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DOL's Fiduciary Regulation: A Catalyst for Annuity Product Innovation?

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Annuity industry professionals are all too familiar with the most frequently levelled criticism of the individual annuity product: “It’s just too expensive!” Though many would take issue with that refrain, the expense structures associated with individual annuity contracts have provided fodder over the years for a number of consumer financial publications, radio and television pundits and others to question whether the costs with annuities might sometimes outweigh their value.

A key driver of annuity expense structures today is, of course, the cost associated with product distribution. But these costs of distribution may be on the verge of changing—and potentially in a major way. The Department of Labor’s final regulation defining the term “fiduciary” for purposes of the ERISA and the Code is aimed squarely at the sales conduct of financial advisors (advisors) to small 401(k) and other employer sponsored plans, participants and IRA holders. The department’s regulation and related prohibited transaction exemptions are likely to require changes to advisor compensation structures. And in many cases those changes are likely to reduce the level of compensation payable to advisors for the successful recommendation of annuity products.

Below, we examine these regulatory-driven changes to advisor compensation and offer some thoughts about how those changes might impact annuity product design down the road.

THE FINAL REGULATION

The new rules defining the term “fiduciary,” which become applicable on April 10, 2017, will largely re-characterize persons who today are non-fiduciary sellers of financial products to ERISA plans, participants and IRA holders, into fiduciaries. The prohibited transaction rules under ERISA and the parallel provisions applicable to IRAs under Internal Revenue Code section 4975 prohibit fiduciaries from exercising their authority in their own financial interest (prohibited self-dealing) and from receiving payments from third parties in connection with a recommended transaction (prohibited kickbacks) **unless** an exemption is available and the fiduciary has complied with its conditions.



THE BEST INTEREST CONTRACT EXEMPTION

Realizing that advisors engaged in the distribution of annuities and other financial products are typically compensated on a transaction basis, the Department has published a new prohibited transaction exemption—the Best Interest Contract or BIC exemption—for purposes of allowing distribution firms and advisors to continue to receive transaction-based compensation, subject to various conditions. The most significant of these conditions requires the distributing financial institution (typically a broker-dealer) to enter into a written contract or similar writing with retail clients of its advisors. The BIC contract is required to include the following statements (among others):

- a promise that the firm and its advisors will provide recommendations that, at the time they are made, are in the client’s best interest by reflecting the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims, based on the investment objectives, risk tolerance, financial circumstances and needs of the client **without regard to the financial or other interests of the advisor**, the financial institution the advisor represents, or any other party;

- a statement that the recommended transaction will not cause the advisor, the financial institution he represents or other related parties to receive compensation for their services that exceeds what is reasonable compensation; and
- a warranty by the financial institution represented by the advisor that the financial institution has adopted policies and procedure reasonably and prudently designed to ensure that its advisors adhere to the best interest standard of conduct described above.

The Preamble language accompanying the BIC exemption makes clear that advisor compensation lies at the heart of matter. The department expresses the view that financial institutions seeking exemptive relief under BIC have an obligation to examine whether the ways in which its advisors are compensated may give rise to conflicts with the interests of the advisors' clients. In particular, where a firm's advisors may be financially incented to recommend the sale of investment products, including annuities that may not be in the customer's best interest, the financial institution is obligated to revise its advisor compensation structure.

Where a financial institution compensates its advisors on a transaction-based basis, the department expresses the view that advisors should not receive differential compensation **within** product categories. As to the payment of differential compensation **between** product categories, the is permissible only to the extent attributable to "**neutral factors**" such as the time and effort involved in explaining a more complex product (e.g., an annuity vs. a mutual fund) to a retirement investor client. Differences in the compensation paid between product categories that might be based on non-neutral factors would, in the department's view, be likely to encourage advice other than in the best interest of an advisor's retirement investor clients.

A RE-ASSESSMENT OF ANNUITY COMPENSATION

Today, the financial compensation available to advisors who successfully recommend the purchase of an annuity product is often well in excess of the compensation available for the recommendation of a non-annuity product, such as a mutual fund. For the reasons described above, the degree of that compensation differential is likely to be significantly reduced for annuity sales to ERISA plan participants or IRA holders taking place on or after April 10, 2017. By that date, selling firms will have needed to examine and re-formulate their advisor compensation structures so as to remove incentives that might cause an advisor to recommend one product, such as an annuity, over another, such as a mutual fund, for reasons related to the advisor's own financial interests.

Few would argue that in the present marketplace, the expense structure of individual annuities reflects the financial incentives offered to distributors, and ultimately, to advisors who market and

sell the product. But what will those expense structures look like in the post-April 10, 2017 marketplace envisioned by the department, where differences in the compensation paid to advisors between products are likely to be limited to neutral factors that do not provide the advisor with a financial incentive to recommend one product over another? While it is too soon to be able to answer that question with certainty, here are a few predictions:

1. The compensation payable to advisors who recommend annuity products is headed sharply downward. The compensation payable by annuity manufacturers to selling firms is likely to reflect this change.
2. Payments made by annuity manufacturers to selling firms for "shelf space," "preferred partner" arrangements and the like are also headed downward. While the BIC exemption does not prohibit these practices, it does require the selling firms who engage in them to adopt policies and procedures to assure that any financial conflicts attributable to such payments at the firm level do not influence advisor recommendations to clients. In light of that, selling firms are likely to re-structure such payments as a uniform access fee paid by all product manufacturers distributing through the firm. The uniform nature of the fee (the same fee will be paid by all manufacturers) means that it will no longer be reflective of actual sales volumes.
3. These reductions in distribution costs, which will likely be significant, will afford product manufacturers an opportunity to either re-price existing products with existing guarantees, or perhaps to re-design those products to deliver additional value—in the form of enhanced guarantees.

For the actuarial profession, this latter possibility is perhaps the most intriguing. In a future-state environment where distribution costs may be sharply reduced and where advisors are no longer financially incented to recommend an annuity over a competing non-annuity product, what new forms of guarantees might product manufacturers develop to remain competitive? Moreover, might the anticipated reduction in product distribution costs clear the way for changes to annuity cost structures, including the amounts and length of deferred sales charges?

In these respects, the Department of Labor's new fiduciary rule could prove to be a catalyst for product innovations and re-designs that will position the annuity industry to respond to some of its harshest critics. ■



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