"Integrity is doing the right thing, even when no one is watching."

Anonymous

Fiduciary Duties and the New DOL Fiduciary Rule

By James K. Tonrey, Jr., Chief Executive Officer

Over the past year, we have fielded questions from both clients and prospective clients regarding the Department of Labor's (DOL) new Fiduciary Rule that was to take effect this month. The new administration this past February, however, issued a memorandum that will delay its implementation for at least a few more months for further discussion and review. Regardless, it will be an important potential change for the investment industry. As such it should be understood by all investment advisory clients.

A little background is necessary before diving into the potential new regulations. Stillwater Investment Management is an independent advisory firm registered with the Securities and Exchange Commission (SEC). This registration does not suggest we are any better than another firm, have any higher level of education, or that the SEC has approved or recommends our service. It simply means that we are regulated by them and thus subject to their rules just like everyone else. The most important element of this regulation is the *fiduciary standard*. We must act in the best interests of our clients and treat their accounts with the same care and diligence as if they were our own. Essentially, we must put the interests of our clients above our own at all times. Two of the most critical components of this standard are to reduce/eliminate and disclose any potential conflicts of interest in managing clients' accounts and, secondly, to state in a very clear and concise manner, any and all fees associated with the management of accounts.

In contrast, salespeople or brokers are required to follow a different, less stringent *suitability standard*. Directly from the SEC's website it states, *"When your broker recommends that you buy or sell a particular security, your broker must have a reasonable basis for believing that the recommendation is suitable for you."* It's not hard to conclude that making a recommendation that is suitable with a reasonable basis versus treating the accounts as one's own are night and day. Simply, the fiduciary standard that investment advisors like Stillwater Investment Management adhere to have a much higher threshold of accountability, legal and otherwise, than the current suitability standard that brokers are obligated to follow.

The new DOL's Fiduciary Rule would, in fact, require that all investment advisors, as well as brokers, be held to the higher fiduciary standard when dealing with clients' retirement accounts. This basically means that all brokers working with clients on their retirement planning will have to be registered as an investment advisor. In 2015, President Obama said, *"Today, I'm calling on the Department of Labor to update the rules and regulations that retirement advisors put the best interests of their clients above their own financial interests. It's a very simple principle: You want to give financial advice, you've got to put your client's interest first."*

Many ask… how did we get to this point? There are two historical actions that are relevant in order to understand. The first is the repeal of the 1933 Glass-Steagall legislation. Glass-Steagall was enacted after the Great Depression to try to separate traditional commercial banking from investment banking. Many at the time felt that the depression was caused by the blurring of the lines and that traditional banks increased risk to pursue the more lucrative investment banking areas. This act was intended to keep these two different businesses separate to avoid another financial crisis.

In 1999, sixty-six years later, and frankly after a number of changes in the banking industry, Glass-Steagall was repealed, which allowed banking and investing under the same roof. The recent Great Recession in 2008/09, due in large part to banks aggressive lending and investment practices, has fueled further discussion whether it was wise to repeal. That is a complicated subject for another day but suffice it to say that the recent financial crisis spurred the SEC and DOL to look at how people in the investment industry provided services specifically to retirement plans. It was obvious that the brokerage business was held to a much lower standard.

Another reason for the movement toward equal, full and fair disclosure is more nebulous, but nevertheless, germane. Over the last century, the full-service brokerage industry has always had the most powerful lobbyists and influence-peddlers. They dominate advertising and marketing on television, internet and radio. If you just landed on earth from outer space, you would think that you *had* to hire a broker from one of the large houses to help you with investment decisions. Because of their tremendous influence, brokers have never had to work under the tougher fiduciary rule. The big brokerage firms cite the extra compliance and administrative costs associated with making their employees accountable in a more client centric way. They feel that it would hurt the average investor by increasing costs and thus lead to less service. Maybe an example would give some perspective on just how off balance this reasoning is. Tara S. Bernard in her recent article, *"Even Math Teachers are at a Loss to Understand Annuities",* describes how teachers are railroaded by brokers into putting their hard earned money into annuities to fund their 403(b) retirement accounts. Many of these contracts are so complex she states that even *"a dozen people with Ph.D.'s in math…..took years to master them."* If the new legislation is passed then annuity vendors and their brokers will have to disclose all related fees, sales commissions and costs to clients in an easy to understand format. Once these disclosures are made, the result will be less of these complex annuity sales to the dismay of brokers and their employers. Additionally, the recent fiasco with the brokerage arm of Wells Fargo further highlights the need for broker reform.

The investment advisory business is difficult. Nonetheless, fourteen years ago when we set up our firm we anticipated many of these changes. We decided early on to be a fee-only firm, not to sell products, only bill clients in arrears after the work has been done, to reduce/eliminate and fully disclose conflicts-of-interest, and to make sure our fees were understood and continuously reported to our clients. Any changes Stillwater Investment Management will have to undertake when/if the DOL's Fiduciary Rule is implemented will be minimal. We have always said that clients should maintain as much *control* and *flexibility* over their hard earned money as possible. We have tried tirelessly to put that business model in place. After all, a true fiduciary in the finance field should put themselves in their clients shoes and say…*if I were looking for an investment advisor for my own money, with all the knowledge and experience I have in the investment industry, what type of firm would I hire?* We asked that question of ourselves when we started our firm.

Every so often, this person named anonymous, who writes these oft-read quotes at the top of this quarter's *Market Commentary*, gets it right. Having integrity in anything is just doing what is right…..no matter if anyone ever knows. If the people who dismiss this new fiduciary rule out of hand had only followed that simple universal rule all along, then there would be no need for any changes.

In accordance with SEC regulations, we ask that you contact us in the event there have been any material changes in your financial circumstances or investment objectives, or if you wish to impose any reasonable restriction on the management of your accounts or modify any existing restrictions.