McLagan Alert

Implications of New FLSA Minimum Salaries and DOL Fiduciary Ruling

It's certainly not a stretch to call 2016 a very challenging year for HR / Compensation professionals in the financial services industry as they respond to two sweeping regulatory changes: the Department of Labor's new fiduciary standard for Financial Advisors and new FLSA minimum salary rate for exempt employees.

Many would argue it was high time for those two large regulatory dominos to fall, and now firms are attempting to accurately predict the aftermath: what other regulations will change, what can or should remain the same, and what proactive steps should firms voluntarily take. We introduce a few theories on how compensation may change in the near and longer term below, and in a subsequent piece will discuss additional areas that will require firms' focus to minimize risk in the new world, while also maintaining and even increasing productivity.

In terms of compensation, the new $47,476 minimum salary will have the most immediate impact, with probably a limited set of potential changes for Financial Advisors (as well as some other commission-based roles such as wholesalers and recruiters). The move from a draw to a true, higher salary will require a corresponding decrease in variable pay, and the lower production levels of commission grids are the most likely targets. Following the lead of a few firms that have already incorporated guaranteed FA salaries, firms may very well adopt a 0% commission rate up to a production level that covers the base salary cost, thus avoiding "double paying." Above that production level, commission rates can kick in, but either at much lower starting rates than those traditionally employed, or in an incremental fashion on production above the stated minimum.

With regards to the new fiduciary rule, the DOL did not knock down as many dominos as some had anticipated. Rather than strict prohibition, many products and compensation structures were spared, but through two main exemptions: Best Interest Contract and Level Fee. However, this stance by the DOL has produced difficult challenges and decisions for firms throughout the industry. By imposing a stricter fiduciary standard but making room for these exemptions, the burden of fiduciary proof falls squarely on firms should lawsuits ensue, which are a possibility now that the new rules no longer limit conflict resolution solely to arbitration.

How you can respond

For direct consultation on these implications, please contact us:

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All of the above pertains to retirement accounts only, but that distinction may be fleeting. The SEC is expected to introduce its own fiduciary standard next year which would pertain to non-retirement accounts. Similarly fleeting may be firms' usage of the BIC exemption. While most firms will be utilizing it in the short-term due to the pending deadlines, it remains to be seen if that crutch can bear much weight as a more permanent solution. Another temporary concession from the DOL is that current assets are grandfathered without needing either exemption, allowing firms to continue paying FAs as originally contracted. However, any new accounts or new money to existing accounts would be subject to the more stringent rules. Furthermore, word is spreading that if an FA is recruited to another firm, any grandfather status will be removed, an eventuality that would slow recruitment volume, as might new requirements around reasonable pay and compensation disclosures.

Given the above changes and the public groundswell around the question, "shouldn't Advisors always act in their clients' best interests?", it seems the prudent decision is for firms to willingly make the move to full fiduciary status on all assets now rather than risk being viewed as dragged there reluctantly a year from now, if they have consistently robust and well documented advisory processes. Firms that make this move early, we believe, would garner strong public and regulatory favor, and, in addition to effectively limiting legal and financial risk, would more likely find other firms following suit. It seems far less risky to publicly announce a firm's commitment to elevating their clients' interests than to fight the tide and publicly resist the inevitable.

Whether firms lead the way to full fiduciary standard or play follow-the-leader, the DOL's rule will undoubtedly require changes to compensation. The pay changes may come to delayed fruition, though, as firms focus more immediately on two other P's: Processes (e.g., compliance controls and best interest checks) and Products (e.g., continued but accelerated shift to fee-based). Ensuing pay changes, while more open-ended on form and magnitude, will be inherently linked to the process and product evolution. For example, firms must apply automated investment tools for small accounts that cannot be profitably served in a traditional FA relationship, and these same tools will be critical for driving consistency in investment recommendations for all clients. As the mix of technology in advice delivery and FA productivity grows, FA pay and performance levels will need to be recalibrated. Compensation structures will also need reforming as the current model potentially becomes outdated; while not expressly forbidden, production based commission grids are most at odds with the fiduciary standard, require the BIC exemption to survive, and leave firms most vulnerable to class action suits. This exposure will be multiplied if the SEC adopts its own fiduciary standard as we and many predict.

Firms can take many approaches to pay changes in response to the new regulatory landscape. At one end of the spectrum lies a complete migration to the base + discretionary incentive model prevalent at private banks, but this strategy seems too drastic and risks mass attrition, especially because the DOL has explicitly permitted commission plans. As some recent examples have demonstrated, FAs will revolt and bolt in response to such a move unless it is mandated by regulators. At the other extreme lies a complete reliance on BIC. This approach seems similarly unlikely, though, as firms would walk a tightrope with regulators and clients alike. A more even-handed reaction can be found by looking at the RIA segment of the industry that is already governed by the more stringent fiduciary definition. A shift from production to asset-based pay has footing at RIAs, and the broader industry has already been heading in this direction with the migration to fee-based products. A transition to asset-based pay would find safe haven under the Level Fee exemption.

Re-designed incentive packages could also introduce some discretionary or qualitative elements into advisor pay, incorporating teamwork and client satisfaction, for example. As the client service delivery model continues to incorporate more of a team approach, including across wealth management business silos, compensation also needs to evolve to support that model. Introducing some team success measures promotes appropriate behaviors, including putting clients' best interests ahead of any misaligned attempt to keep clients and assets to oneself. Client experience tracking will be more critical than ever due to the expansion of Robo Advisor and Call Center platforms (exacerbated by firms resetting client minimums for advisory relationships), increased book transitions related to retiring advisors, and growing generational wealth transfers. Last but nowhere near least, a client-centric component of pay would serve as tangible proof to regulators that firms aim to deliver against client expectations.

Amidst all the moving parts of future FA pay plans, the fundamental underpinnings of any successful compensation program must remain and, in some areas, be fortified. Those include clear links between performance and pay in a transparent, understandable, differentiated yet equitable fashion, as well as aligning client, FA, and firm definitions of success.

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