Level Fee Fiduciaries and the BICE

Marcia S. Wagner, Esq.

Under ERISA, an investment advice fiduciary's receipt of commissions or any other type of compensation that varies based on the particular investment recommended to a retirement client has always been unlawful, because it creates an incentive to steer the plan client to the better paying investment alternative and therefore creates a conflict of interest for the advisor. A fiduciary advisor is only permitted to earn variable compensation if the advisor qualifies for an available exemption from the prohibited transaction rules. The new DOL fiduciary rule includes such exemptions and thereby creates a class of advisors who can continue to earn "conflicted" compensation if they comply with the terms of an applicable exception, in particular the new Best Interest Contract Exemption (BICE). This article will consider some of the ramifications of this system if advisors opt to comply with the BICE exemption by limiting their compensation to a level fee.

Rollovers and the BICE. Let's start by considering rollovers. Financial advisors soliciting rollovers and expecting to earn commissions will need to comply with the full BICE requirements by entering a contract with the rollover client promising adherence to the new "best interest" standard. This will provide prohibited transaction relief for any commissions earned on rollover assets and will also cover the conflict created by the fact that the advisor may earn a higher level of compensation as a result of the rollover, regardless of whether it is variable or level.

Streamlined BICE. Level-fee advisors will also need relief under the BICE when offering rollover advice, but they will be entitled to rely on a streamlined version of this exemption. Advisors should make sure they know what it takes for compensation to qualify as a "level fee" for this purpose. According to the DOL, this term only refers to compensation received by the financial institution, the individual advisor and any affiliate received in connection with advisory services that is based on a fixed percentage of the value of assets under management, or a set fee that does not vary with the particular investment recommended. In this regard, the value of the assets needs to be determined by independent valuations or from readily available independent sources. In other words, valuations by the advisor are problematic. In addition, receipt of commissions, 12b-1 fees, revenue sharing, or other payments beyond the level fee by the financial institution, advisor, or an affiliate will compromise their status as level fee fiduciaries and require compliance with the full BICE.

Assuming the level fee condition is satisfied, the requirements of the streamlined BICE are simple. The retirement investor must be given a written statement of the fiduciary status of the financial institution and advisor, and they must both comply with the new impartial conduct standard which means acting for the best interest of the client, accepting only reasonable compensation, and avoiding misleading statements. However, no contract, warranties, compliance policies, or disclosures are needed.

Special Documentation Requirement. Nevertheless, the DOL added a significant additional requirement in order to qualify for the streamlined BICE when a level fee fiduciary recommends a rollover from an ERISA plan to an IRA, a rollover to an IRA from another IRA, or a switch from a commissioned-based account to a fee-based account. In these situations, the fiduciary must document the reasons why the level fee arrangement was considered to be in the retirement investor's best interest. This requires consideration of the investor's alternatives to a rollover, including leaving the money in the plan, if permitted, fees and expenses associated with the plan and the IRA, whether the employer pays for some or all of the plan's administrative expenses, the different levels of services under the plan and the IRA, and different investments available under each option. Differences with respect to potential withdrawal penalties, protection from creditors, and the applicability of required minimum distributions should also be considered. Of special note is the fact that the services to be provided for the advisor's level fee must be included in this documentation. This is a sign that being a level fee fiduciary does not, by itself, allow an advisor to treat his or her fiduciary duties as having been met.

The consideration and documentation of the retirement investor's individual needs and circumstances are similar to the requirements of FINRA Notice 13-45, which the DOL thinks should be the basis for evaluating these needs. Conformity with Notice 13-45 means that the advice must be reasonably based on its suitability for the plan participant. This, in turn, requires the advisor to consider the impact of the rollover decision on the participant's investment profile, including the participant's (i) age, (ii) investments outside the plan, (iii) financial situation, (iv) tax status, (v) investment goals and experience, (vi) investment time horizon, (vii) liquidity needs, and (viii) risk tolerance, as well as other information the participant may disclose.

As noted above, the BICE is not a cure-all, and it does not cover prohibited transactions that involve self-dealing. Therefore, if in the context of a rollover, an advisor engaged in reverse churning by recommending that an asset continue to be held solely in order to generate fees, the advice would not qualify for relief under the BICE. Similarly, it appears that the DOL views recommending a fee-based account to an investor with low trading activity and no need for ongoing monitoring or first recommending a mutual fund with a front-end sales load and then recommending that the customer transfer the fund shares into an advisory account subject to asset-based fees as not qualifying for BICE relief.

Reasonable Compensation. No transactions for which relief is sought under the BICE may generate more than reasonable compensation for advisory services. The reasonableness of the compensation depends on the facts and circumstances of each recommendation and is based on the market value of the package of services, rights, and benefits acquired by the investor. The range of factors taken into account in evaluating reasonableness encompasses the advisor's ongoing services, including monitoring.

Monitoring and Other Post-Transaction Services. The DOL has clarified that advisors are "generally free not to enter" into advisory arrangements that involve ongoing monitoring. This unusual language apparently means that a rollover, distribution, or services recommendation does not automatically create a monitoring obligation and that the advisor can contract away any implied requirement of follow-up services. But the nature, complexity, or risk of certain investment products may demand further guidance, and the DOL has stated that a financial institution should carefully consider whether these investments can be prudently recommended to an individual retirement investor in the first place without a mechanism in place to provide monitoring of the investment for the investor's protection.

It would seem that even though compensation for advisory services may be structured as a level fee meeting the literal requirements of the streamlined BICE, the expected relief could be lost if the fee is not properly aligned with the nature of the product and the magnitude of the fee.

Marcia S. Wagner *is the Managing Director of The Wagner Law Group. She can be reached at 617-357-5200 or* Marcia@WagnerLawGroup.com.