

## Differential Compensation Based on Neutral Factors: Interesting Angles on DOL's Fiduciary Rule #24

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Tuesday, October 25, 2016

### The Meaning of Differential Compensation Based on Neutral Factors

This is my twenty-fourth article covering interesting observations about the fiduciary rule and exemptions.

The DOL's fiduciary "package" consists of a regulation that expands the definition of advice and exemptions, or exceptions, from the prohibited transaction (PT) rules. If a recommendation by a fiduciary adviser does not constitute a PT (e.g., does not affect the adviser's compensation, or that of an affiliate, and does not cause a payment from a third party), no exemption is needed. However, if the fiduciary recommendation causes a PT, an exemption must be used – and most often that will be BICE – the Best Interest Contract Exemption. Therein lies the rub . . . the compensation of the financial institution (e.g., the broker-dealer) and the adviser are regulated by BICE.

Under BICE, the compensation of broker-dealers can be "variable," but must be "reasonable." In other words, a broker-dealer can receive different payments from different product providers (e.g., mutual funds), so long as the total compensation received by the broker-dealer is reasonable relative to the services provided to the particular plan, participant or IRA owner.

The rules for compensating advisers are similar because the compensation of the adviser also must be reasonable (relative to the services that the adviser is providing to the plan, participant or IRA owner in the first year and in succeeding years). But, from that point on, the rules are different.

The starting point for understanding the other rules for adviser compensation is to determine "reasonably designed investment categories." A reasonably designed investment category is an investment product or service that, when properly analyzed, should produce a certain level of compensation for the adviser's services. For example, non-discretionary investment advice about mutual funds probably involves a different set of services and complexity than investment advice about individual variable annuities. In that sense, each could be called a reasonably designed investment category.

The next step is to understand that, within a particular investment category, the adviser's compensation must be level. For example, where an adviser is providing non-discretionary advisory services concerning mutual funds, the adviser's compensation must be level regardless of which mutual funds are recommended or how much those mutual funds pay the broker-dealer. In that way, the adviser will be "financially agnostic" as to which funds are recommended and will, at least in theory, only be interested in recommending the funds that are the best for the qualified investor (e.g., reasonable priced and of good quality). Similarly, if another investment category covers individual variable annuities, the adviser will be paid the same regardless of the particular annuity contract, insurance company, or imbedded mutual funds. That is, the adviser's compensation will be the same across all variable annuity contracts, regardless of which one is recommended.

But, what if some categories require more work or services than other categories? For example, what if it takes more work to recommend and service an individual variable annuity than to provide non-discretionary investment advice about mutual funds? In that case, the Department of Labor says that it is permissible to pay differential

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compensation among reasonably designed investment categories, so long as the differences are based on neutral factors. So, for example, if the amount of work, the complexity of the product, and so on, means that the services for a variable annuity are twice as valuable, the adviser could earn twice as much for recommending an individual variable annuity and assisting with the selection of the embedded investments. On the other hand, if the services for the variable annuity were only 50% more difficult each year thereafter, then the adviser could be compensated 50% more than the annual fee that could be paid for a qualified account with mutual funds.

The key to understanding these concepts is to realize that the “neutral factors” differential compensation is not a dollar amount. Instead, it is a ratio established, for both the first and each subsequent year, between the different categories of investments. Where the relative compensation to the adviser for different reasonably designed investment categories could vary according to those ratios, compensation must still be reasonable.

So, as described in this article, an individual adviser’s compensation must be “reasonable,” “level” within an investment category, and “neutral” in differences between investment categories.

It is going to be difficult and time-consuming for the financial services community to adjust to these changes. And, the deadline is April 10 (with an extension for some purposes until January 1, 2018).

*The views expressed in this article are the views of Fred Reish, and do not necessarily reflect the views of Drinker Biddle & Reath.*

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