At IRI Legal Conference, Lawyers Parse the “Fiduciary Rule”

By Kerry Pechter *Thu, Jun 9, 2016*

The Department of Labor decided not to send an invited panelist the Insured Retirement Institute's Government, Legal and Regulatory Conference on Monday--perhaps because the IRI is party to a federal lawsuit calling for the annulment of the DOL's "fiduciary rule."

Two unexpected things happened on the first morning of the Insured Retirement Institute’s Government, Legal and Regulatory Conference on Monday in Washington, D.C., which focused on the DOL’s controversial, freshly issued (April 6) fiduciary or “conflict of interest” rule.

First, it was clear that neither Tim Hauser or Judy Mares would be in attendance. They are two Labor Department officials who had, earlier, at different times, been named (with Mark Iwry from Treasury) in the IRI meeting’s preliminary agendas as members of a panel discussion on the Obama administration’s retirement policy.

That was unexpected, but not surprising. The IRI is a plaintiff in week-old lawsuit asking a federal court in Dallas to “vacate and set aside the [fiduciary] Rule,” which the DOL spent six years writing and revising. An IRI spokesperson couldn’t explain their absence, but maybe the DOL felt less than welcome in that venue. Seth Harris, a former Deputy Secretary of Labor, took Hauser’s place.

Direct opposition to the DOL’s initiative by a major retirement industry group has the potential to create confusion within the industry about whether to begin adjusting to the rule. News of the DOL’s absence from the IRI event was contrasted however by a sanguine word from Steve Saxon, a leading ERISA lawyer at the Groom Law Group who participated in a separate panel discussion at the IRI conference.

Only weeks ago Saxon appeared fit to be tied at the terms of the fiduciary rule. But Monday he acknowledged that his law firm was not representing any of the plaintiffs in the two federal suits filed so far against the DOL, in Dallas and in the District of Columbia. Instead, he told *RIJ*, “We’re going to work with them.”

By “them,” Saxon meant the DOL. By “we,” he meant a group of “seventeen [401(k)] recordkeepers.” Recordkeepers, it should be said, have less conflict with the DOL than, say, annuity distributors; the new rule will ripple, but not disrupt, the recordkeepers’ business model. Saxon’s comment represented a trace of hope that some of the remaining ambiguities of the new rule might be resolved through negotiation instead the more expensive and time-consuming route of ligitation.

Criminalizing high commissions?

If you're new to this controversy, here's a synopsis. The Obama Administration a few years ago became alarmed about the rollover (when defined contribution plan participants change jobs or retire) of trillions of dollars in tax-deferred savings from tightly regulated institutional 401(k) accounts to loosely regulated retail rollover IRA accounts.

Regulators worried that inexperienced, bred-in-captivity IRA owners might be exposed to sales of investment products and services with much higher prices than could be charged in the 401(k) plans, and to predatory sales practices. So, in 2010, the DOL drafted a "fiduciary" rule requiring advisors to IRA accounts to adhere to the same rules as advisors to 401(k) plans. That is, to act "without regard to" their own financial interests and only in the "best interest" of their clients.

The rule was reproposed in 2015, and finalized two months ago. It all but criminalizes the sale of high-commission or high-cost products to IRA owners. It strikes particularly hard at variable and fixed indexed annuities (FIAs), as well as load mutual funds, whose sales by registered reps and insurance agents are driven by the lure of high commissions. Last week's lawsuits by the IRI et al, and by the National Association of Fixed Annuities, were the financial industry's attempt to block the rule from taking effect.

Variable versus level compensation

Because this was a legal conference, discussions focused on unresolved ambiguities in the fiduciary rule, and on aspects of the law that might make industry players vulnerable either to DOL scrutiny or, more importantly, to class action lawsuits from opportunistic plaintiffs' attorneys.

One area of ambiguity, according to Harris, involves "differential compensation." Compensation inevitably varies for selling different products and services. But, under the rule, advisors who choose to sell products that earn more income for them (and cost clients more) will bear the burden of justifying their choices.

In its rule, the DOL says that differences in compensation on sales of products to IRA owners must be based on "neutral factors," such as differences in the amount of time or expertise that's required to sell a product, and not based on a desire to incentivize advisors to recommend one product or type of product over another.

This raises new hair-splitting questions, such as: Is compensation allowed to vary by product category, or by each product within a category? How can anyone objectively compare a one-time commission with an annual asset-based fee? Why do advisors who charge "level fees"—fees based on assets under management—get lighter treatment under the new rule, especially when a one-time commission might be cheaper for the client in the long run, or when asset-based fee structures bias advisors against recommending annuities, which remove assets from direct billable management?

"The DOL prefers level fees, but that doesn't work for everybody's business model," Harris said. "It's clear that the DOL disapproves of the old system, where the amount of money you brought into the firm decides your compensation. If at the end of the day we see a lot of advisors saying, 'It's not worth it,' and exiting the distribution system, that will cause a lot of trouble for a lot of folks. I think these issues are solvable. But they are complex, and will be different for each company."

Asked during a panel discussion whether or not the DOL rule would put downward pressure on FIA commissions, Kansas City compliance consultant Kevin W. Mechtley said, "Today, if you have three contracts with similar features and the same surrender period paying commissions of 5%, 6% and 8%, the 8% product will outsell the others all the time. In the future, it will be hard to keep selling at 8%. A push toward like-commissions for like-products will be the immediate effect of the rule. Over the long-term, it will depend on the results of litigation."

Who signs the BIC for insurance agents?

Another much-discussed area involves the sale of indexed annuities and the Best Interest Contract. To accept commissions on the sale of products to IRA owners, an advisor, broker or agent must work for a regulated financial institution that will sign a contract pledging that all of its salespersons will work solely in the clients' interests, and that it will establish procedures for monitoring and documenting their sales activity, and that it will bear the legal liability for their conduct.

For registered representatives, broker-dealers will sign the BIC. But insurance agents who sell indexed annuities fall into a grey area. They are generally affiliated with insurance (or field) marketing organizations (IMOs or FMOs). But IMOs are not, strictly speaking, financial institutions, and it's not clear whether they want to take on that responsibility.

The DOL rule, in section II, J-3, allows non-financial institutions like IMOs to apply to “individual exemptions” that will allow them to serve as signatories to the BIC for their agents. Steve Saxon of Groom Law Firm said he believes one or more of the IMOs will take advantage of that because it will give them a competitive advantage over other IMOs and allow them to remain in competition with broker-dealers in the sale of indexed annuities.

“There’s going to be an FMO or group of FMOs who will talk to the Labor Department and say, ‘We want to stay in this business. What do we need to do to be the institution that signs the BIC?” Saxon said during a Q&A with the IRI audience. “The FMO will do it because they’ll see it as a business opportunity. But it can take as long as two years to qualify for such an exemption.”