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The Department of Labor Fiduciary Rule:
Likely Impact on Securities Arbitration and Litigation Claims

by Barry R. Temkin

Since passage of the Dodd Frank Wall Street Reform and Consumer Protection Act in 2010, the momentum has been towards adoption of a uniform fiduciary standard for all financial advisers, whether registered representatives or registered investment advisers. In 2016, The Department of Labor ("DOL"), under President Obama, proposed a series of rules and regulations, published in the federal register, to impose a fiduciary standard upon financial advisers giving investment advice to retirement investors, primarily in individual retirement accounts. These new regulations were intended to eliminate conflicts of interest in financial advice to IRA investors by implementing impartial conduct and disclosure standards. The DOL fiduciary regulations were prompted in part by a perception -- fueled by years of class action litigation and investor activism -- that retirement commissions and fees often benefited advisers more than investors. As former Secretary of Labor Thomas Perez explained, the DOL Fiduciary Rule "boils down to a very simple concept: If someone is paid to give you retirement investment advice, that person should be working in your best interest."[1]

On February 3, 2017, President Trump issued a memorandum directing the DOL to undertake a review of the proposed fiduciary rule to ascertain "whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice."[2] President Trump specifically directed the DOL to investigate whether the fiduciary duty rule was likely to harm investors by reducing their access to retirement savings offerings and whether it was likely to give rise to unnecessary litigation, the cost of which might be passed on to consumers.

On May 22, 2017, Labor Secretary Alexander Acosta announced that the DOL would institute partial implementation of the fiduciary rule on June 9, 2017 "with full implementation on January 1, 2018."[3] The DOL announced that certain parts of its regulations would go into effect on June 9, while other regulations would be delayed, pending further study and review, "as directed by the President," until January 1, 2018. What went into effect on June 9 was implementation of impartial conduct standards requiring financial advisers to act as fiduciaries in the best interest of IRA customers. These standards require retirement advisers to exercise reasonable prudence, defined as the care, skill, prudence and diligence that a prudent person would use in giving retirement advice, based on the investment objectives, risk tolerance, financial circumstances and needs of the retirement investor. In addition, the impartial conduct standard requires advisers to act in the best interests of their IRA customers, rather than those of the adviser or firm, to charge no more than reasonable compensation, and to abstain from misleading statements about the investment transaction, compensation and conflicts of interest.

Deferred until at least January 1, 2018 (and possibly indefinitely, depending on the DOL's review), are implementation of the documentation required by the DOL best interest contract exemption, which requires disclosures and written contracts for advisers who are compensated by commission or any basis other than a level fee. On August 9, the DOL proposed pushing back the January 2018 compliance deadline by eighteen months, until July 2019.[4] Thus, it is likely that the best interest contract exemption will be delayed for two years, if not indefinitely.

Notably absent from the movement towards a uniform fiduciary standard was the Securities and Exchange Commission, which had issued a report in 2011 recommending such a standard, but has not promulgated its own rules over the ensuing six years. The Trump Administration and Congress have expressed opposition to the fiduciary rule. To put it mildly, the

current state of adviser regulation is unsettled and inchoate.

This article will briefly analyze the impartial conduct and disclosure requirements set forth in the DOL's fiduciary regulations, and consider their potential implication for future litigation and arbitration claims, should the rules be fully adopted. In so doing, the author does not venture any option on the merits or likely success of any potential future arbitration or litigation claims. Moreover, given the unsettled nature of the regulations, which are under review by the DOL, many of the predictions in this article are by nature speculative.

Status Of Uniform Fiduciary Rule and Best Interest Contract Exemption

As mentioned, the retirement services industry is currently in a transition period, in which the DOL impartial conduct standards are in effect, but compliance with the DOL best interest contract exemption has been held in abeyance, pending further studies and review, until January 1, 2018, and potentially later.

Historically, registered representatives have not been held to a fiduciary standard unless they charge a level fee or have written discretion to manage customers' funds. A registered representative who receives only commissions had been held to a mere negligence standard, whereas an adviser who charges a level percentage advisory fee was traditionally held to a fiduciary standard.[5] Moreover, securities arbitrations have been generally governed by the FINRA "know your customer" rule, which requires only that an adviser have a reasonable basis, viewed at the time of the recommendation, for making a recommendation.[6] Under existing FINRA rules, there is no explicit obligation for a commission-based broker to act as a fiduciary or otherwise place the customer's interests before those of the adviser herself.

Those principles changed for retirement accounts on June 9, 2017, with the implementation of the impartial conduct regulation. Regardless of whether brokers and firms are ultimately required to execute contracts and make written disclosures under the best interest contract exemption, retirement advisers are now fiduciaries, may not charge unnecessary fees and must avoid conflicts of interest.

Impartial conduct requirements are imposed by the regulations upon all retirement advisers, regardless of compensation. Level-fee fiduciaries, by definition, are compensated with a percentage of assets under management, and are subject to the Impartial Conduct Standards of Section II (e). (See § II (h) (2); 81 Fed. Reg. No. 132 at 44778). Additional requirements in Section II of the regulations apply to commission-based advisers who ultimately seek to utilize the Best Interest Contract exemption.[7] According to the DOL, "Financial Institutions and Advisers seeking to rely on the [BIC] exemption must adhere to Impartial Conduct Standards in rendering advice regarding retirement investments."[8] These standards, which went into effect on June 9, require financial institutions and their advisers affirmatively to undertake the following when invoking the Best Interest Contract Exemption for retirement accounts: 1) provide competent advice in the best interest of the retirement investor; 2) charge reasonable compensation; and 3) eschew misrepresentations. In addition, the financial institution must warrant that it has adopted written policies and procedures designed to ensure that its advisers comply with the impartial conduct standard, to winnow out and disclose any conflicts of interest and to avoid quotas, bonuses or other production goals or rewards which might create incentives contrary to the investors' best interests.[9]

While level-fee and BIC advisers must both adhere to the impartial conduct standards for retirement accounts, additional requirements may ultimately be imposed on the latter. Deferred until at least January 1, 2018 – and potentially as late as July 2019–are implementation of sections (a) and (e) of Part II, which require preparation of written best interest contracts and disclosure to retirement investors promising, in writing, to adhere to the fiduciary standard.

Thus, Section II (a) of the new regulations purports to require the firm and advisers to enter into contracts with IRA investors providing for implementation of fiduciary standards for commission-based compensation. The DOL regulations provide that: "The contract must be enforceable against the financial institution."[10] This contract can be freestanding or else incorporated into the advisory firm's existing customer agreement or new account application.

The 2016 DOL fiduciary regulations posit that the written best interest contract should:

1. state the best interest standard;
2. describe material conflicts of interest, and disclose fees or charges;
3. notify the investor of his right to obtain copies of the financial institution's policies and procedures;
4. provide a link to the financial institution's web site;
5. disclose any proprietary product or third party payment in connection with the recommended investment;
6. provide contact information for a representative to discuss concerns about advice;
7. describe whether or not the financial institution and adviser will monitor the investments on an ongoing basis.[11]

In addition, the firm would be required to maintain a website disclosing its business model, conflicts of interest, a

schedule of typical account or contract fees, a model contract, and a description of the firm's policies and procedures.

A streamlined condition applies to ERISA plans and level-fee fiduciaries in Section II (h) by which they simply affirm their fiduciary status in writing and agree to comply with the impartial conduct standards. Bank networking arrangements must only comply with the impartial conduct standards.

While, as mentioned, there is a great deal of uncertainty about the regulatory landscape, and which, if any, regulations will still be in effect when the dust settles in January 2018 or July 2019, the securities industry has already devoted significant resources to implementing the fiduciary rule. Industry representatives have reported that most firms, particularly larger broker-dealers, are pressing forward with implementation of the fiduciary rule for a variety of reasons. Some firms have already devoted significant resources in terms of money and personnel to designing and implementing compliance procedures under the rule; other firms believe it is simply good business to comply with the DOL fiduciary rule and, in any event, consistent with the firm's advertisements to the investing public.[12]

Several U.S. District courts have upheld the DOL fiduciary rules against a challenge by industry litigants, including the Chamber of Commerce, which had sought to enjoin enforcement of the regulations on the grounds that they would have imposed an undue burden on the securities industry.[13] The court noted in its opinion that the DOL had agreed to delay regulatory enforcement actions under the rules.

Investment Advisers

The new DOL fiduciary rule is unlikely to have a significant impact on level-fee fiduciaries, who charge management fees based on assets under management rather than commissions. Level-fee advisers are exempted from the requirements of most provisions of the SEC best interest contract rule, specifically Sections II (a) (b) (e) (f) (g), III and V, and are not required to enter into best interest contracts. Rather, level-fee fiduciaries must simply furnish investors with written acknowledgement of their fiduciary status, and comply with the impartial conduct standard of Section II (c) of the regulations, which, as discussed above, requires acting in the investor's best interest, charging reasonable compensation, and avoiding misleading statements – standards which are already in effect under existing law. The primary new requirement for level-fee fiduciaries under Section II (a) is that the financial institution document specifies reasons to justify a recommendation to rollover an ERISA plan to an IRA.[14] According to the DOL, "This documentation must include consideration of the retirement investor's alternative to a rollover, including leaving the money in his/her current employer's plan, if permitted, and must take into account the fees and expenses associated with both the plan and the IRA . . ."[15] Thus, an adviser recommending the rollover of an ERISA plan into an IRA must be prepared to document and justify the reasons for the move in the best interest of the customer.

Grandfathered Exemption

Section VII of the DOL regulations provides an exemption for pre-existing transactions.[16] This exemption permits advisers and financial institutions to charge commissions and 12b-1 fees in connection with the purchase, sale, exchange or holding of securities acquired prior to the June 9 applicability date. These grandfathered retirement transactions are exempted from the regulations provided that they meet the following conditions: 1) compensation is received pursuant to a pre-existing, current agreement; 2) the transaction is not otherwise prohibited pursuant to ERISA; 3) compensation is not connected to a fresh investment; 4) the compensation is not unreasonable. Any investment recommendation made after the June 9th applicability date must comply with the duty of care and diligence set forth elsewhere in the regulations.

Anticipated Impact on Litigation and Arbitration Under the DOL Fiduciary Rule

Given the uncertainty regarding the ultimate status of the DOL regulations, their delayed effective date and the possible role of the SEC, it is a daunting task to predict the effect that the fiduciary standard may have on future litigation and arbitration. Nonetheless, some speculations seem more plausible than others.

By its very nature, the DOL fiduciary rule is intended to eliminate conflicts of interest, increase the scrutiny of financial advisers and give rise to breach of contract claims for violation of the best interest contract exemption. Thus, to the extent that the DOL fiduciary regulations are fully implemented, they can be expected to result in an increase in claims, both quantitatively and qualitatively.[17] With or without the BIC contract exemption, the DOL rules are likely to foment additional litigation, and to increase claimants' arbitration victory rates from their current lackluster rate of approximately 40%.[18] While the merits and ultimate success of future litigation are speculative and difficult to predict, it does seem likely that it will be expensive to defend.

These obligations, as explicated in more detail in the DOL 2016 Frequently Asked Questions, are likely to result in more litigation and arbitration, and more success by customers in those proceedings.[19] These FAQs explain a number of different issues that may be raised under the DOL fiduciary rule. For example, as the DOL explained in 2016, firms must be careful to avoid conflicts of interest in their compensation structure.[20] The DOL FAQ point out that substantial forgivable promissory notes or other bonuses which reward brokers for hitting large commission goals or quotas could create an "acute conflict" by incentivizing advisers to engage in active trading in order to meet the bonus or quota objective.[21] The DOL

also has invited scrutiny of commission compensation grids by which there are significant jumps from one grid to the next. The lure of a significant bonus, according to the DOL, could give rise to a conflict of interest.

The DOL notes that a retirement fund rollover from an ERISA account to a fee-based account could be subject to scrutiny, and possibly an investor claim, if the additional fee, even if a level advisory fee, does not result in significant benefit to the investor. The DOL has further warned of the possibility of reverse churning, by which an investor with a buy and hold strategy undertakes no transactions in the IRA, yet is charged an annual management fee by the advisor for doing essentially no work at all. These sorts of claims could also result in litigation or arbitration.

There are various other potential claims that could be brought under the DOL fiduciary rule. One consumer advocate predicts "that enforceable contract provides a hook for litigation."[22] In addition, as the DOL has suggested in its FAQs, an adviser held to the fiduciary standards has a continuing duty to monitor retirement accounts, and to advise customers when to make a move in existing holdings. This represents a departure from previous FINRA regulations and from the Second Circuit's 2006 decision in DiKwiatkowsky v. Bear Sterns, which held that a broker compensated on a commission basis was not a fiduciary and did not have an ongoing duty to monitor or advise sophisticated customers about existing investments.[23]

FINRA arbitrations are likely to see a substantial uptick in customer claims. Of course, FINRA touts itself as a forum of equity, and FINRA arbitrators are taught in their training materials that they are not required strictly to follow the law in making their decisions.[24]

Nonetheless, with or without the best interest contract exemption, the impartial conduct standards are likely to have a significant impact on FINRA arbitrations, and represent an important tool in the hand of skilled claimants' lawyers. Under existing FINRA standards, a customer must show, in the event of a suitability claim, that the recommendation lacked a reasonable basis in light of the investment objectives, securities holdings and risk tolerance of the customer. Conversely, an adviser may defend an arbitration claim by arguing that while he may or may not have recommended the best product for the customer, the adviser's recommendation had a reasonable basis. Now, with the advent of the fiduciary standard, these claims would be harder to defend, and the existence of alternative reasonable investments may be used to argue that the recommended product was not in the customer's best interest.

Similarly, experienced defense lawyers frequently point to the customer's sophistication, investment experience, and financial acumen, arguing that the customer understood the risk and cost of the investment, and should assume responsibility for any losses in the account. These defenses could prove harder to sustain in the new environment, as a fiduciary is expected to give beneficial advice in the best interests of even the most sophisticated investor.

Also, claimants' lawyers can be expected to launch new and creative attacks based on alternative or conflicted fee structures, and proprietary house products are likely to undergo even more scrutiny with the impetus of the new fiduciary rules.

There might be a spillover effect in hybrid arbitration claims, which include, as is often the case, claims from both qualified and non-qualified accounts. A claimant's lawyer who seeks relief with respect to both qualified and non-qualified accounts is likely to argue that the same fiduciary standards should apply to both, and it is difficult to imagine an arbitrator applying different standards to two accounts managed by the same adviser, particularly in situations in which the alleged conduct is similar.

Also, the duty to avoid misrepresentations is imposed upon advisers under the impartial conduct rule. Claimants' counsel might argue that this duty should be applied regardless of intent or scienter and could result in liability to advisers who negligently or inadvertently convey incorrect information. Thus, advisers and firms could be subject to claims -- whether meritorious or not -- arising from an error or omission in a prospectus or private placement memorandum that they are not even aware of, or of a commission or charge not beneficial to the investor.

While most customer complaints are adjudicated in FINRA arbitrations, some are still litigated in court for a variety of reasons. The advent of the uniform fiduciary standard could complicate traditional court litigation where, contrary to the practice in FINRA arbitrations, judges are not reluctant to apply the law, and losing parties have the right to appeal. Application of the fiduciary standard is likely to make it more difficult for financial institutions to prevail on some summary judgment motions or motions to dismiss in court inasmuch as compliance with a fiduciary standard imparts a higher duty which is more likely to be fact-intensive.

Finally, as if the foregoing were not sufficiently complex and unsettled, the securities industry continues to await action by the SEC, which was specifically invited by Labor Secretary Acosta to participate in the rule-making process. In his *Wall Street Journal* article, Secretary Acosta wrote that: "Under the Obama administration, the Securities and Exchange Commission declined to move forward in the rule-making. Yet the SEC has critical expertise in this area. I hope in this administration the SEC will be a full participant."[25] The SEC has accepted Acosta's invitation and re-opened its 2013 request for comments on uniform fiduciary standards, which it was directed to study in the 2010 Dodd-

Frank Wall Street Reform Act. A decision by the SEC to adopt a uniform fiduciary standard for advisers could tip the scale towards that result or even possibly take an issue out of DOL's hands. Conversely, an abstention by the SEC could hand the field over to the DOL.

Conclusion

There is considerable uncertainty during the transition period pending DOL review of the Obama-era fiduciary rules for retirement accounts. During this period, advisers who do not receive level-fee compensation are held to the DOL impartial conduct standard for retirement accounts, but are not required to enter into best interest contracts for commission-based compensation. Under these impartial conduct standards, advisers are required to make recommendations in the retirement investor's best interest, charge reasonable compensation, and avoid misleading statements. Additional requirements, including the proposed best interest contract requirement, and web-based disclosure are deferred to at least January 2018 and are under review by the DOL. Moreover, the DOL, at the time of writing, has proposed delaying full implementation of the fiduciary rule another 18 months, to July 2019. An additional wildcard, as if one was needed, involves what role, if any, the SEC elects to assume and whether the Commission accepts Secretary Acosta's invitation to participate in the regulatory process.

In the interim, the DOL impartial conduct standards are likely to result in more litigation and arbitration, and a higher success rate for investors' representatives. If and when the BIC exception goes into effect, these claims will include breach of contract. Even under the impartial conduct standards in effect now, these additional claims may include and be based upon a variety of theories, including, (a) "reverse churning" in which fee-based accounts are utilized for low-activity customers; (b) failure to properly document a rollover from an ERISA account to a fee-based IRA; (c) firm compensation based on quotas and bonuses which create incentives contrary to the customer's interest; (d) compensation grids which incentivize advisers to engage in more active trading; (e) purchase of class A mutual funds or other securities with front-end commissions which are subsequently moved into an advisory account.

Endnotes

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