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POTENTIAL IMPACT OF THE NEW DEPARTMENT OF LABOR FIDUCIARY RULE

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BACKGROUND - The Department of Labor's (DOL) new Fiduciary Rule essentially broadens the definition of investment advice, making routine broker-dealer activity in connection with retirement plans subject to fiduciary duties. This represents a dramatic change for the broker-dealer community, which until now has relied upon certain technical regulatory exemptions to avoid being deemed a fiduciary when advising retirement plan clients. Broker-dealers will now have to analyze how they conduct their business, assess the costs and benefits of transacting certain lines of business, as well as implement and enforce policies and procedures to ensure compliance with the law's new and enhanced duties.

THE DOL? What is the DOL's interest in developing a Fiduciary Rule which governs the investment community? The DOL is responsible for oversight of employer sponsored activities, such as retirement plans, ERISA plans, 401(k) plans and IRAs. Until now, certain regulatory exemptions helped avoid a conflict between the DOL, Securities and Exchange Commission (SEC) and FINRA, particularly as to IRA accounts.

WHAT HAPPENED? The world has changed. Public trust and confidence in investment professionals is at an all-time low due to financial scandals (e.g., Madoff) and investor distrust of aggressive, commission based salespeople whose advice is perceived to be solely self-serving. As the population ages and lives longer, elected officials look to protect investors saving for retirement. In the face of these events and changes, (including the Dodd Frank Legislation passed by Congress in July 2010), the SEC has defaulted by doing nothing. It has not developed its own Fiduciary Rule for consideration or comparison. SEC Chair White claims it is her intention to do so, but with only 3 sitting Commissioners, and 2 Commission seats open, the hope for new term action from the SEC is dim. Therefore, the investment community is forced to abide the DOL's effective usurpation of rulemaking authority.

WHAT IS ANTICIPATED IMPACT OF THE NEW FIDUCIARY RULE? It is inevitable that the Fiduciary Rule will cause shocks and tremors, especially in FINRA arbitrations. Arbitrators will have a new, higher standard of conduct to apply to brokers. A discussion of some of these anticipated effects include:

CLASS ACTIONS – The DOL Fiduciary Rule mandates that clients have the right to bring a class action. Class actions are prohibited in FINRA arbitration. So, to the extent that there is an alleged problem with an investment common to all ERISA plan, 401(k) or IRA investors, a class action lawsuit can be filed. If a class action is filed, defense costs will certainly be higher. But it is not likely that the Fiduciary Rule alone will give rise to many new class actions. Securities class actions historically have dealt with either a patently defective investment product which effective due diligence should have caught, or misrepresentations in written offering materials affecting all investors – and not the garden variety individual suitability claims styled as a breach of fiduciary duty in the typical FINRA arbitration.

CLAIMS SHOULD INCREASE – Expect an increase of claims. Claimants' lawyers in FINRA arbitrations have a new theory or argument to make, and financial professionals should expect counsel for investors to opportunistically test the viability of the argument and gauge Arbitrators' receptivity and interest. This will be exacerbated by the fact that most arbitration panels now consist of all public arbitrators, all of whom have read/heard so much about the new DOL Fiduciary Rule. Arbitrators, many of whom possess no legal or securities industry background will be unable to resist the temptation to play judge and jury. While the law doesn't strictly apply in arbitration, claimants' lawyers will no doubt latch on to the new rule to trumpet a broker's heightened duties to his/her clients.

BREACHES OF FIDUCIARY DUTY WILL LIKELY BE TREATED HARSHLY - Defense lawyers have routinely seen breach of fiduciary duty claims in typical FINRA Statements of Claim. Claimant's counsel frequently argue the existence of a fiduciary duty in arbitration hearings. In response, respondents have argued that the ordinary, arms' length broker-customer relationship is not so inherently special or unique as to automatically give rise to fiduciary duties, and there is ample legal authority to support this position. With the new Fiduciary Duty Rule, however, the debate over the existence of fiduciary duties owed to IRA account holders ends. Brokers indisputably owe fiduciary duties of loyalty, impartiality, to avoid conflicts, to use care and skill, and to exercise caution as to those customers. In other words, brokers and insurance agents must act in the customers' best interests first and disclose all conflicts that might prevent them from doing so (e.g., disclosing commissions, revenue sharing, soft dollar compensation, 12b-1 fees, etc.) This is new ground for both brokers and insurance agents, and broker-dealers and insurance companies alike will have to develop, implement and enforce procedures to disclose and mitigate conflicts of interest. Compliance departments will be tested. Investment professionals and clients will have to be educated. Given public sentiment, it is anticipated that a breach of the Fiduciary Rule will be dealt with harshly, and requests for rescission of investments and disgorgement of compensation will increase.

WHAT TYPES OF INVESTMENTS ARE MOST LIKELY TO BE IMPACTED? Any tax beneficial investment in a retirement plan account – such as an annuity – will be impacted in some way. Other investments are more difficult to predict. There will be some tumult, a "sorting" if you will, as people stumble through the new Fiduciary Rule issues. The DOL and the SEC are clearly not in sync, and while the SEC ultimately will not default, whatever the SEC finally does will inevitably conflict to some extent with the DOL's Fiduciary Rule. So, that will cause uncertainty. Regardless, the markets always "speak" to us. Recently, oil and gas investments have suffered. As a result, it should come as no surprise if we see increases in claims by oil and gas investors suggesting that the prospects of investment success were unreasonably inflated given prevailing circumstances.

SUITABILITY, DISCLOSURE AND MONITORING - The suggestion will be made that hard earned retirement dollars should be preserved at all costs, and risk oriented investments intended to hedge against inflation are inappropriate for average retirement oriented investors (except possibly small doses.) Investment professionals will be expected to disclose all forms of compensation and possible conflicts of interest. There is now a continuing duty to monitor investments after sale, and to suggest strategic and portfolio changes as appropriate. In other words, a financial professional's job is now never done.

NEW EXPOSURES – Early Fiduciary Rule arbitration awards will be watched with great interest. As indicated, the number of claims and the severity of suitability awards are expected to increase. But, because arbitration awards typically aren't explained, care must be taken not to draw broad, sweeping conclusions from early results which may be anecdotal. A pattern will likely become perceptible in the range of 10-20 FINRA arbitration awards, which, given the life cycle of a FINRA case, likely means waiting for a couple of years.

About The Author:

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