



DOL Issues First Guidance on Fiduciary Rule

On October 27, 2016, the U.S. Department of Labor (“DOL”) issued initial guidance on its new fiduciary rules, which are scheduled to become effective on April 10, 2017. The guidance was issued in the form of FAQs and is expected to be the first of three rounds of guidance to be published by DOL prior to the effective dates of the new rules.¹

Perhaps not surprisingly, the FAQs address in large part a variety of compensation questions that are top of mind for both broker-dealer firms and their financial advisers.

Background

In April 2016, the DOL greatly expanded the scope of persons who would be deemed fiduciaries under ERISA² and Internal Revenue Code (the “Code”) when dealing with retirement plans and IRAs. As revised, any broker-dealer or financial intermediary (“Financial Institution”) that makes any suggestions as to how or where a retirement investor should invest may be a fiduciary. In addition, the individual financial advisers or registered representatives employed by Financial Institutions (“FAs”) may be fiduciaries. Given the prohibitions under ERISA and the Code regarding self-dealing by fiduciaries, the expanded definition effectively proscribes the use of commissions and other variable compensation in dealings with retail retirement investors unless the transaction can fit into an available exemption. Of particular interest when dealing with retail retirement investors are two new exemptions released by DOL in April 2016: the Best Interest Contract Exemption (“BIC Exemption”) and the Principal Transactions Exemption (“Principal Exemption”). Each exemption requires the Financial Institution and FAs to adhere to “Impartial Conduct Standards,” and they impose a number of other requirements. The Impartial Conduct Standards require the Financial Institution and the FA to act in the best interest of the retirement investor in order to avoid unreasonable compensation and to make full and fair disclosure of all material facts, including all fees and any material conflicts of interest.

Guidance from the FAQs

The FAQs address a number of important topics as summarized below.

Scope of BIC Exemption. The FAQs confirm that the BIC Exemption is potentially available for transactions in all categories of assets.

What Constitutes Unreasonable Compensation? Both the BIC Exemption and the Principal Exemption prohibit the receipt of compensation “that is in excess of reasonable compensation...” The FAQs advise that “the essential question is whether the charges are reasonable in relation to what the investor stands to receive for his or

¹ <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf>

² The Employee Retirement Income Security Act of 1974, as amended.

her money.” DOL suggests that, to avoid the receipt of unreasonable compensation, Financial Institutions should be attentive to market prices and benchmarks; prudently evaluate the retirement investor’s needs; make sure they make full disclosure of all charges, costs and conflicts of interest; and stay alert to potential abusive practices involving customer fees and charges.

Incentive Compensation for FAs. DOL advised that Financial Institutions may continue to use incentive compensation for their FAs and still comply with the BIC Exemption. However, DOL strongly cautioned that any such arrangements must be carefully structured and monitored to avoid creating, or allowing the continuation of, incentives for FAs to act in a manner that would not be in the best interest of the retirement investors.

DOL advised that it would be improper to base incentives to FAs on the relative profitability to the Financial Institution of certain products. For example, a Financial Institution should not pay an FA a higher commission for selling Fund A as compared to Fund B if the funds are similar products but Fund A has a higher payout to the Financial Institution. Rather, 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 FAs for certain categories of products.

DOL also cautioned that any volume-based incentive grids should not include provisions that might tempt FAs to act imprudently. For example, increases in payout percentage as the FA progresses up the grid should be “modest,” and there should be no retroactive application of higher payout percentages to transactions completed before the FA qualified for the higher payout level.

Recruitment Bonuses. DOL advised that signing bonuses used to hire FAs should be compatible with the new rules, provided that the bonus is not contingent upon any sales or similar production target. Back-end loaded recruitment bonuses that largely depend upon reaching certain production levels are viewed by DOL as creating “acute conflicts of interest that are inconsistent” with the BIC Exemption.

Level Fee Fiduciaries. In the FAQs, DOL acknowledged that a Financial Institution may manage some accounts on a Level Fee Fiduciary basis while managing other accounts on a commission basis.

DOL confirmed that the fees of a Level Fee Fiduciary who is compensated on the basis of a percentage of assets under management or a similar model (“AUM”) would not be prohibited transactions under the new rules. As a result, a Level Fee Fiduciary need not comply with the BIC Exemption in order to charge a fee based on AUM. However, Level Fee Fiduciaries are still fiduciaries under the rule, and they need to act in the best interest of their retirement investors. In this regard, a recommendation to roll over an IRA, or to change a commission-based account to a flat fee account, may entail a conflict of interest for the fiduciary who stands to benefit from a stream of fees generated by the new account. As a result, such recommendations could be prohibited transactions. The BIC Exemption includes a “short-form” provision that enables the Level Fee Fiduciary to comply by acknowledging in writing its fiduciary status, adhering to the Impartial Conduct Standards and documenting the basis for the recommendation to roll over or open a new account.

DOL further advised that a Financial Institution seeking to qualify as a Level Fee Fiduciary may not receive transaction-based payments from third parties in connection with any accounts managed on a level fee basis, nor may it limit its investments to proprietary products. Third-party payments would be viewed as the equivalent of commissions and would require the Financial Institution to comply with all provisions of the BIC Exemption. Similarly, the conflicts associated with proprietary product are viewed by the DOL as inconsistent with the status of a Level Fee Fiduciary if its compensation is in any manner contingent upon recommending proprietary products.

Bank Networking Arrangements. The new rules permit a bank to receive payments from an unaffiliated broker-dealer with whom it has a networking arrangement, provided that the bank complies with the Impartial Conduct Standards. In the FAQs, DOL advised that a referral by a bank to an affiliated broker-dealer would not,

in and of itself, be viewed as investment advice, but rather would be viewed as marketing the services of an affiliate, which would not trigger fiduciary concerns.

Effective Date. As expected, DOL advised that it does not intend to delay the effective date of the new requirements. The new rules will become effective on April 10, 2017, although compliance with some of the new contract provisions is deferred to January 1, 2018. DOL indicated that it will continue to work with the industry during the initial compliance period, with a view to assisting rather than sanctioning those who are making a good faith effort to comply. In light of the significant penalties that can arise from violations of these complex new requirements, the financial industry will certainly welcome a cooperative approach from DOL.

Conclusion

The FAQs provide helpful guidance on a number of issues. In particular, they illuminate two important aspects of the new rules: (i) the implications of compensation arrangements for FAs and (ii) compliance requirements for level fee fiduciaries.

DOL has consistently emphasized that Financial Institutions seeking to comply with the BIC Exemption or the Principal Exemption must not utilize compensation arrangements for FAs that might encourage them to make recommendations that are not in the best interest of the retirement investor. With their extensive comments on compensation grids, the FAQs serve notice that DOL will scrutinize the details of compensation arrangements to enforce this requirement. The FAQs indicate that compensation incentives that “incentivize the adviser to recommend investments based on their profitability to the firm, rather than their value to the investor” will not be acceptable. Traditional incentive programs based on contributions to firm profitability will need to be re-evaluated. The FAQs also reiterate that Financial Institutions have an on-going obligation to carefully monitor how compensation arrangements are affecting FA behavior.

The FAQs remind level fee fiduciaries, such as investment advisers and broker-dealers managing accounts on a fee-basis, that they are not exempt from the new rules. Although fees based on AUM are not variable compensation requiring compliance with the BIC Exemption, recommendations to roll over a retirement account or to change an account from commission-based to fee-based do require compliance with a streamlined version of the BIC Exemption. Moreover, receipt of third-party payments or limitation of recommendations to proprietary products would vitiate reliance on the provisions for level fee fiduciaries and would require them to comply with all of the relevant provisions of the BIC Exemption. Finally, like all fiduciaries, level fee fiduciaries are subject to the Impartial Conduct Standards.

The FAQs do not address most of the questions raised by investment bankers and product sponsors regarding underwriting and distribution arrangements for many investment products. Hopefully, the succeeding FAQs will address these issues.

Authors

Hillel Cohn
Los Angeles
(213) 892-5251
hcohn@mofo.com

Paul Borden
San Francisco
(415) 268-6747
pborden@mofo.com

Contacts

Lloyd Harnetz
New York
(212) 468-8061
lharnetz@mofo.com

Anna Pinedo
New York
(212) 468-8179
apinedo@mofo.com

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