WASHINGTON UPDATE

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George B. Delta, Esq.
(202) 393-0041
gdelta@deltalaw.net

How the Fiduciary Rule May Affect Awards Programs

The Department of Labor ("DOL") has issued a new rule that is scheduled to be phased in between April 10, 2017 and January 1, 2018 that expands the "investment advice fiduciary" definition under the Employee Retirement Income Security Act of 1974 ("ERISA"). The new fiduciary rule is intended to elevate all financial professionals who work with retirement plans or provide retirement planning advice to the level of a fiduciary and require him or her legally and ethically to meet the standards of fiduciary status. While the new rules are likely to have at least some impact on all financial advisors, their greatest impact would appear to fall on those who work on commission, such as brokers and insurance agents.

The status of the fiduciary rule is uncertain, however, because President Trump issued an executive order and a draft presidential memorandum on February 3, 2017 instructing the DOL to conduct "economic and legal analysis" on the rule's potential impact, and the DOL has delayed its implementation until June 9, 2017 to collect more comments. If the DOL were to conclude that the fiduciary rule does hurt investors or firms, it can propose a rule "rescinding or revising" it. The actions of the president and the DOL will most likely delay the implementation of the rule by at least 180 days. It is nonetheless important to understand the fiduciary rule because, after several years of preparing for it, many mutual funds and other investment companies are in the process of complying with it regardless. Indeed, not only is there considerable momentum in favor of compliance within the finance industry, but the public supports the additional investor protections, as well.

The new rule's definition of a fiduciary demands that advisors act in the best interests of their clients and put their clients' interests above their own. It leaves no room for advisors to conceal any potential conflicts of interest, and it states that all fees and commissions must be clearly disclosed in dollar form and amount to clients. The definition of a fiduciary has been expanded to include any professional making a recommendation or solicitation, and not simply giving ongoing advice. Previously, only advisors who were charging a fee for service (either hourly or as a percentage of account holdings) on retirement plans were considered fiduciaries.

The "fiduciary" standard is much more exacting than the "suitability" standard that had previously been required of financial salespersons, such as brokers, planners and insurance agents, who work with retirement plans and accounts under ERISA. Under a "suitability" standard, if an investment recommendation met a client's defined need and objective, it was deemed appropriate. Now, financial professionals are legally obligated to put their clients' best interests first rather than simply finding "suitable" investments. While the new rule could therefore eliminate many commission structures that govern the industry, it should not be objectionable to obligate a broader category of financial professionals to put their clients' best interests first, as they should have been doing all along. Stated differently, investment recommendations that were deemed suitable as a matter of law were often ill-suited in fact to the needs of the client.

Financial advisors who wish to continue working on commission will need to provide clients with a disclosure agreement, called a "Best Interest Contract" ("BIC") exemption in circumstances where a conflict of interest could exist (for example, the advisor receives a higher commission or special bonus for selling a certain product). The BIC exemption document is essentially a disclosure agreement that an advisor must provide to clients that would permit the advisor to offer products or strategies that could potentially have conflicts of interest and may not be in the best interests of the client.

If a financial advisor is to earn commissions that vary by product, the transaction would need to qualify under the BIC exemption. This is to guarantee that, as a client's fiduciary, the advisor is working unconditionally in the best interest of the client. The BIC exemption would permit firms to use many of their current compensation models if they acknowledge their fiduciary status, give prudent and impartial advice, disclose potential conflicts of interest and information about their revenue model, avoid misleading statements and receive no more than reasonable compensation. Most importantly, all compensation that is paid to the fiduciary must be clearly spelled out. The sale of variable annuities and fixed-indexed annuities to ERISA plan accounts and IRAs is allowed under the fiduciary rule only through the BIC exemption. That is also the case for advice provided to small 401(k) plans.

There are different types of BICs, depending on the recipient. For example, if a financial advisor provides advice to IRAs and plans that are not qualified under ERISA, the BIC would need to be more comprehensive, and this arrangement implies that a fiduciary relationship must be in effect before the parties execute any advisory agreement. Moreover, there must be an agreement reflecting the relevant standards for advice, and containing disclosures with respect to compensation and any related conflicts. The BIC provides for mandatory arbitration in individual disputes, but it also retains a client's right to participate in class action litigation against a financial advisor.

On the other hand, if a financial advisor provides advice to ERISA plans, the advice given under such plans is already subject to a fiduciary standard. Therefore, financial advisors would not be required to sign a written contract. A written statement setting forth compensation and the advisor's fiduciary status would be sufficient. In addition, financial advisors would also be required to provide the same disclosures on compensation and potential conflicts as in the more comprehensive BIC.

The final version of the fiduciary rule added a provision for level fee fiduciaries, as well. This deals specifically with recommendations that clients roll their 401(k) balance to an IRA account under a level fee arrangement. The BIC exemption would be more streamlined; it would have to document the reasons the rollover is deemed to be in the best interest of the client. It would also apply in the case where the client will be moved from a commission arrangement to a level fee arrangement. In order to move a client into an advisory relationship, the advisor would need a BIC covering the higher ongoing fee. This more streamlined BIC would require advisors to provide a written statement of fiduciary status and a written rationale explaining the reasons that their recommendation would be in the best interest of the client. There would be no need for other disclosures, however, under this type of BIC exemption.

The DOL has advised that financial institutions may continue to use incentive compensation and awards for their financial advisors and still comply with the BIC exemption. The DOL strongly cautioned, however, that any such arrangements must be carefully structured and monitored to avoid creating, or allowing the continuation of, incentives for financial advisors to act in a manner that would not be in the best interest of the retirement investor.

Moreover, henceforth, it would be improper to base incentives to financial advisors on the relative profitability to the financial institution of certain products. For example, a financial institution should not pay an advisor a higher commission for selling one mutual fund as compared to another such fund if the two funds are similar products but the former has a higher payout to the financial institution. Incentives should be based upon "neutral" factors, such as the amount of work involved or other factors justifying distinctions in the amount of compensation payable to a financial advisor for selling certain categories of products.

Finally, the DOL has cautioned that any volume-based incentive grids should not include provisions that might tempt financial advisors to act imprudently. For example, increases in payout percentage as the advisor progresses up the grid should be "modest," and there should be no retroactive application of higher payout percentages to transactions completed before (s)he qualifies for the higher payout level.

Until there is greater clarity with respect to the new fiduciary rule, some financial institutions may be leery of using incentive or award programs to motivate and/or compensate their employees, while others are restructuring their programs to place a greater emphasis on general recognition and education, for example, instead of providing sales-based incentives. Although financial institutions may be overreacting, that is understandable in the context of prior practices when conflicts were rife, as fund companies competed to encourage brokers and advisors to put people in their funds, regardless of the clients' best interest. Mutual fund companies also compensated intermediaries with trips to exclusive destinations and other lavish prizes. They also shared revenues with brokers. For example, Franklin Templeton paid $31.1 million and American Funds paid $55 million in revenue sharing to Edward Jones as recently as in 2015. *See* Leslie Norton, "The Fiduciary Rule Still Has Momentum," *Barron's*, Feb. 6, 2017, at 38.