Part 2 of Undisclosed (and Disclosed) 12b-1 Fees: Interesting Angles on the DOL's Fiduciary Rule #83

Article By:

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This is my 83rd article about interesting observations concerning the Department of Labor's (DOL) fiduciary rule and exemptions. These articles also cover the DOL's FAQs interpreting the regulation and exemptions and related developments in the securities laws.

In last week's post (**Angles #82**) I discussed the fiduciary and prohibited transaction rules that should be considered in light of the SEC's "Share Class Selection Disclosure Initiative" ("SCSDI"). As a refresher, the SCSD Initiative is a self-correction and self-reporting program where RIAs can identify, correct and report failures to adequately disclose the receipt of 12b-1 fees in addition to their advisory fees. My article discussed the consequences under the DOL's guidance for the receipt of 12b-1 fees—on top of advisory fees—for both non-discretionary investment advice and discretionary investment management, where the results are quite different.

This article builds on that. The topics for this article:

- When will, or could, a recommendation of a higher-cost share class (and, therefore, a more expensive investment) satisfy the best interest standard of care (that is, the prudent person rule and the duty of loyalty)?
- What kind of disclosure of 12b-1 fees would be adequate under the fiduciary rule?

Let's look at each of those issues.

When will, or could, a recommendation of a higher-cost share class (and, therefore, a more expensive investment) satisfy the best interest standard of care (that is, the prudent person rule and the duty of loyalty)?

As a general principle, a fiduciary adviser should not recommend or select investments that are more expensive than reasonable and necessary. That is one of the considerations under the prudent man rule and under the duty of loyalty. On the other hand, investment advisers are entitled to receive reasonable compensation for their services.

A fiduciary adviser could recommend mutual funds that pay 12b-1 fees as long as the total compensation to the adviser and the firm does not exceed a reasonable amount and as long as the cost of the investment (*e.g.*, expense ratio) is not unreasonably high. (This assumes that there is adequate disclosure of the 12b-1 fees.) So, for example, if an adviser recommends a mutual fund that has a 1% expense ratio, and 25 basis points is paid as 12b-1 fees, the reasonableness of the cost for the mutual fund should be the net expense ratio, or .75%. The adviser needs to determine whether that cost is appropriate and reasonable for the particular qualified account.

On the other hand, if the payment of the 12b-1 fee to the adviser's firm—when added to the advisory fee—results in excess (or "unreasonable") compensation for the services, the compensation would not be justifiable and it could mean that the cost (or expense ratio) of the mutual fund was unreasonably expensive (since the cost of the 12b-1 fee was not justified). The former is a prohibited transaction and the latter is a fiduciary breach.

In a nutshell, the prudent man rule and duty of loyalty require an evaluation of the cost of the investment (*e.g.*, mutual fund). However, that analysis is connected at the hip to the reasonableness of the adviser's compensation.

What kind of disclosure of 12b-1 fees would be adequate under the fiduciary rule?

While the Department of Labor ("DOL") hasn't issued any specific guidance on this subject, it has issued guidance about disclosures of compensation in other situations. For example, the DOL's 408(b)(2) regulation requires that service providers disclose their compensation to plan fiduciaries. While 408(b)(2) applies only to compensation for plan services, it may help understand the expectations for other fee disclosures under the fiduciary rule.

Simply stated, the 408(b)(2) guidance is that the retirement plan fiduciaries must be provided with adequate information to make two determinations. Those are:

- Whether the compensation of an adviser and the firm is reasonable relative to the services provided.
- Whether, and to what extent, an adviser and the firm have conflicts of interest.

With that understanding, it seems reasonable to think that the expectation of the fiduciary rule is that the disclosures would enable an investor to calculate a relatively accurate estimate of the compensation paid. For example, it would be risky to say that the adviser or his firm "may" receive 12b-1 fees. The question is, would a reasonable person be able to approximate the total compensation based on that information. Another example would be where the disclosure is that the firm will, in addition to the advisory fee, receive 12b-1 fees in the range of -0-% to 1.00%. Again, the issue is whether the investor can reasonably calculate the total compensation when provided with that information.

A significant risk is that, where the disclosures are inadequate, the adviser and the firm are receiving compensation that was not approved—and that the DOL and IRS would take the position that the payment was a prohibited transaction.

These rules—and particularly, the prohibited transaction rules—are complex and, if not understood, can result in significant problems.

However, once understood—and with appropriate disclosures and agreements—compliance is not conceptually difficult.

The views expressed in this article are the views of Fred Reish, and do not necessarily reflect the views of Drinker Biddle & Reath.

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