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Fiduciary Rule Update

The roller coaster ride that has been the controversial Fiduciary Rule recently took a couple more hairpin turns. First came the news that the U.S. Department of Labor (DOL) officially delayed full implementation of its version of the rule. The DOL was quoted in an article published on March 16th by Bloomberg Law as saying, "Pending further review, the Department will not be enforcing the 2016 Fiduciary Rule." Then on April 18th, the U.S. Securities and Exchange Commission (SEC) announced its proposed version of the rule, which, to nobody's surprise, is not as strict as the DOL version. Below we provide our point of view, as well as responses from some of our clients on what we might expect to see happen in the near-term.

The Latest Ruling and SEC Response

The most significant shift in momentum to date took place on March 15th, when the U.S. Court of Appeals for the Fifth Circuit, struck down the Fiduciary Rule in a divided ruling. This occurred after finding out that the DOL overstepped its regulatory authority by redefining an investment advice fiduciary under ERISA. The Court held that the reinterpretation of a fiduciary unreasonably expanded such status to parties appropriately regulated by the SEC.

The result was a delay in the requirements that investment advisor retirement plans and Individual Retirement Account (IRA) owners use to ensure their compliance with the impartial conduct standards. These involve providing clients with certain disclosures, warranties, and contract provisions, and adopting sufficient compliance policies and procedures. While this occurred in the Fifth Circuit, the impact is nationwide. The entire Fiduciary Rule was invalidated "in toto"; the result being that neither the impartial conduct standards nor the procedures and disclosures rules that were put forth by the DOL under the previous administration are in force at this time. Granted, different rulings have been issued on this topic in other circuit courts. This split among circuits begs the question as to whether this matter may go before the Supreme Court.

However, the scales are tipping to an outcome the brokerage industry has long awaited—a more appropriate regulatory body, such as the SEC, to define and enforce standards of care. On March 19th, the SEC almost immediately proclaimed that it intended to further its less onerous advisory compliance model, which was announced on April 18th. The fundamental difference in the SEC vs. DOL versions is maintaining some form of the legacy suitability standard as opposed to the best interest standard. This lower threshold provides firms with greater latitude to continue offering clients a broader choice of products, with less risk involving the types of class action suits identified by firms as being the most dangerous outcomes of the DOL fiduciary rule. Meanwhile, proponents of the DOL version believe that the SEC stance does not go far enough to adequately protect clients.

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What Comes Next?

Our point of view is that while in theory the ruling may have significant implications for wealth management pay practices and other reporting and business structure issues, we don't anticipate much change in practice for the short-term. Most firms have already invested huge sums to comply with the stricter rule and shifted their business to a more discretionary model. This won't be unwound. It is probably difficult, especially from a "court of public opinion" standpoint, to walk back some of the changes already implemented. The increased documentation and client communication requirements DOL demanded will endure. However, the probable new path forward provides more flexibility and lower risk, which will be welcomed by most firms. It will be interesting to see if there are any areas where firms may, indeed, revert back to prior practice.

One is back-end or performance-based recruitment deals. Due to the large jumps in pay that these "all or nothing" deals can yield and the potential conflict of interest they created, some firms quickly abandoned those features, relying totally on front-end guaranteed deals. Other firms maintained their blended deal structures consisting of guaranteed and performance-based compensation. In general, those firms that eliminated back-end deals have remained competitive in the arms race for experienced talent, even with lower total deals. While not a certainty, we might expect those firms who dropped them to resurrect back-end deals, given the allure of paying for post recruitment performance rather than entirely for prior-firm performance. Simultaneously, we will potentially see a continued migration from production-based to asset-based back-end performance thresholds as a safer landing spot from a regulatory / client first perspective. We predict those back-ends to not simply be added onto the front-ends to arrive at previous total deal levels, but rather contribute to a potential "new normal" of somewhat lower total recruitment deals.

In polling our clients, another theme emerged—one that continues further down the path of a fiduciary standard. The topic is different pay for different products, from which the industry has steadily and consistently moved away ever since the Tully Commission, although some subtle remnants do remain. Even if those pay features encourage a fee-based approach, which has traditionally passed the client-first sniff test, they can still introduce potential conflict of interest. Every so often a firm is disciplined for employing such practices. Given that, a few firms are taking a hard look at such FA payout components, and we have every reason to believe that firms will continue that steady march towards total product neutrality. This attitude is also a nod to the prevailing belief that the SEC's final version of the fiduciary rule will have sharper teeth than the legacy version, especially after the public comment process.

As for standard FA compensation plans, predictions of radical wholesale changes and rumors of the commission grid's demise were greatly exaggerated. Some firms made minor changes around the edges, such as increasing the number of steps on the grid, or moving from a year-to-date production total with retroactive payments to rolling 6-month or 12-month production totals with no retroactive feature. Many firms had already moved in that direction, as the associated smoother cash flows are positive all the way around. Those types of changes are expected to continue, and the future of the commission grid appears to be on even more solid footing.

A final overarching, common thread throughout our clients' responses revealed their consistent support of a fiduciary / client standard, but desire for it to be led by the body that oversees all of the business, not just the retirement side. They expected the SEC to promptly follow course, and sure enough, April 18th marked the opening salvo on that front. Firms welcome a uniform standard as opposed to a hodgepodge of rules from multiple regulatory bodies. Perhaps the brokerage industry can emerge from this DOL journey with the best of both worlds – lower risk and flexibility to provide client choice, but with a higher threshold of care than in the past, and the type of greater transparency that is increasingly demanded by today's investor.

To discuss this topic further and share your own opinions, please contact Todd Crowley or Peter Keuls.

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