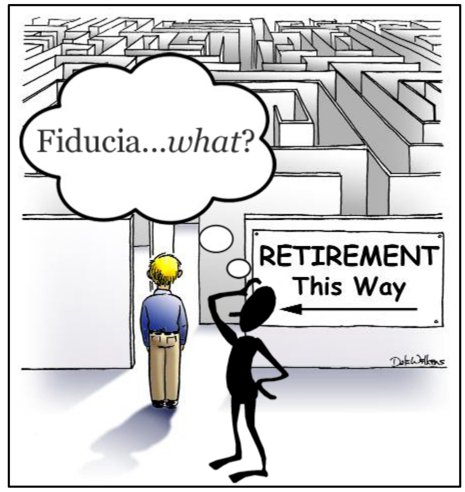
Why DOL's new "fiduciary" rules matter

Navigating the Retirement Maze



"Integrity is doing the right thing, even when no one is watching."
– C. S. Lewis, novelist, theologian (1898-1963)

In 2010, President Obama signed the Dodd-Frank Act into law. One of its directives was to increase investor protection, including rules that mandated the disclosure of information on investment costs, risks, and conflicts of interest by the seller. It also included provisions for the Securities and Exchange Commission (SEC) to impose regulations requiring "fiduciary duty" by investment professionals to their customers.

Five years later, the SEC had yet to issue any fiduciary standard, explaining that the subject required further study. The idea of imposing a broad fiduciary standard was assailed within Congress, most likely at the urging of their Wall Street patrons who feared that such a rule would significantly constrain their current business models. (Read: "Make profits the way that they always have.")

Well, surprise. In what amounted to an end run around the SEC, the U.S. Department of Labor (DOL) decided that it would impose its own fiduciary standard on all of the investments that came under its purview, namely all retirement accounts (IRAs, 401(k)s, etc.). As this comprises over a third of total U.S. household assets according to the Investment Company Institute, the financial industry took notice. Panic ensued. Lobbyists were unleashed. However, efforts by Congress to forestall these new rules were repeatedly blocked by the Administration. Much to Wall Street's consternation, the DOL announced the rules earlier this month.

So what? How does this affect you as an individual? Pay attention to the following, because it falls under the classification of "boring but important." It will have a major impact on the investment advice you get, the products that you are sold, and the fees you pay on your retirement accounts. Plus, there is a high likelihood that in the not too distant future, similar rules will cover all of your investments.

What, and who, is a "fiduciary"?

Put simply, a fiduciary has a legal responsibility to act in another party's best interests, and to put that party's interests ahead of their own. Fiduciary comes from the Latin word "fiducia," meaning "trust." Because the investment fiduciary typically has greater knowledge and expertise than the person who they are advising, they are thus held to this higher standard.

Licensed investment advisors (Series 65 registration) are already legal fiduciaries. (Note: I have been an investment advisor since I began working in this industry.) Currently, brokers who are licensed by FINRA, the association that oversees their activities, are only required to comply with a weaker standard called "suitability," meaning that the investment sold to the client must be appropriate for that client's particular financial situation. Under the new DOL rules, the fiduciary definition will now apply to anyone who receives compensation for providing investment advice related to retirement plan assets. This includes insurance products, securities, mutual funds, property, and even choosing investment managers.

Why it matters

Although this new mandate will not begin to take effect until a year from now, and the full rules will kick in January 2018, here is what's important to you as an investor. Once you open an account with an advisor or broker for your retirement account assets, you will sign a contract with the firm for which they work that will state that they acknowledge their fiduciary status, will adhere to the "best interest" standard, and disclose any conflicts of interest. This will provide legal protections to you that were not previously available.

Fees will matter more than they now do, because any recommendation to invest in a fund that pays the advisor or broker more than a lower cost equivalent fund will be a clear violation of the fiduciary standard. Expect to see a greater usage of low-cost funds for your investments. You will also receive more thorough information about the fees that you pay.

Much more scrutiny will be given to rollovers from existing qualified (tax-deferred) plans into those offered by investment advisors and brokers. If the Rollover IRA that is being recommended has a higher fee than the existing retirement plan, it will be considered a prohibited transaction under the new rules unless the advisor or broker demonstrates that they are acting in the best interests of the client, and also satisfy a number of disclosure and contractual requirements. Alternatively, the advisor or broker can choose to "educate" the client about the distribution alternatives in a thorough and unbiased way – education does not fall under the fiduciary standard – and then the client can make the decision on their own to roll over their IRA assets.

It will be interesting to see how this last scenario plays out in the marketplace, as there will definitely be a gray area between "unbiased education" and "selling one's services." The tort lawyers are already salivating over the prospects for litigation here. Investment professionals will need to document their conversations and recommendations to clients even more thoroughly than they currently do.

What to look for

There are some other points worth noting. In particular:

- Variable annuities (VAs), those complex and often expensive hybrid insurance-investment products, received an exemption permitting "differential compensation" because of the additional time that it takes to explain them to clients. However, the standards for selling them will be tightened as of 2018.
- Proprietary products (those managed by the broker's or advisor's employer) are still permitted, though the commissions and/or fees must be disclosed to the investor.
- These rules do not apply to non-retirement accounts. The SEC is responsible for regulating those.
- As the DOL has limited resources, no one knows how these rules will be enforced. Lacking direct enforcement, penalties for transgressions may well get decided by the courts.

Once fully implemented, these new rules should help curtail excessive compensation by financial professionals, as well as provide you with better information to make informed choices about your investments and advisors. So will these new rules increase consumers' trust in the financial community, which currently sits somewhere between that of lawyers and members of Congress, according to Gallup? Maybe not, but at least the DOL's new regulations will increase the protections provided for the average retirement investor, as well as increase the public's awareness of why they should insist on a fiduciary to manage all of their investments.

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