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LAWFLASH

FIDUCIARY RULE FAQs CHALLENGE BACK-END RECRUITMENT BONUSES

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AUTHORS AND CONTACTS

Samuel S. Shaulson, Andrew J. Schaffran, Lindsay B. Jackson, Katrina L. Berishaj, Daniel R. Kleinman

Financial services firms with active recruiting programs should consider immediately how the DOL's FAQs affect their compensation packages with respect to back-end recruitment awards.

To help the financial services industry implement its Conflicted Advice Rule for Retirement Investors (the so-called "DOL Fiduciary Rule") scheduled to be effective on April 10, 2017 (the Rule), the US Department of Labor (DOL) released answers to a number of frequently asked questions (FAQs).

The FAQs aim to answer questions relating to the suite of new exemptions, including the Best Interest Contract (BIC) Exemption, as well as amendments to existing exemptions included in this wide-sweeping rulemaking. The BIC Exemption would provide relief that would permit an investment advice fiduciary to receive certain types of otherwise "prohibited compensation" where, among other things, the investment advice fiduciary acknowledges fiduciary status and, in some cases, contractually agrees to be subject to a "best interest" standard.

BACKGROUND

Of immediate concern for broker-dealers and other financial institutions with registered representatives and advisers intending to rely on the BIC Exemption is FAQ12. FAQ12 calls into question whether, and to what extent, "back-end awards" can continue to be included in recruitment compensation packages after the Rule's effective date (currently April 10, 2017):

- Back-end awards or bonus arrangements generally provide for contingent compensation based on preset asset or revenue targets extending over multiyear periods.
- The DOL is concerned that these types of awards "significantly increase conflicts of interest for the advisers [dealing with retirement investors] . . . particularly as the adviser approaches the target" because the awards "commonly result in large amounts of income to the adviser . . . on an 'all or nothing' basis."
- Based on the concern above, the DOL concludes that "financial institutions generally may not enter into

- › such arrangements” when relying on the full BIC Exemption.

GENERAL ISSUE

As many broker-dealers and other financial institutions are intending to rely on the BIC Exemption in one form or another after the Rule’s effective date, compensation packages need to be reviewed to determine whether they should be restructured to address the DOL’s concerns.

IMMEDIATE ISSUE / DOL GRANDFATHERING RULE

Because recruiting advisers is an ongoing process (with firms maintaining active inventories of open recruitment offers), and because compensation packages generally stretch over multiyear periods, which will extend past the Rule’s effective date, *firms need to start addressing these issues today*. However, a “grandfathering rule” may apply under certain conditions:

- › Recognizing that firms may be contractually obligated to honor back-end bonus arrangements that were entered into in good faith prior to this new guidance, the DOL has created a “grandfathering rule.”
- › Specifically, the DOL states that it was not its “intent to overturn such pre-existing binding contracts . . . and that the [DOL] would not treat the parties as having created an impermissible incentive structure under the exemption based on such a pre-existing agreement.”
- › The guidance provides generally that a pre-existing arrangement exists if the firm entered into such an arrangement *as part of a written and binding contract that it is contractually bound to honor* prior to the date of the FAQ guidance, which was published on the DOL website on *October 27, 2016*.
- › The DOL goes on to state that to the “extent that the [firm] chooses to honor these pre-existing arrangements . . . it must adopt special policies and procedures specifically aimed at the conflict of interest introduced by the arrangement.”

PRACTICAL CONSIDERATIONS

As firms generally have active recruitment programs, they should consider the following questions in light of the FAQs:

- › Will the firm rely on the BIC Exemption and be subject to this new guidance?
 - › Relatedly, does the guidance have any applicability with respect to other exemptions subject to the DOL’s new “impartial conduct standard” (e.g., PTE 77-4 for fiduciary investments in affiliated mutual funds) on which the firm may rely post Rule effective date?
- › Does the firm’s standard recruitment package include bonuses or awards that could be viewed as running afoul of this guidance?
 - › How can the firm restructure potentially problematic arrangements under this guidance?
 - › How will the industry as a whole respond to these changes in compensation arrangements? What are the strategic ramifications of the changes?
- › What offers were outstanding as of the date that the FAQ guidance was published (October 27, 2016), and what constitutes a “contractually binding agreement” on behalf of the firm?
 - › Were any offers accepted on the date of the guidance?
 - › What process will the firm employ to determine in “good faith” whether it is contractually bound to

- ➤ honor arrangements entered into prior to the date of the FAQ guidance?
- How will otherwise revocable offers that have not officially been accepted as of October 27, 2016 be treated?
 - What are the potential employment law and other legal issues related to revoking an offer?
 - Should outstanding offers be restructured and, if so, how?
 - Should the firm adopt some type of temporary or transitional compensation arrangements while evaluating these changes?
- What special policies and procedures need to be adopted to address the DOL's concerns with any pre-existing recruitment arrangements?
- What types of litigation and enforcement risks do these and similar types of arrangements represent to firms after the Rule goes into effect?

Morgan Lewis continues to evaluate the potential effects of FAQ12 (and the other FAQs) and analyze their potential impacts on our clients and the industry as a whole. We are closely following the Rule's development and will provide updates as they occur.

ADDITIONAL RESOURCES

Catch up on our prior thought leadership covering the Rule to date:

- DOL Releases First Wave of FAQs on Fiduciary Rule
- The Final DOL Fiduciary Rule—Considerations for Plan Sponsors
- More DOL Final Fiduciary Rule Fallout: Some Potential IRS Pitfalls for IRA Custodians and Trustees (Part 2 of 2)
- More DOL Final Fiduciary Rule Fallout: Some Potential IRS Pitfalls for IRA Custodians and Trustees (Part 1 of 2)
- Final DOL Fiduciary Rule—First Impressions
- DOL Sends Fiduciary Rule to OMB for Review
- Any Congressional Action on Proposed DOL Fiduciary Rule Postponed to 2016
- Threshold Issues Raised by DOL's Proposed Fiduciary Rule
- DOL's Proposal to Expand Fiduciary Definition Would Bring Many Service Providers into Scope
- DOL Fiduciary Rule to Revamp Regulation of Advice to Plans and IRAs
- DOL Sends Proposed Conflict of Interest Rule to OMB for Review

CONTACTS

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis lawyers:

Boston

Lisa H. Barton

T. Peter R. Pound

Chicago

Marla J. Kreindler

Julie K. Stapel

New York

Craig A. Bitman
Jeanie Cogill
Jennifer L. Klass
Barbara D. Klippert
Andrew J. Schaffran
Samuel S. Shaulson

Philadelphia

Robert L. Abramowitz
Joseph J. Costello
Brian J. Dougherty
Vivian S. McCardell
Steven D. Spencer
David B. Zelikoff

Pittsburgh

John G. Ferreira
R. Randall Tracht

Washington, DC

Brian J. Baltz
Katrina L. Berishaj
Lindsay B. Jackson
Daniel R. Kleinman
Christina Payne-Tsoupros
Michael B. Richman
Steven W. Stone