LEGAL UPDATE

Managed Accounts and the Conflicts of Interest Rule

Marcia S. Wagner, Esq.

DOL regulations relating to the selection of a 401(k) plan investment menu require plan fiduciaries to ensure that investment and service provider fees are reasonable and consistent with market pricing. Class action lawsuits have charged 401(k) plan sponsors with violating their fiduciary duties by failing to investigate investment alternatives less expensive than mutual funds, such as managed accounts and bank collective investment funds (CIFs).

Scope of Fiduciary Definition. The DOL's new Conflicts of Interest Rule, which goes into effect on April 10, 2017, extends the scope of fiduciary investment advice so that virtually all recommendations with respect to investing in or managing securities or other investment property will cause an advisor to be treated as a fiduciary, including guidance relating to the selection of third parties to provide investment management services. Accordingly, 401(k) plan advisors will generally be acting in a fiduciary capacity if they render advice with respect to managed accounts and CIFs. In addition, managed accounts may have one or more model providers that create model portfolios of securities. Even though the model providers may not know the identities of individual plan clients, they too could conceivably be viewed as fiduciaries under the new rule's broadened definition. If model providers are deemed to be fiduciaries, an advisor's recommendation to a client to use a particular model provider could also be viewed as fiduciary advice under the new rule.

Variable Compensation. One of the restrictions imposed on these fiduciaries is ERISA's prohibition of their receipt of variable compensation, such as commissions or any other type of compensation that varies based on the particular investment recommended to the retirement client, unless an exemption from the prohibited transaction rules applies. Because of the broad scope of the new fiduciary definition under the Conflicts of Interest Rule, the DOL recognized that exemptive relief would be necessary for advisors who had not previously held themselves out as fiduciaries, but would be deemed to be fiduciary advisors after the rule change. For this reason, the DOL issued a new prohibited transaction exemption called the Best Interest Contract Exemption (BICE).

Best Interest Contract Exemption. The BICE is a complicated exemption, because it includes four alternative sets of conditions that apply based on the type of retirement investor to whom fiduciary advice is rendered as well as other circumstances. In its most demanding version, qualifying for the exemption requires a written agreement between the firm of a fiduciary advisor and retirement client that must be executed no later than a recommended transaction's execution. The agreement must acknowledge the advisor's fiduciary status and contain certain mandatory provisions and warranties, including a promise to adhere to a new standard of conduct requiring an advisor to base recommendations on the client's best interests and to disregard the advisor's own financial interests. The agreement must reflect general disclosures concerning the advisor's compensation and any related conflicts and include a warranty that the firm has adopted compliance policies designed to mitigate the conflicts. In addition to the written contract, the advisor's firm must also provide transaction disclosures for each recommended investment. Advice rendered to 401(k) plans will generally be subject to all of these requirements except for the need to incorporate them in a written agreement.

Eliminating Discretion That Prevents BICE Compliance. A major drawback to the BICE, however, is that it does not provide relief for discretionary advice. Therefore, advisors providing managed accounts, which by their nature endow them with considerable flexibility in managing the account's underlying investments, cannot receive variable compensation. CIFs are on the same footing as managed accounts, since either the bank trustee or the CIF advisor would need to possess full discretionary investment authority over the CIF's underlying assets. It is likely that both of these parties would either possess or exercise such power that would make the BICE inapplicable. Thus, CIFs, like advisors to managed accounts, would be restricted to receiving level compensation.

Level Compensation As An Alternative to the BICE. The alternative to complying with the BICE is that individual advisors, as well as their firms, can only receive a level fee, such as a flat dollar amount or a percentage of the client's assets under the advisor's management. This also requires eliminating or restructuring revenue sharing paid to an advisor's firm by sponsors of turnkey managed accounts. Revenue sharing payments could be restructured by changing them to flat dollar amounts that do not vary based on sales or assets. Variable compensation that would need to be similarly addressed could also arise from sub transfer agent fees, 12b-1 fees, or revenue sharing paid by mutual funds or a clearing broker to the advisor's firm in its capacity as the sponsor of a proprietary managed account program. Although levelizing third party payments seems contemplated by the wording of the BICE, DOL representatives have created doubt as to whether this will be permitted by stating that all third-party payments will necessitate compliance with the BICE. This interpretation would eliminate the ability of discretionary advisors and their firms, for whom the BICE is not available, to receive any third party payments. As of this writing, this issue remains unresolved.

Even if a client pays a level fee in order to participate in a managed account program, another potential source of variable compensation that would need to be addressed arises from the ability of an advisory firm sponsoring one of these programs to increase its net fee by selecting a less expensive strategist or subadvisor to construct asset allocation models. In addition, if an advisory firm sponsors a proprietary managed account program, variable compensation could arise because the firm could earn more under its proprietary programs than under an independent turnkey program. In other words, this would create an incentive to recommend the in-house program resulting in larger fees.

To deal with these situations, some firms are considering strategies that would levelize their net compensation by charging the client an incremental amount to cover the particular compensation rate of the chosen strategist or subadvisor. Thus, the gross fee paid by the client would vary depending on which strategist or subadvisor is selected. Other firms are exploring levelization of their gross fees while net compensation would vary. However, there is no indication from the DOL as to whether this approach would be appropriate.

Conclusion. Managed accounts and CIFs can be utilized to provide an "all in one" investment solution to 401(k) plan participants. However, these services, by their nature, involve discretionary fiduciary functions precluding reliance on the BICE. Nevertheless, program sponsors and fee-based advisors can safely provide managed account and CIF advisory services, as long as they comply with the DOL rules and limit themselves to only receiving level compensation. Advisors and plan sponsors should be sure to consider the consequences of the new DOL rule to determine if these asset allocation solutions are appropriate for them.

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