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The Fiduciary Rule Prohibits Commissions… or Not (Myth #6): Interesting Angles on the DOL’s Fiduciary Rule #81

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The Fiduciary Rule Prohibits Commissions . . . or Not (Myth #6)

This is my 81st article about interesting observations concerning the Department of Labor’s (DOL) fiduciary rule and exemptions. These articles also cover the DOL’s FAQs interpreting the regulation and exemptions and related developments in the securities laws.

This is another in my series of articles about myths concerning the Fiduciary Rule. The myth for this post is the oft-repeated statement that the Fiduciary Rule prohibits the payment of commissions.

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Before getting into the explanation, though, I should give you some background information. Under the prohibited transaction rules in ERISA, a fiduciary advisor cannot make a recommendation that causes a payment from a third party (for example, a 12b-1 fee or an insurance commission) or that directly increases the advisor’s compensation (for example, a commission on a securities transaction). While those ERISA prohibited transactions only apply to retirement plans, there are virtually identical rules under the Internal Revenue Code–which apply to both qualified retirement plans and IRAs.

However, those prohibited transactions apply to advisors who are fiduciaries. As a result, the prohibitions were not a problem for non-fiduciary advisors prior to the June 9, 2017 expansion of the definition of fiduciary. With that new Fiduciary Rule, almost every advisor to retirement plans or IRAs is now a fiduciary. That includes financial advisors of broker-dealers, investment advisors with RIAs, and insurance agents and brokers.

Now that advisors are usually fiduciaries, ERISA and the Internal Revenue Code prohibit the receipt (i) of payments from third parties and (ii) of compensation that varies with the recommended investments or insurance products. If that were the end of the story, then it would not be a myth to say that commissions are prohibited by the Fiduciary Rule. But, it’s not the end of the story. On June 9, 2017, the “transition” version of the Best Interest Contract Exemption (BICE) also came into effect. Under transition BICE, there is only one explicit restriction on compensation. That is that advisors and their financial institutions can receive no more than reasonable compensation for their services. In other words, and as a general rule, the BIC exemption permits the payment of reasonable compensation in virtually all forms. As the DOL said in its preamble to the BIC exemption: *“[T]he Department confirms that this exemption provides relief for commissions paid directly by the plan or IRA, as well as commissions, trailing commissions, sales loads, 12b-1 fees, revenue sharing payments, and other payments by investment product manufacturers or other third parties to Advisers and Financial Institutions.”*

But . . . there is still more to this story.

The Department of Labor has also said, on several occasions, that it expects financial institutions (such as broker-dealers and RIAs) to have policies, procedures and practices that ensure that the form of compensation does not cause advisors to recommend investments that are not in the best interest of the retirement investors. As a result, financial institutions should develop policies, procedures and practices for those purposes. That could include reducing the differences between levels of commissions, close supervision of certain types of transactions, and/or specifying the process by which recommendations are to be developed. In other words, the development of those policies, procedures and practices needs to be done thoughtfully. There is no “one-size-fits-all” solution that will satisfy the requirements for all types of transactions. For example, it is difficult to imagine a single policy that would cover issues as diverse as recruitment bonuses, recommendations to participants to roll over, and sales contests.

I am concerned that some broker-dealers, banks and RIAs may be underestimating the importance of well-developed policies for each of the types of potential conflicts of interest that could impact advice to plans, participants and IRA owners.

Note: The BIC exemption only provides relief for nondiscretionary investment advice. This article does not apply to arrangements for discretionary investment management.

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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