

Asked & Answered: The Dept. of Labor's Fiduciary Rule

A new Department of Labor (DOL) rule requires financial professionals advising retirement savers to advance their clients' best interests above their own profits. Known as the Fiduciary Rule, the White House Council of Economic Advisors estimates that it will save retirement savers \$17 billion annually.¹

What is a conflict of interest?

A conflict of interest arises when financial professionals recommend investments that benefit themselves financially (e.g., high commissions) but are not necessarily in their clients' best interests.

How will the new rule affect me?

Financial professionals who offer advice regarding your retirement accounts must recommend investments that are in your best interests. In other words, financial professionals must act as a fiduciary in regard to your retirement accounts. There is a caveat, however. Advisors can continue receiving commissions if they sign a contract promising to charge "reasonable" fees and disclose conflicts of interest, among other things (see "Will I see new documentation?" on page 4).

What is a fiduciary? Why is important that my financial advisor is a fiduciary?

A fiduciary is required to put his client's interests first and to eliminate or at least disclose conflicts of interest. In contrast, financial advisors who recommend investments based on "suitability" must have a "reasonable basis to believe" an investment is suitable for an investor based on various factors (e.g., age, tax status, investment objectives, liquidity needs, and risk tolerance). Here's a common example: Mutual fund A pays a higher commission to the broker and is more

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Upcoming Events

- Connect and Discover: Empowering Female Business Owners to Prepare for the What Ifs
03/07/2017 | 6:00pm | Mequon, WI
- Workshop: Ten Tips to Prevent and Detect Investment Fraud
01/24/2017 | 10:30am | Mequon, WI
03/22/2017 | 10:30am | Wauwatosa, WI

Exciting News

We are pleased to announce that Melnick & Melnick, S.C. will be moving to a new office space at the end of January. Our new office is located across the street from our current location at:

10600 N. Port Washington Rd., Ste. 101
Mequon, Wisconsin 53092

expensive for the client to purchase and own. The broker can still recommend it as long as it's suitable—even if mutual fund B is much cheaper for the client.

Who must follow the new rule?

Financial professionals—including brokers, insurance agents, and investment advisors—who provide retirement investment advice in exchange for a fee must act in the clients' best interests (i.e., as a fiduciary).

Please see *Asked & Answered* on page 4

Case Study: Conflicts of Interest in Action

The City of Milwaukee and a top Milwaukee investment firm, the Robert W. Baird & Co. Inc., were central to a series of articles recently published by the *Milwaukee Journal Sentinel* that underscored the importance of brokers' disclosures and consumers' understanding of conflicts of interest.

In December, the *Journal Sentinel* untangled a web of competing interests.

- A Baird executive and broker, James H. Herrick, maintained ties to six limited liability companies that owned rental properties in the City of Milwaukee. Some of the rental properties associated with Herrick were "repeatedly cited for violating city building codes and were delinquent on property taxes."
- Herrick failed to disclose his interests in four of the six LLCs to his employer, Baird.
- The City of Milwaukee is a client of Baird, which manages \$38 million for the city.

As a broker registered with the Financial Industry Regulatory Authority ("FINRA"), the nongovernmental agency tasked with regulating brokers and firms, Herrick is required to comply with FINRA's rules and regulations. In particular, FINRA's rule 3270 prohibits brokers from being compensated in relation to "any business activity outside the scope of the [broker's] relationship with his or her member firm" unless the broker provides prior written notice to the broker's member firm. However, "passive investments" and private securities transactions are exempt.

Brokers disclose "Other Business Activities" when registering with FINRA and must update their information within 30 days of "learning of facts or circumstances that prompt an update." According to FINRA's guidelines, on Form U4, brokers must "Enter 'yes' or 'no' to indicate whether [they] currently are engaged in any other business, either as a proprietor, partner, officer, director, employee, trustee, agent, or otherwise."

FINRA requires brokers to make such disclosures to ensure transparency. When a broker discloses "Other Business Activities" to her firm, the firm is then obligated to consider whether the activity will "interfere with or otherwise compromise" the broker's responsibilities to her firm or the firm's customers or affect the firm's customer's perceptions of the firm's business. In this instance, Baird was in the dark and unable to assess whether Herrick's ties to four LLCs compromised his work or the firm's business.

According to the *Journal Sentinel*, Herrick's attorney described Herrick as "a passive investor in the companies" and therefore no disclosure to Baird was required. However, the City of Milwaukee and Mayor Tom Barrett disagreed. Mayor Barrett told reporters that the City would "be interested in knowing that there was a principal who was not disclosing activities that hurt the city."

The newspaper's reporting cast doubt on whether Herrick's relationship with the LLCs was in fact passive, as his attorney claimed. For example, "[f]ive former and current employees of the LLCs told the *Journal Sentinel* that they received instructions on how to maintain the buildings directly from Herrick."

Meanwhile, Herrick amended his disclosure of his "Other Business Activities" to FINRA—where he previously listed his connections to only two LLCs, his updated Broker Report now lists 11.

Additional Information

To review your broker's FINRA disclosures, visit: <https://brokercheck.finra.org/>.

For investment advisors registered with the Securities and Exchange Commission, review their employment and disciplinary history at: <https://www.adviserinfo.sec.gov/>.

Resolve to Better Protect Your Business in 2017

Business owners are so busy getting through their never ending to-do lists that they lose track of steps they should take to protect themselves and their businesses. Move these resolutions to the top of your 2017 checklist.

I will select and create the right entity for my business.

Creating an entity for your business erects a liability barrier between you and your customers, vendors, and the public, for example. Moreover, establishing an entity will force you and your co-owners to address the what ifs of owning a business, for example, what if your partner wants out of the business or passes away. Common entities include:

- Corporation—managed by a board of directors which is elected by shareholders. Certain corporations qualify to elect S corporation status.
- Limited Liability Company (LLC)—has members, not shareholders. Members (all or some) may elect to directly manage the LLC or non-member managers may operate the LLC for the members.
- Other Wisconsin entities include limited partnership and limited liability partnership.

I will search for similar uses of my trademark, tradename, or logo.

If you use a trademark and conduct business in more than one state, consider taking steps to protect your brand. Trademarks identify the source of goods. Although rights to a trademark flow from use not registration, registering your trademark with the U.S. Patent and Trademark Office gives you important rights and adds value to your business, particularly should you decide to sell.

Hiring an attorney or a search firm to conduct a trademark search will alert you if competitors have registered similar marks for related products. Had the U.S. National Park Service run such a search they would have learned that a private company, which ran the park's hotels, restaurants, and shops, registered the trademark "Yosemite National Park" and avoided a contentious dispute. On the other

hand, if no one registered marks on similar or related goods or services, it might be time to file your application.

I will update or create written contracts.

Plain English written agreements are essential to developing clear relationships with your vendors and customers. Moreover, enforcement is much easier when terms are spelled out in writing.

I will evaluate our business's technology.

Businesses and their employees regularly collect large amounts of sensitive information, including addresses and social security numbers of your customers as well as your company's financial data. Maintaining so much information can leave your business vulnerable to cyber security threats.

In addition to ensuring the safety of customer information, evaluate whether your business's files, are secure and sufficiently backed up (ideally to multiple locations). If your computer fails, will you be able to retrieve your files? Even if you can retrieve your files, how long will your business be down before your data is restored? Think about revamping your IT system to ensure a computer failure doesn't crush your bottom line.

I will develop or update my business plan.

A business plan serves many purposes—it spells out your goals, market, and identity, for example. Evaluate new projects against your plan to ensure they align. Business plans not only help with big picture thinking, they should also incorporate specific sales goals and budgets to guide you throughout the New Year.

Contact Us

If you want to learn more about how to protect your business or how the Fiduciary Rule will affect you, or you have concerns about your financial advisor, email smelnick@melnickmelnick.com and ask about a Legal Business Consultation or an Investment Review.

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Does this new rule mean that all investment advisors will be the same?

No. Many call themselves financial professionals but behind these designations (e.g., financial planner, broker, wealth manager, or financial advisor) are very different education, training, experience, and credentials. The quality of advice you receive will vary depending on which provider you select. That said, the Fiduciary Rule will implement one change applicable to all financial professionals who provide retirement-related advice—they will be fiduciaries and as such required to put your interests ahead of their own.

Will I see new paperwork?

Yes, probably. Firms who will elect to continue to receive fees, including commissions, that may conflict with investors' interests need to provide investors with a contract (the Best Interest Contract or BIC/BICE) promising the firm will: (1) act in the investors' best interests; (2) charge "reasonable compensation"; (3) disclose how they are paid (including on the firm's website); and (4) adopt policies and procedures to ensure compliance with the new rules. New customers will sign the contract when completing paperwork to open an account. Existing customers may receive a notice (by mail or email) disclosing the investors' new rights. Investors are not required to take action, unless they wish to object to the terms outlined. The Best Interest Contract is not required until January 1, 2018.

Do investors have any recourse if an advisor fails to act in their best interests?

Investors have the right to pursue legal action if financial professionals do not comply with the new standards. Most disputes must still be resolved through arbitration (not in court), with a new and notable exception—investors may bring class action lawsuits.

When does the new rule take effect?

The rule takes effect on April 1, 2017 but some requirements (e.g., the Best Interest Contract Exemption) allow phased implementation with full

compliance required by January 1, 2018.

What's not covered?

- Non-retirement accounts
- Educational materials—if no specific investments are recommended
- Advice provided before April 10, 2017
- "Hire me" recommendations—financial advisors can urge you to hire them or their firms even if doing so is not really in your best interest.

Could the new administration block the rule?

Maybe, but not easily. The Fiduciary Rule is final and effective beginning on April 1, 2017. As a result, the new Secretary of Labor cannot repeal the Fiduciary Rule; although, he could delay implementation. The DOL could replace it, but the process—new regulations, public comment, modifications, and Office of Management and Budget's analysis—is slow. Congress could pass legislation that would overturn or amend the rule but that, too, would be difficult, considering the makeup of the Senate and time-consuming process involved. The new administration could also choose not to enforce the Fiduciary Rule or decline to defend it in pending litigation. Notwithstanding the new administration's opinion concerning the Fiduciary Rule, large wealth management firms have expended time and money preparing to comply, including using the new fiduciary standard as a marketing opportunity. And, buzz surrounding the Fiduciary Rule has awakened investors to the importance of hiring a fiduciary. As a result, political will to stop or delay the Fiduciary Rule may not be enough to motivate the new administration or Congress to take on the intricate and time-consuming task.

Additional Information

For a thorough explanation of the background and applicability of the rule, read: "[Consumer Protections for Retirement Investors – FAQs on Your Rights and Financial Advisers](#)" prepared by the DOL in January 2017.

To watch the DOL announce the rule, including speeches by former U.S. Secretary of Labor Thomas E. Perez and Senator Elizabeth Warren, visit: https://youtu.be/uDe_T9lrAiU.