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Alerts

ERISA Fiduciary Standards Will Apply to IRAs Starting in June

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Securities Brokers' Liability

On April 4, 2017 the U.S. Department of Labor issued an order effective April 9, 2017, stating that implementation of the so-called investor Fiduciary Rule applicable to Individual Retirement Accounts will go into effect June 9, 2017. Under the rule, all salespersons that sell investment products to IRA customers will now be subject to uniform fiduciary standards and DOL oversight.

The Department acknowledged in its order that additional time is needed to evaluate certain issues identified for further study in President Trump's executive order of February 4, 2017. That Presidential order directed that the following issues must be studied prior to implementation of the Rule:

1. Whether implementation would result in a lack of adequate service and investment advice to investors in light of previous criticisms that smaller investors would be adversely affected.
2. Whether the Rule would result in dislocations and disruptions in the retirement services industry that would adversely affect retirement investors.
3. Whether the Rule would increase litigation and/or increase the price investors would be required to pay to gain access to retirement services.

Fiduciary Rule Remains in Place

Importantly, the implementation of the "Investment Fiduciary Definition" will not be delayed beyond June 9, 2017. That Definition overrides conflicting state laws which frequently hold that a commissioned salesperson involved in a single product sale, such as a life insurance agent, is not considered a fiduciary. A statutory fiduciary has a higher duty of care and broad disclosure duties. These include avoiding conflicts of interests, making suitable recommendations and fair disclosure of the comparative costs and risks of recommended investments.

These fiduciary duties are imposed under ERISA to registered financial advisors. In substance they also already apply to licensed stock brokers under FINRA Rules 2090 et seq, the "Know Your Customer" Rules. Those Rules impose substantially similar obligations regarding product suitability and full and fair customer disclosure of material risks regarding the investment and potential alternative options.

The Securities Industry did not raise major objections to the application of the Definition to commissioned based securities salespersons. Many states already hold stock brokers providing investment advice to fiduciary standards.

One issue that was the subject of comment was whether the SEC should be the primary regulator in this area. There are pending proposals that the SEC promulgate companion rules applicable to all retail security sales and not just sales to IRA customers.

However, it is now clear the DOL will have primary jurisdiction over IRA investment standards in the future for several reasons. First, not all products potentially sold to IRA customers satisfy the definition of a security. In addition, the DOL already has jurisdiction over two of the three alternative forms of retirement investments - defined contribution plans and defined benefit plans. Logic dictates that ERISA standards apply to all forms of retirement investments. The DOL is the sole agency that supervises retirement plans subject to ERISA. However, the SEC is the sole regulator of investment advisors and broker dealers and most IRAs are invested in securities also falling under the SEC's jurisdiction. Further study of the "dislocations and disruptions" issue under the executive order, may support the conclusion that the SEC, as the agency that has traditionally regulated the securities industry issue the final rules governing the disclosure requirements and sales practices of registered securities firms.

Key elements of fiduciary status include avoiding conflicts of interest, such as receiving undisclosed compensation for recommending and selling the product. A fiduciary must also ensure that the investment is suitable to the investor's needs, economic means and investment goals. Finally, in most cases the product and the customer's overall retirement portfolio will need ongoing monitoring to ensure that the investments and allocations continue to meet the customer's needs and reasonable expectations over time.

The Best Interests Contract and Prohibited Transactions Exemption Will Receive Further Study

A much more fraught question is the fate of the highly criticized Best Interests Contract (BIC) and Prohibited Transactions Exemption (PTE) elements of the Rule. These provisions allow commission based sales and the sale of certain proprietary products or those in which the firm acts as principal, subject to onerous disclosure and written warranty requirements. The burden imposed by these specific requirements of the Rule are likely to drive many firms out of the business of selling commission based and similar currently popular investment products. Some brokerage firms have adopted early voluntary implementation policies. Such firms have made efforts to steer customers to level fee arrangements to avoid the potential liability risks of the full implementation of the Rule. This has caused a flight to competing firms of brokers whose customer base is composed largely of investors opposed to level fees as opposed to one time commissions. Many sophisticated investors see little value in paying level fees for the mere privilege of being customers, irrespective of account activity or performance. Critics of the Rule argue it will impair customer choice as fewer firms will be willing to take on the compliance burdens and the greater liability risk of traditional commission based services.

The practical effect of the BIC element is therefore a limitation of customer choice, particularly among those who disfavor paying annual advisory fees in lieu of one time commissions. Commentators have noted that the same type of regulation has been implemented in the United Kingdom. Studies show the smaller investor in the U.K. has often been left with inadequate assistance at affordable prices. Many firms that traditionally serviced such smaller investors have completely abandoned that clientele by establishing minimum investment portfolio requirements. Others treat these clients as self-directed and offer only the lowest cost product - such as index funds - to those that are unwilling to sign on as fee based customers.

Thousands of white papers have been submitted to the DOL both before and after the recent executive order was issued. Innumerable changes to the Rule have been proposed. However, the final Rule is likely to have new elements which replace rather than repeal the BIC and PTE components.

In particular:

- The current BIC disclosure and guaranty elements are heavily weighted toward a quantitive individual product sale test. They clearly favor level fee based securities professionals with whom the DOL has more familiarity given its existing oversight of the administration of pensions and plans under ERISA.

The final Rule is likely to have better overall definition and qualitative elements. This could include the service guarantees a commission based salesperson agrees to provide in connection with the establishment of an IRA account. Amortized over time, the commissions charged as part of such a service package could provide a more economically reasonable and affordable option than the payment of annual fees over the life of an account to a financial advisor.

- The new administration, like previous Republican administrations, advocates tort reform. The DOL may seek to streamline and simplify the disclosure requirements of the Rule and eliminate the class action waiver prohibition. It may also reject the prohibition on exculpatory provisions. Customers traditionally warrant in the subscription and application process that they had conducted personal due diligence by reviewing written disclosures on the product and its risks. These written disclosures and warranties are important in the defense of many investment suitability cases.

What This Means for Agents and Brokers Today

The adoption of the Investment Fiduciary Definition will subject a large nationwide salesforce of life insurance agents and others who sell investments destined for IRAs, including self-directed IRAs, to federal fiduciary standards. The days of caveat emptor ("let the customer beware") state law standards will come to a sudden end this June. Agencies employ these agents will have to enhance and modify their agent trainings and systems to ensure compliance with the new ERISA standards.