
DOL fiduciary rule: Election impact and FAQs

We believe yesterday's election will have less impact on the Department of Labor's (DOL) fiduciary duty rule than some in the media are currently speculating.¹ While some provisions may be modified by a new Administration, we believe the rule's core framework will remain intact. The industry has already made significant progress toward complying with the rule, and there is general recognition of the importance of removing conflicts of interest between financial advisers and retirement investors. A Trump Administration is unlikely to want to immediately restore such conflicts that could harm the very voters who propelled him into office.²

As a result, financial advisers and firms should continue their work to meet the rule's requirements and should consider the DOL's recently released frequently asked questions document (FAQs). Under the rule, an investment recommendation given to an employee benefit plan or an individual retirement account (IRA) owner is considered fiduciary advice and therefore must be in the "best interest" of the investor. As a result, the rule limits commission-based compensation for financial adviser's retirement advice unless the adviser's firm uses one of the rule's exemptions, in particular the Best Interest Contract exemption (BIC exemption), which would allow advisers to continue to receive commission-based compensation under certain conditions. The FAQs clarified that firms utilizing the BIC exemption would not be allowed to offer recruitment bonuses that are dependent on meeting certain sales or assets targets and that grandfathering for products acquired before the compliance deadline would be broader than originally anticipated. However, the majority of the FAQs confirmed the industry's existing expectations, including the upcoming April 10, 2017 deadline.

- 1. Target-based recruitment bonuses will be restricted.** Prior to the FAQs, there were industry questions as to which types of recruitment-related bonuses would be permitted for firms utilizing the BIC exemption. The DOL clarified that target-based recruitment bonuses (i.e., dependent upon sales or asset targets) will not be permissible as they have the potential to incentivize advisers to make sales that are not in the best interest of clients. Such target-based recruitment bonuses would include the common industry practice of offering a loan to an adviser upon joining a firm, and gradually forgiving the loan as the adviser meets sales targets (i.e., employee forgivable loans). The DOL differentiated target-based recruitment bonuses from "sign-on" bonuses which are not contingent upon meeting sales targets or bringing investors to the firm and will continue to be allowed. However, the DOL recognized that some firms may have signed contracts which include obligations to pay target-based recruitment bonuses before the FAQs were issued, so the FAQs indicated that such contracts entered into before October 27, 2016 are allowed to be honored by firms utilizing the BIC exemption. This FAQ clarification is likely to drive significant changes to the ways that firms recruit new employees and potentially reduce the number of advisers switching firms.

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- 2. Grandfathering is more widely applicable than originally anticipated.** The BIC exemption allows advisers to continue to receive commission-based compensation for products acquired by an investor before April 10, 2017 (i.e., grandfathering), but the industry expected that grandfathered status would be voided if additional amounts were invested in the product. However, the FAQs clarified that recommendations to augment previously purchased products will not cause the products to lose their grandfathered status, as long as the adviser complies with the BIC exemption's conditions for the new recommendation. The FAQs also stated that grandfathering will be applicable to dividend reinvestment programs entered into prior to April 10, 2017. We now expect firms to develop the technological capability to separate grandfathered products and to train advisers on how they can make recommendations without losing grandfathered status.
 - 3. Third party payments are not allowed for firms using the streamlined BIC exemption.** The final rule allowed firms to use a streamlined version of the BIC exemption (i.e., "level fee" provisions) in cases where the adviser recommends that the investor move from a commission-based compensation arrangement to an arrangement where the adviser receives only a flat fee (e.g., based on a percentage of assets).³ Some advisers assumed that they could continue to recommend products that generate third party payments (e.g., revenue sharing and 12b-1 fees) when using the streamlined BIC exemption, so long as the payments are rebated back to the investor (or if the payments are the same for all products). The FAQs confirmed, however, that these advisers cannot utilize the streamlined BIC exemption for *any* recommendations that generate third party payments, so the adviser must instead meet the full conditions of the BIC exemption (e.g., signed contracts and disclosures) in order to make such recommendations.⁴ In addition, the FAQs confirm that advisers cannot rely on the streamlined BIC exemption to sell proprietary products (as is allowed under the full BIC exemption).
 - 4. Additional clarity on plan rollover recommendations.** The final rule stated that advisers using the streamlined BIC exemption for rollover recommendations must evaluate and compare fees and services associated with both options. The FAQs confirmed that this evaluation should also be performed when using the full BIC exemption, which was not explicitly stated in the final rule. Although the information needed for this evaluation is available in employee benefit plans' annual participant fee disclosure, the FAQs clarified that if this information is not readily available, the adviser may rely on alternative data sources (e.g.,

the plan's annual report or reliable benchmarks). This clarification should benefit technology vendors that have been developing rollover evaluation tools with alternative data. However, if alternative data is relied upon, the FAQs added that the adviser must inform the investor and document the rationale for relying on the alternative data.

- 5. Certain grid-based commission structures will be permissible, but with clarified limitations.** The DOL clarified that firms can continue to use grid-based commission structures (i.e., increasing the amount of an adviser's commission as the adviser meets escalating sales thresholds). However, the FAQs advised that firms should avoid drastic increases in thresholds and retroactive adjustments (i.e., applying a higher commission rate to prior sales upon reaching a new threshold) as these arrangements may incentivize advisers to meet thresholds even if doing so may not be in the best interest of a client.

The FAQs also confirmed that commission structures that differentiate adviser commission rates by product category (e.g., mutual funds, annuities, etc.) will be allowed for firms intending to utilize the BIC exemption, as long as the differences in commission rates are based on "neutral factors" such as the time and complexity to sell the product, rather than factors based on the firm's financial interests (e.g., profitability of the product). Many large wealth managers that are planning to leverage the BIC exemption have already been operating according to this expectation, and have begun developing a "neutral factors" framework, in part by quantifying the time involved in selling different products.

- 6. Price discounting will still be allowed.** Many in the industry were uncertain as to whether the DOL would consider price discounting as an acceptable practice for firms utilizing the BIC exemption. In welcome news to the industry, the FAQs recognized that there are many legitimate reasons for an adviser to discount prices for clients and confirmed that firms could continue to provide discounts while utilizing the BIC exemption. However, the FAQs note that advisers must not discount in a way that introduces conflicts of interest (e.g., by providing a discount in order to influence clients to purchase a product that benefits the adviser). If a firm is utilizing the BIC exemption and wants to continue discounting, it must establish a reasonable pricing structure and establish detailed discounting policies. Most financial advisers have had significant freedom in this respect, which has resulted in wide pricing variations across the industry. Going forward, we expect wealth managers to make significant changes to their pricing and discounting policies in order to drive pricing into a narrower range.

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- 7. Referrals to affiliates will not be considered investment advice.** The final rule described which communications from an investment adviser would constitute investment advice (and therefore require an exemption to receive commission-based compensation) and which would not. The FAQs confirmed that a recommendation to engage an affiliated investment adviser will not constitute investment advice, provided the affiliation is disclosed and no investment recommendation is made. This clarification is particularly helpful for bank brokerage firms which receive referrals from their retail bank affiliates. We expect that many banks offering referral programs will develop detailed guidelines and scripts to ensure investment advice is not inadvertently provided alongside referrals.
- 8. Independent marketing organizations (IMOs) will still be able to receive commissions for selling annuities.** Under the final rule, IMOs are not able to utilize the BIC exemption to receive commission-based compensation for investment recommendations. The FAQs clarified that an IMO can continue to receive commission-based compensation if it works with an insurance company that complies with the BIC exemption. The insurance company would have ultimate responsibility for compliance with the conditions of the BIC exemption, but would be able to delegate some compliance tasks to the IMO. As a result, we expect that some insurance companies will continue to partner with those IMOs that provide a high proportion of the insurers' revenue. If an IMO does not partner with an insurance company, it can apply to the DOL to continue to receive commissions for selling annuities. The DOL indicated that there are a number of applications pending, and it is considering issuing a class exemption for IMOs.

- 9. Disclosure of executed BIC exemption contracts is best practice, but is not required.** In order to utilize the BIC exemption, the final rule indicated that firms must sign a contract with each new investor and make it available online.⁵ As of now, some in the industry have prepared to post each individual executed contract online whereas many other firms were planning to post a model contract. While the FAQs stated that posting a model contract would satisfy the requirement, the FAQs clarified that making each individual retirement investor's executed contract available online is best practice.
- 10. The FAQs provide some insight into the DOL's compliance expectations.** Beyond clarifying the final rule, we believe the FAQs indicate two overall activities that will help firms prepare for compliance:
- *Conduct adviser training.* Firms should be able to demonstrate that they have conducted adviser training on the "impartial conduct" standard.⁶ They should also train advisers on new processes for acting in their clients' best interest, such as documenting their rationale behind recommendations and pricing exceptions. Developing content and conducting training can be an onerous exercise for firms with a large and geographically dispersed salesforce, and will likely require engaging third-party specialists.
 - *Plan for changes to adviser compensation and enhanced monitoring.* Within the FAQs, it is clear that the DOL expects firms to go beyond relying on written policies and procedures and actively supervise adviser behavior. As a key example, firms should develop capabilities to monitor advisers' activities near commission rate thresholds to ensure that they continue to act in the best interest of their clients.

Endnotes

1. The rule was finalized in April 2016. See PwC's *First take, Ten key points from the DOL's fiduciary duty rule* (April 2016).
2. The election results, however, are likely to have a bigger impact on the SEC's version of the fiduciary rule (which would be applicable beyond retirement accounts) which has yet to be proposed. President-elect Trump could appoint up to four (of five) SEC commissioners in 2017. Of the three commissioners currently seated (Chair Mary Jo White, Republican Michael Piwowar, and Democrat Kara Stein), Chair White has indicated her intentions to retire soon and Commissioner Stein's term expires in June 2017.
3. Even though the adviser in this case is not receiving a commission for a recommended product, the rule nonetheless required the adviser to utilize an exemption to make this recommendation because the recommendation would presumably benefit the adviser in the long run through fees earned over time.
4. The FAQs note that if firms or individual advisers are in doubt about whether a certain activity qualifies for the streamlined version of the BIC, they should rely on the full BIC exemption.
5. For existing clients, advisers can send a contract modification and rely on negative consent, but this contract modification must also be posted online.
6. Under the impartial conduct standard advisers must act in their clients' best interest, charge no more than "reasonable compensation," and avoid misleading statements about investment transactions, compensation, or conflicts of interest.

Additional information

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