Department of Labor Finalizes IRA Fiduciary Rule

Andrew H. Friedman
Jeff Bush
The Washington Update

The Department of Labor has issued its much-anticipated final rules that impose a fiduciary duty on financial advisors to the extent they recommend investments for their clients' IRA and other qualified accounts. We believe that, from the industry's perspective, these final rules represent a significant improvement over the proposed rules DOL issued last year, although some fundamental concerns remain to be worked out.

This paper summarizes the major changes in the final rules and provides an overview of the rules as finalized.

Changes in the final rules

In our view, the most important change is the final rules' acknowledgement that differential compensation (including commissions) may be appropriate for the sale of different categories of investment products. For example, compensation paid for a mutual fund sale need not equate with compensation paid for the sale of an annuity. The new rules do require, however, that such differing compensation be based on "neutral factors", such as the time or complexity of the work involved, rather than to promote sales of more lucrative products. Thus, for instance, a firm might draw a distinction between compensation paid for sales of mutual funds and variable annuities based on the additional time needed to explain the latter investment to the client.

Other changes made by DOL include the following:

- The rules clarify a number of questions raised by the proposed rules:
  - Payment of traditional forms of compensation -- including commissions, trails, sales loads, 12b-1 fees, and revenue-sharing payments -- remains permissible.
  - Advisers are not required to recommend the lowest fee product available where there are countervailing reasons why other investment choices might be more beneficial to the client.

    - Advisers are permitted to receive compensation (including commissions) in connection with the sale of annuities and other insurance products. Compensation for annuity sales may exceed compensation received for the sale of less complex products.

- The rules eliminate the requirement that the adviser enter into a complicated contract with a potential client before giving any advice. Instead the firm may have a new client execute a more streamlined contract along with other account opening papers.

- The rules eliminate restrictions on products that may be made available for IRA holders. The rules also make clear that advisers may continue to sell proprietary products.

- The final rules significantly reduce compliance burdens on firms and financial advisers by (among other things) eliminating many of the more cumbersome disclosure requirements, such as projections regarding asset performance.

- The rules provide significantly expanded transition (grandfathering) relief:

    - Advisers are not subject to the new rules until April 2017.

    - Firms have until January 2018 to finalize the documentation requirements and come into compliance.

    - Advisers may continue to receive compensation on products sold before the rules become effective. This exception applies to advice to retain a prior investment; to adhere to an earlier established systematic purchase program; and to change investments among choices available under a product such as a variable annuity (provided the adviser does not receive additional compensation for such advice).

- The final rules also make two significant adverse changes:

    - They expand the fiduciary obligation to apply to investments by 401(k) plans with less than $50M in assets (not only to IRAs and similar types of individual accounts).

    - They subject fixed indexed annuities to the new fiduciary requirements. Fixed rate annuities continue to be exempt from the new rules.

Overview of the final rules

In early 2015, President Obama traveled to AARP headquarters in Washington to decry “Wall Street brokers” who receive “backdoor payments and hidden fees” that cause them to put their own interests ahead of their clients’. According to his Administration’s calculations, IRA holders lose an aggregate $17 billion annually as a result of this "conflicted advice". The President directed DOL to promulgate rules to "address conflicts of interest in providing retirement advice."

DOL proposed regulations in April 2015 and finalized them a year later. Both the proposed and final rules impose on a financial adviser a "fiduciary obligation" when making investment recommendations for IRAs, similar individual retirement accounts (such as SEPs and SIMPLEs), and small 401(k) accounts. (The DOL rules do not apply to non-qualified account investments.)

Like the proposed rules, the final rules set out a general prohibition on the payment of differential compensation for IRA investments. In the DOL's view, such differential compensation inappropriately incentivizes advisers to recommend investments in their best interest rather than the client's.

The rules, however, provide an exception to this general rule, denominated the "best interest contract" (BIC) exemption. The final rules make clear that common forms of traditional compensation -- commissions, trails, sales loads, 12b-1 fees, and revenue-sharing payments -- remain permissible under the BIC exemption. We expect that virtually all financial services firms will seek to comply with this exemption so they may continue to offer non-fee based compensation for appropriate investment products.

To meet the BIC exemption, a firm and its financial advisers must meet four requirements:

1. *Contract*

The firm and client must enter into a streamlined agreement attesting to the firm's fiduciary obligation. The agreement must disclose fees, compensation, and any material conflicts of interest associated with investment recommendations. Clients may execute the agreement when they sign the other account opening papers. Existing clients are not required to sign a new agreement; it is sufficient that they not object when informed of the new rules.

2. *Reasonable compensation*

All compensation paid to the adviser must be "reasonable". The regulations leave it up to the firms to determine whether compensation is reasonable, rather than providing safe harbors. They further note that the fact compensation has been customary does not necessarily imply it is reasonable.

3. *Differential compensation*

The third requirement forms the crux of the BIC exemption: Firms must prohibit compensation practices that encourage advisers to make recommendations not in the best interests of the client.

As noted above, the final rules nonetheless acknowledge that differential compensation (including commissions) may be appropriate for the sale of different categories of investment products. Thus, for example, the final rules make clear that firms may continue to pay traditional types of compensation in connection with the sale of annuity products under the BIC exemption. Moreover, compensation paid for the sale of an annuity need not equate with compensation paid for the sale of less complex mutual fund.

The rules do require, however, that differing compensation among investment product categories be based on “neutral factors”, rather than to promote sales of more lucrative products. The rules give two examples of acceptable neutral factors: payments to compensate for specialized expertise developed and deployed by the advisor, and payments to compensate for the additional time involved in explaining and finalizing the sale of a complex investment product.

The rules state that differential compensation based on non-neutral factors is likely to encourage advice that is not in the client’s best interest and thus presumably is not permitted. Similarly, the rules preclude compensation variation for recommendations within the same investment category (such as mutual funds from different asset managers or annuities from different carriers).

Continuing the above example, an adviser is likely to spend more time explaining the features of a complex annuity product than those of a simpler mutual fund investment. Based on such a neutral consideration, the adviser may receive greater compensation in connection with annuity sales.

The challenge for firms will be demonstrating that additional annuity sale compensation fairly reflects the additional time spent and that the compensation is reasonable. Beyond stating that differing commissions based on neutral factors is permissible, the regulations do not provide a safe harbor (a compensation plan firms may follow to avoid later liability) or give more specific guidance on how firms should formulate an acceptable investment compensation arrangement.

4. *Class action suit*

If a firm compensation plan allows for differential compensation based on criteria later determined to be improper, the consequences are severe. Under the BIC exemption, clients have a non-waivable right to join or initiate a private class action suit against the adviser and firm if the client later concludes that that compensation paid was unreasonable or the firm’s compensation plan created a conflict of interest that resulted in an investment not in the client’s best interests.

As noted above, the rules provide no “safe harbor” for compensation arrangements. Industry observers fear that this requirement may engender lawsuits by clients whose IRA assets have declined, even if due only to market performance.

401(k) rollovers

The final rules make clear that recommendations to roll over 401(k) assets to an IRA are subject to the fiduciary rules. Thus, firms must comply with the BIC exemption with respect to rollover advice.

The rules acknowledge that a decision to move assets out of a 401(k) may be based on factors other than fees, such as a broader range of investment choices or more personalized investment advice. In discussing a possible 401(k) rollover with a client, an adviser must document factors supporting leaving the investments in the plan as well as the benefits of taking the distribution. The adviser must fully disclose the alternatives to a rollover, including the benefits of remaining in the 401(k) (such as lower fees). The adviser must document why the rollover makes sense in the client's case, perhaps based on factors such as greater investment options or a higher degree of service.

It appears to us that 401(k) rollover disclosure and compliance will become similar to those involved in advising clients now on a 1035 exchange of annuities: the adviser will be required to set out the pros and cons of the change and the reasons why the change is appropriate in the client's circumstances.

Conclusion

From an industry perspective, the final DOL fiduciary rules represent a significant improvement over DOL's initial proposal. But uncertainty remains regarding the application of the differential compensation standard. The hope is that some of this uncertainty will be resolved as firms begin to consider how to comply before the rules become effective.

Andrew H. Friedman is the principal of The Washington Update LLC and a former senior partner in a Washington, D.C. law firm. He and his colleague Jeff Bush speak regularly on legislative and regulatory developments and trends affecting investment, insurance, and retirement products. They may be reached at www.TheWashingtonUpdate.com.