of the financial intuitions policies and procedures that summarize key components of conflict-mitigation, and to the extent possible a list of all product manufacturers with whom the financial institution maintains arrangements that provide third party payments.[68]

For a contract to satisfy the BIC exemption, it must *not* include a provision disclaiming or otherwise limited liability, a provision that waives or qualifies the right to bring or participate in a class action, agreements to arbitrate or mediate individual claims in venues that are distant or otherwise unreasonably limit the ability of the retirement investors to asset the claim, or a liquidated damages provision.[69] With such extensive disclosure requirements and prohibitions, the DOL clearly favors level-fee based accounts over commission-fee based accounts. This favoritism has cause significant disagreement among industry professional.

III. Industry Comments and Pushback

The new DOL rules have come under harsh criticism from industry professionals and analysts. While the media portrayed a total pushback by the financial industry of the new fiduciary rules and standards, the real push back is solely against how the fiduciary standard is imposed upon advisors through the BIC exemption.[70] Industry professionals argue that implementing the BIC exemption will harm both investors and industry.

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[68] *Id*.
[69] *Id*. at 21041-42.
[70] Daisy Maxey, *Fiduciary-Rule Review: Experts Weigh In*, WALL STREET JOURNAL (Feb 15., 2017).
https://www.wsj.com/articles/fiduciary-rule-review-experts-weigh-in-1487190167 (Explaining experts concerns about the cost of complying with the new rule without mentioning the BIC execption.)

Due to the BIC exemption's hostility toward commission base accounts, the rule seeks to hasten the already existing trend toward level-fee accounts.[71] The BIC exemption method may cut too broadly and cause low-balance account holders the most harm. InvestmentNews and Legg Mason conducted a research survey of which over 1,700 industry professionals responded.[72] The survey gaged the reaction of advisors to the proposed rule and then after the final rule.[73] The advisers surveyed control more than $200 billion in assets and around 57% of those assets were in retirement accounts that would be affected by the new rule.[74] Of the retirement assets 23%, 12% of the total assets under management, were in low-balance IRAs holding less than $25,000.[75] Under the final rule, 35% of respondents stated they would no longer be serving low-balance-accounts.[76] Accounting for the percentage difference in responses between Independent Broker-Dealers and Wirehouse firms that would no longer serve low-balance IRAs, and extrapolating the data to represent the entire industry, the total amount of assets that would be left orphaned amounts to $333.9 billion.[77]

The main reason a considerable number of advisors are considering halting service to low-balance accounts is due to the unprofitability on level-fee based low-balance accounts. Some study's show that with an $50,000 minimum for open a fee-based account, over 57% of accounts

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[71] *See generally* Dechert, *The New DOL Fiduciary Rule: Impact on Mutual Fund Distribution* (Aug. 2016), https://www.dechert.com/files/Uploads/Documents/FSG/Onpoint%20-%20The%20New%20DOL%20Fiduciary%20Rule%20Impact%20on%20Mutual%20Fund%20Distribution.pdf.
[72] IvestmentNews & Legg Mason Management, *The Economics Of Change: How The DOL Fiduciary Rule Will Set Money In Motion And Alter Business Models Across The Advice Industry* at *2 (May 6, 2016), http://www.investmentnews.com/assets/docs/CI105297516.PDF.
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Id.*

would not qualify.[78] The study finds that account levels below $50,000, on average, would see fees rise by 68 basis points if converted to a level-fee based account from a commission based.

Furthermore, switching medium and high balance accounts from commission to level-fee based may harm investors if their transaction rate is low. Investors generally choose the payment basis of their account on the determination of whether they are active or passive within the account.[79] Passive investors, who would benefit from a commission based account, due to low turnover could be forced into level-fee based accounts and forced o bear the burden of the high compliancy costs of the new rule.[80] Harms to these investors would arise if the payment based on a percentage of the account assets were higher than the amount due based on the commission of trading.[81]

Even if switching to level-fee based accounts were equally as profitable for advisors and not harmful to investors, these accounts are still subject to a form churning. The DOL cites to churning as a reason against commission based accounts and the reason for a fiduciary standard. However, level-fee accounts still run the risk of reverse churning.[82] Where churning is the constant turnover of investments to generate commission, reverse churning is the lack of turnover because the advisor receives a level-fee regardless of their effort.[83] This makes the DOL's distraction and favoritism toward level-fee accounts suspect because there are still risks to investors, there is just a change of incentives for advisors. Also, from an investors litigation

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78 NATIONAL ECONOMIC RESEARCH ASSOCIATES, *Comment on the DOL Proposal and Regulatory Impact Analysis* (July 17, 2016), http://www.sifma.org/issues/item.aspx?id=858995544.
79 *Id.*
80 *Id.*
81 *Id.*
82 Daisy Maxey, *SEC Targets 'Reverse Churning' By Advisers,* WALL STREET JOURNAL (Feb. 24, 2014), https://www.wsj.com/articles/SB10001424052702304610404579403251590760602
83 *Id.*

prospective it is much easier to show an advisor churning an account rather than reverse churning, due to action verse inaction.

Second, there would be adverse effects in the distribution channels for mutual funds. The first method of distributing mutual fund shares is through directly interacting with the customer through service enters and webpages maintained by the funds and their sponsors. While the DOL has found that this method out performed funds sold through an intermediary, direct distribution under the new rule could be curtailed.

Mutual funds are concerned about the potential that these direct communications could be deemed financial recommendations under the new fiduciary rule and thereby implicate a fiduciary status. The service centers run by mutual funds communicate with investors and discuss the merits of the fund.[84] Under the new rules, the communication could rise to the level of a recommendation, potentially triggering fiduciary states. Mutual fund websites would need to be reviewed to ensure that the statements could not be interpreted as rising to the level of a recommendation and therefore imposing a fiduciary standard. Fear of implicating a fiduciary duty could significantly limit the information available to the investors or force them to work with intermediaries due to the mutual funds unwillingness to run the risk giving recommendations.

Mutual funds use intermediaries to assist in the distribution process in order to gain access to a large base of potential investors.[85] In order to keep the fund running, investors are

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[84] *See generally* Dechert, The New DOL Fiduciary Rule: Impact on Mutual Fund Distribution (Aug. 2016), https://www.dechert.com/files/Uploads/Documents/FSG/Onpoint%20-%20The%20New%20DOL%20Fiduciary%20Rule%20Impact%20on%20Mutual%20Fund%20Distribution.pdf.
[85] *Id*.

charged with fees and expenses associated with their investment.[86] While some of these fees are for the underlying operations of the mutual fund, some of these fees are used as commission for the intermediary selling the fund's shares. The three most common forms of commission structures are front-end load payments, back-end load payments, and revenue sharing agreements[87].

The BIC exemption imposes onerous requirements upon advisors and the potential alternative arrangements could be harmful to investors. Unaffiliated Broker-Dealers are those advisors who are selling shares of a mutual fund and their firm is not the sponsor of the fund. Algorithm-based advice would allow a fiduciary to receive any amount or form of compensation related to advice provided in accordance with an unbiased computer model created by a third party, where the advice is conveyed by an individual person.[88] This algorithmic advice, known as robo-advice, is aimed out cutting out the intermediary all together. However, robo-advisors cannot give personalized investment advice and merely give output based on your profolio alone.[89] The robo-advisor does not answer investor question, does not assure or warn them about their financial future, nor does it have face-to-face meetings.[90] The new rules seem to favor these robo-advisors and the impersonal nature of such technology is likely not going to be widely accepted retirement investors, cutting against the DOL.

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[86] *Id.*
[87] SECURITIES & EXCHANGE COMMISSION, MUTUAL FUND FEES AND EXPENSES (Jan. 13, 2013), https://www.sec.gov/fast-answers/answersmffeeshtm.html#salesloads.
[88] Dechert, supra note 84.
[89] *Id.*
[90] *Id.*

The costs to the industry and to investors are still tentative at best. While these claims may come to fruition, the actual significance of the impacts will not be felt until after the rule's implementation.

IV. Consolidation and Recommendation

When taking the DOL's findings in support of the new rules and looking closely at the industry's push back, there are multiple logical fallacies that undercuts their position. For the industry to show a greater harm than benefit, the cost of compliance and harms must be larger than the 100 basis points or $10 billion cost of conflict avoided by the implementation of the rule.

The first argument is that investors will be harmed by the cost of complying with the BIC exemption. The InvestmentNews study attempts to draw concern to the fact that there may be a large number of orphaned accounts due to 35% of respondents stating that they would not serve low-balance accounts.[91] However, this means that 65% of the respondents will or may service these accounts. These orphaned accounts would likely be received with open arms and while there will be a period of transition, there is no reason to believe all of these accounts would not find an advisor willing to service their needs. Furthermore, some professionals feel that the DOL rule "will foster greater trust and bring more retirement savings back into the market, a potential victory for the investing public and for those who faithfully advise them."[92] Not only will orphaned accounts find a new advisor, but there will be new accounts formed giving advisors increased incentives to comply with the rules.

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[91] *Id.*
[92] Thomas Hoops, *DOL Rule Change Could Spur Innovation*, LEGG MASON ASSET MANAGEMENT (May 2016), https://www.leggmason.com/en-us/advisor-resources/main/dol-fiduciary-rule/dol-rule-change-could-spur-innovation.html.

The second claim made is that low-balance, fee-based accounts would cause investors to pay a higher percentage of around 68 basis points.[93] Even if this is true, it does not outweigh the conservative, 100 basis point estimate of increased performance. Moreover, compliance with the new rule would deter capital from underperforming funds and investments. Allocating that capital toward the top performers would comport with the underlying goals of securities regulation. Therefore, not only do investors on average see a 32-basis point increase of performance, the economy benefits from more efficient allocation of resources.

Lastly, the studies point to reverse churning as a reason fee-based accounts are no different than commission based. This argument is illogical, assuming a selfish incentive of increasing the advisor's own profits, a fee based account would encourage the maximization of efforts. The DOL calls this, the aligning of interests because the advisor would be able to earn more as the account grows. Reverse-churning, while it does exist, runs counter to the assumption that individuals seek to maximize their own profits. Also, the SEC added reverse churning to its 2015 Examination Priority, which should cut down on any potential abuses or at least identify violations.[94]

Mutual funds will face some adversity once the new rule is rolled out early next year. There are three claims that the mutual fund industry makes: 1) less direct distribution, 2) inability to use Unaffiliated Broker-Dealers, and 3) robo-advise cannot adequately fill the gap.[95] The DOL's study highlights studies showing that funds that are directly distributed to investors outperform those sold through intermediaries. While this is qualified because the studies do not

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[93] NATIONAL ECONOMIC RESEARCH ASSOCIATES, *Comment on the DOL Proposal and Regulatory Impact Analysis* (July 17, 2016), http://www.sifma.org/issues/item.aspx?id=858995544.
[94] SECURITIES & EXCHANGE COMMISSION, EXAMINATION PRIORITIES FOR 2015 (*available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf
[95] Hoops, *supra* nota 92.

hold for investor sophistication, it is likely that an interpretive guideline could be released by the DOL carving out mutual fund call centers from the fiduciary definition. This would likely be the most equitable solution because there is no evidence that mutual fund call centers causes conflicts of interest, and therefore, should be included within the fiduciary definition.

The DOL rules indeed make it difficult to distribute funds of actively managed funds due to the load fees that are *per se* conflict of interest payments. A Capitalist society, the foundation of American ideology, would allocate funds toward actors with the able to work most efficiently within the rules. If the Industry believes that prohibiting conflicting payments would end the mutual fund industry because no actor could work within the rule, then we need to rethink the foundational socio-econoimc philosophy of American culture. However, with the rise of passively managed, smart-beta funds, actors have already identified a lower cost and better return alternative. Smart-beta funds "uses alternative index construction rules instead of the typical cap-weighted index strategy, in a transparent way. It takes into account factors such as size, value and volatility."[96] Industry analysts have a positive outlook for smart-beta funds under the new rules because "[l]everaging lower-cost products may allow advisors to better manage their regulatory risk while seeking to serve the client's best interest."[97] Smart-beta funds offer a low cost solution to load fees that avoid conflict of interest payments.

The rise of smart-beta funds, and advisors finding ways to work within the rules also partially address that issues with robo-advisors. While analysist fairly points out the limitation of

[96] Andrew Ang, *Smart Beta Guide*, BLACK ROCK (Nov. 2015), https://www.blackrock.com/au/intermediaries/literature/whitepaper/blackrock-smart-beta-guide-en-au.pdf
[97] Ryan Sullivan, *Exchange Thoughts: DOL Fiduciary Rule Could Propel $1.5 Trillion into ETFs*, BROWN BROTHERS HARRIMAN (June 6, 2016), https://www.bbh.com/en-us/insights/exchange-thoughts--dol-fiduciary-rule-could-propel--1-5-trillion-into-etfs/16320

robo-advise due to their lack of individuality and empathy, the use of robo-advisors does offer some benefits. Using robo-advisors to assist 'real' advisors would allow for impartial advice, but also account for individualistic circumstances. Betterment Investing's comment during the rulemaking process, in favor of the rule, stated that "consistent and unconflicted algorithms make recommendations to clients on how to reach their goals, tailored to each client's personal circumstances . . . mitigating human tendencies to make poor decisions."[98] Therefore, the use of robo-advisors could help investors and advisors make better investment decisions.

While its highly unlikely that the industry's harms outweigh the benefits to investors under the new rule, there is a significant chance that the current administration will attempt to block its implementation.[99] If the rule is repealed, a fiduciary rule handed down from either the SEC or FINRA could avoid a majority of the issues posed by the DOL's rules because neither regulatory body would have to create a BIC exemption. A fiduciary standard from the SEC or FINRA would place Title II advisors on the same playing field as Title I advisors.

FINRA's Chief Executive Officer, Robert Cook, stated that if the DOL rule was overturned that SEC would, and should, craft a replacement rule, which he hopes FINRA will play an important part in constructing.[100] The worst-case scenario is that the rule is repealed and no new rule would be drafted given the Trump Administration, the SEC's two member board, the acting Chairman Piwowar, and the unknown policies of future Chairman Clayton. Even if

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[98] John Stein, *Betterment's Letter to the Department of Labor* (Sept. 15, 2015), https://www.betterment.com/resources/inside-betterment/betterments-public-comment-to-the-dol-no-more-conflicted-advice/.

[99] Michael Wursthorn & Lisa Beilfuss, *Donald Trump Victory Casts Clouds Over Fiduciary Rule*, WALL STREET JOURNAL (Nov. 11, 2016), https://www.wsj.com/articles/donald-trump-victory-casts-clouds-over-fiduciary-rule-1478709489.

[100] Chelsea Emery, *SEC Could Step Up If DOl Fiduciary Rule Is Overturned*, *FINRA CEO Says*, FINANCIAL PLANNING (Jan. 29, 2017), https://www.financial-planning.com/news/sec-could-step-up-if-dol-rule-is-overturned-says-finra-ceo.

FINRA were to take the initiative to draft a rule, it would likely be rejected by the SEC. The future of the fiduciary standard faces an uncertain future even with its clear benefits. With the benefits to investors, the opportunity for advisors to find ways to work within the new rules, and courts upholding the rule, hopefully the administration will be unsuccessful in blocking the DOL's new fiduciary rule and BIC exemption.