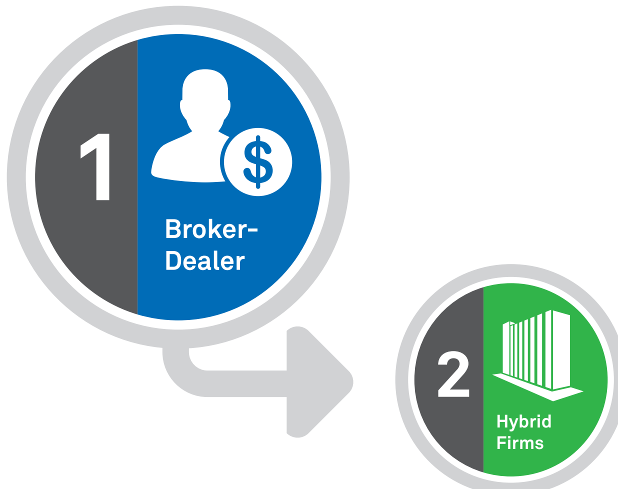
Conflicts in a Rapidly Changing Fiduciary Landscape

Part One:

A Focus on Broker-Dealer Challenges



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In collaboration with Thomas Roberts, a member of Groom Law Group's Fiduciary practice group

Breaking Down the Issues Around Common Broker-Dealer Practices

The federal securities laws describe the conduct of broker-dealers as engaging in the securities transactions business. Broker-dealers may provide investment recommendations to clients, but those recommendations are secondary to the primary business of trading securities.

The fundamental difference between the broker-dealer model and the investment advisor model is that broker-dealers are primarily compensated for selling and trading securities—not for their advice. Investment advisors, on the other hand, are compensated for the investment advice they deliver to clients.

Financial Industry Regulatory Authority (FINRA) rules governing broker-dealer conduct stem from broker-dealers' obligation to deal with clients fairly, and in accordance with high standards of commercial honor. A key aspect of broker-dealer fair dealing is the suitability obligation. This requires a broker-dealer to make recommendations that are consistent with the interests of its clients.

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That obligation towards "fair dealing" is creating pressure to re-evaluate and re-structure existing compensation practices.

That obligation towards "fair dealing" is creating pressure to re-evaluate and re-structure existing compensation practices. The pressure springs from multiple sources:

- Dodd-Frank mandates that the Securities and Exchange Commission develop uniform standards of care for broker-dealers and investment advisors
- The Department of Labor's (DOL) concern that additional layers of regulatory protection are needed to safeguard the interests of retirement savers.

While the outcomes of the Dodd-Frank mandate and the DOL's proposal remain uncertain, for the foreseeable future, broker-dealer firms are likely to experience increasing pressure to demonstrate that they have policies and procedures that identify and prevent conflicts of interest. Let's discuss some of the common practices that we believe to be potential conflicts.

Potential Conflict

Sales of Mutual Fund Shares and the Receipt of 12b-1 Fees

Broker-dealers often receive 12b-1 fees as compensation for sales resulting from recommendations of mutual funds to clients. Regulatory scrutiny of the process involved in developing the recommendations that generate 12b-1 fee compensation is likely to intensify.

- Broker-dealers need to be prepared to explain the process used to determine which mutual funds have been approved for sale to clients.
- Firms should be able to explain their due diligence process for product review and approval, and how the products approved for sale are anticipated to be used to meet particular client needs.
- These firms should demonstrate the process for supervisory review of the funds that representatives have recommended to clients with a view to whether those recommendations are aligned to meet client interests.

Potential Conflicts and Solutions

Sales of Mutual Fund Shares and the Receipt of 12b-1 Fees

Firms should be able to explain the process used to determine which mutual funds have been approved for sale, the due diligence process for product review and approval and their process for the supervisory review of funds.

Receipt of Revenue Sharing Payments

Any revenue sharing arrangements must be disclosed to clients and prospects. Firms must determine whether the arrangement presents an inappropriate conflict of interest.

While 12b-1 fees are an important element of brokerage firm compensation, FINRA is interested in the firm's policies and procedures for monitoring all elements of the firm's compensation model, as well as the splits between the firm's compensation and the compensation received by registered representatives.

Potential Conflict

Receipt of Revenue Sharing Payments

Certain fund companies make revenue sharing available to broker-dealers. This typically involves payments by the mutual fund's investment advisor or distributor from its own resources. Unlike 12b-1 fees, revenue sharing payments are not directly derived from the fund itself. Generally, revenue sharing payments are a percentage of broker-dealer client assets invested in a particular fund (i.e., 5 basis points (0.05%) of average monthly assets).

While revenue sharing arrangements are not unusual, broker-dealers need to carefully and thoughtfully decide to accept revenue sharing payments:

- Broker-dealers need to consider the purpose of the payments.
- Many broker-dealers accept revenue sharing payments to offset the costs of registered representative education and training on funds that are useful in serving client needs. If the arrangement is for purposes other than training and education, the firm should consider whether the arrangement presents an inappropriate conflict with client interests.
- Any revenue sharing arrangements must be disclosed to clients and prospective clients.

Many, if not most, broker-dealers with revenue sharing relationships, prominently disclose the names of the fund families, the purpose of those arrangements, and that the firm tends to concentrate its sales efforts on those fund families that maintain revenue sharing relationships with the firm. In addition, many broker-dealers publish a ranking of their mutual fund revenue sharing arrangements by identifying fund families according to the amount of revenue sharing paid.

Transaction Fee and No-Transaction Fee Mutual Fund Sales

Broker-dealers should ensure that there are policies and procedures for supervision and that recommendations are not influenced by compensation considerations.

Recommendations Concerning the Investment of ERISA and IRA Assets

Broker-dealers must adhere to fiduciary standards of conduct and FINRA rules, including prohibited transaction avoidance rules under ERISA and the Internal Revenue Code. Firms can work with their legal counsel to develop and use strategies to take advantage of prohibited transaction exemption relief.

It is important to consider: the extent to which revenue sharing relationships with fund families may give rise to inappropriate conflicts of interest when it comes to sales recommendations made by the firm's registered representatives. FINRA has suggested that, as a best practice, registered representatives not participate in revenue sharing with their broker-dealers.

Potential Conflict

Transaction Fee and No-Transaction Fee Mutual Fund Sales

Many broker-dealers offer transaction fee and no-transaction fee (NTF) funds to clients. The differences in the way the broker-dealer is compensated on transaction fee and NTF fund offerings can be seen as a conflict of interest. Depending on the size of a client's investment and the anticipated length of the holding period, the firm may earn more compensation if the client purchases a NTF fund rather than a transaction fee fund (or vice versa).

To avoid conflict or the appearance of conflict, a broker-dealer should make sure it has policies and procedures for supervision that ensure recommendations are not influenced by compensation considerations.

Potential Conflict

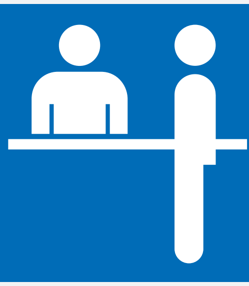
Recommendations Concerning the Investment of ERISA and IRA Assets

Individuals and firms that act as fiduciaries when making investment recommendations with respect to IRAs and ERISA plans are subject to the broker-dealer standards of conduct and FINRA rules. They are also subject to the fiduciary standards of conduct and prohibited transaction avoidance rules under ERISA and the Internal Revenue Code. Those standards of conduct are particularly intolerant of conflicts of any kind. Prohibited transaction exemptions must be adhered to in order to receive compensation that would otherwise be considered prohibited due to conflict. These exemptions are often highly detailed and technical.

It is important to note that IRAs are considered individual plans and are subject to these rules.

The DOL has proposed some dramatic changes to the regulations that define when an individual advisor or firm is acting as a fiduciary. If adopted, those changes could dramatically change firm business models.

Under current law, the DOL's regulations utilize a five-part test to determine the circumstances under which someone will be deemed a fiduciary by rendering investment advice for compensation. It is important to note that IRAs are considered individual plans and are subject to these rules. Under the current law:



An **ERISA fiduciary** is someone who provides investment advice for a fee, if he or she:

1. makes **recommendations** as to the advisability of investing in, purchasing or selling securities or other property, or gives **advice** as to their value,
2. on a **regular** basis,
3. pursuant to a **mutual agreement**, arrangement or understanding, with the plan or a plan fiduciary, that
4. the advice would serve as a **primary basis** for investment decisions with respect to plan assets, and that
5. the advice is **individualized** based on the particular needs of the plan.

The determination of fiduciary status is critical. An ERISA fiduciary is not allowed to engage in transactions where he or she has a conflict of interest, unless the requirements of a specific prohibited transaction exemption can be satisfied. Under ERISA, disclosure alone does not resolve conflicts. Conflicts of interest for ERISA fiduciaries include:

- Self-dealing (i.e., a transaction in which the fiduciary has a financial or other interest)
- Receiving kickbacks (i.e., payments from a third party in connection with a plan transaction)

Many broker-dealers today take special precautions to avoid ERISA fiduciary status when providing investment recommendations to clients with respect to IRA and qualified plan accounts. For example, many broker-dealers make sure their clients acknowledge that their broker does not provide investment advice under ERISA and that any recommendations made should not serve as the primary basis for decision-making.

In circumstances where a broker-dealer does provide recommendations as a fiduciary to qualified plans and IRA accounts, special precautions are required. The objective is to make sure that any compensation received for those recommendations does not lead to a violation of the prohibited transaction rules under ERISA and the Internal Revenue Code. This includes the prohibitions against fiduciary self-dealing. In many cases, broker-dealers seek to avoid potential conflicts in these situations by leveling their compensation and rebating to client accounts amounts that may exceed the level agreed upon. Prohibited transaction exemptions issued by the DOL may also be available. Some firms have worked with their legal counsel to develop and use strategies to take advantage of prohibited transaction exemption relief.

Best Practices

Under ERISA, disclosure alone does not resolve conflicts.

FINRA has published suggestions on best practices for avoiding conflicts of interest, which include:[1]

- Establishing a committee to consider whether new products are appropriate for the firm's clients
- Establishing a comprehensive system for supervising the recommendations by all firm registered representatives
- Ensuring that no advisor participates in any revenue sharing from a preferred provider, nor earns more for the sale of a product issued by a preferred provider or a proprietary product than for other, comparable products, and that the registered representative discloses to clients the payments that the financial institution and its affiliates have received from a preferred provider or for a proprietary product
- Establishing thresholds in the compensation structure that will require increased supervision of advisors who have approached the thresholds
- Monitoring an advisor's recommendations to determine whether products or services for which the registered representative receives higher compensation are being sold improperly
- Penalizing advisors by reducing compensation, based on the receipt of client complaints or indications that conflicts are not being carefully managed
- Developing metrics for behavior (e.g., red flags), comparing a registered representative's behavior against those metrics and, in part, basing compensation on them
- Use of product neutral compensation grids to reduce incentives for financial advisors to prefer one type of product over another. Under this system, a registered representative receives the same percentage of the gross dealer concession (GDC) no matter the product sold. The broker-dealer also may monitor recommendations of its financial advisors to determine whether any are concentrated in high GDC products.
- In the context of mutual fund and variable annuity sales, using fee-capping to reduce incentives for a registered representative to favor one product family over another for comparable products. For example, a broker-dealer may cap at 4% the GDC for emerging market equity funds. This cap would eliminate incentives for a registered representative to favor an emerging market equity fund that paid a higher GDC than the 4%.

The Bottom Line

Staying ahead of the regulatory curve and keeping up with requirements will remain challenging. Firms that adopt management practices aimed at identifying potential conflicts of interest between the firm's compensation interests and those of its clients, and supervisory practices to assure that client interests always come first, will have an advantage in preserving their firm's good reputation—now and for the future.

1. *See, e.g.,* FINRA Report on Conflicts of Interest, October 2013.

Thomas Roberts is a member of Groom Law Group's Fiduciary practice group. Mr. Roberts has an extensive background in retirement services and the insurance industry. His expertise focuses on ERISA fiduciary, tax, securities and state insurance laws affecting defined contribution plan product and service offerings. Prior to joining Groom, Mr. Roberts served as Chief Counsel of ING U.S. Legal and supervised legal support to ING's retirement services businesses.

Updates and further information on this topic are available at www.groom.com.

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* Based on number of broker-dealer clients, *InvestmentNews* 2015

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