DOL 101: The fiduciary rule’s impact on IMOs

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Part 3 of this series of articles about the DOL fiduciary rule's impact focuses on independent marketing organizations. (Photo: iStock)

The **Department of Labor’s fiduciary rule** is the most significant industry game-changing development we have seen since the tax reform to annuities in the early 1980s. As an annuity compliance expert with a leading consulting company, the biggest question I receive these days is: “How do I comply?” Even though I’d like to have a panacea response, my answer is often the same: “It depends.”

Every company, distributor and producer is in a unique position under this rule, and compliance answers will vary based on the licenses a producer carries, the types of annuity products manufactured and the role served by the distribution firm.

This is part 3 of a series of articles taking a deep dive into what the annuity world is likely to look like once the rule takes effect next April. (**Part 1** addresses the rule’s impact on insurance-only producers, and **Part 2** takes a look from the perspective of the annuity carrier). Part 3 analyzes the fiduciary rule's impact on independent marketing organizations (IMOs).

How did the DOL address IMOs in the rule?

IMOs make up the largest distribution channel for **fixed indexed annuities**, accounting for around 60 percent of total sales. More than half of those sales are in the qualified market, which the DOL rule seeks to regulate. One would think, then, that such a large distribution market would be discussed at length in the 1,023 pages that make up the fiduciary rule — especially because of the enormous impact the rule has on the distribution of annuity products.

Any guesses how many references the DOL made to the IMO?

One.

In the preamble to Prohibited Transaction Exemption (PTE) 84-24, there is a reference to an IMO in the "Insurance Commission" definition analysis. It reads: "It was not the Department's intent with respect to the Insurance Commission to disrupt the practice of paying commissions through a third party, such as an *independent marketing organization*." That's it.

(Just for fun, I checked how many times the fiduciary rule made reference to indexed annuities. The Best Interest Contract Exemption (BICE) mentioned them 36 times, and PTE 84-24 referenced them 75 times).

There are a few schools of thought as to why the DOL did not spend much energy discussing the IMO channel. Some believe the DOL did so intentionally because there was not enough evidence to treat them the same as other, more widely regulated distributor "financial institutions," such as the broker-dealer, RIA, bank or carrier. Others argue that the DOL didn't completely understand the IMO's role in the insurance marketplace and decided instead to leave the door open down the line for an individual or class exemption that would classify the IMO as a financial institution if the IMO could prove to the DOL that it could comply as such.

Regardless, the DOL did not provide much of a roadmap for IMOs to comply with the fiduciary rule, leaving many of them with an uncertain future.

IMOs feel the DOL pinch

Because the DOL declined to name the IMO as a "financial institution" under the rule, there are some that question how the IMO as we know it today can survive come April 2017.

There are several reasons for this belief, but most importantly is the pinch the DOL created with the **BICE contract requirement**, which must accompany the sale of all indexed annuities. Under the BICE, an actual, written contract must be signed by a supervising financial institution and the customer. The contract must warrant compliance and adherence to impartial conduct standards and must disclose any conflicts of interest, among many other requirements.

Because the IMO cannot sign the BICE contract as a financial institution, the IMO must rely on some other entity to sign for indexed annuity sales by the IMO’s agents. There are some carriers that are considering this difficult path, which would certainly help ensure that the IMO has a future role (see **Part 2 of this series** for more information on that analysis).

But at what cost?

Will the carrier that decides to take on the added liability that accompanies signing the BICE contract also require the IMO to handle supervision on their behalf? Will the carrier reduce compensation to the IMO in return for the extension of an olive branch to help keep them in business? Will the carrier limit the number of IMOs it will work with to only those top few that have the resources to supervise? Does the IMO have another option?

Other potential pathways to compliance

In addition to the above option where carriers take on the BICE liability, there are some additional pathways to compliance being considered by IMOs at this time.

First, the IMO could affiliate with or purchase a broker-dealer or RIA firm. This would eliminate the BICE contract sign-off issue, but only for those indexed annuity sales from registered representatives or investment advisor representatives. Under this new world, it is likely that the current practice of selling insurance products as "outside business activities" would be out the window, with all sales (potentially even nonqualified sales) now running through supervision and oversight from the broker-dealer. This could inevitably result in lower commissions for IMOs as the broker-dealer would condition such supervision on the receipt of additional compensation.

Unfortunately, this option does not fully clear up the BICE contract issue for insurance-only agents, even though some believe an agent could be classified as an "associated person" under FINRA rules and could then be "supervised" by the broker-dealer for indexed annuity sales.

Could this be a potential loophole? Some say yes. Some say no way.

I probably lean toward the latter camp when it comes to the "associated person" angle for several reasons. For one, it might be a stretch to argue that an independent agent meets the spirit of the definition of an associated person under FINRA rules. Perhaps more importantly, it could be a slippery slope to expressly grant securities regulators authority over unregistered insurance-only agents. This could potentially open up Pandora's Box to full reviews of insurance-only agent business activity (including nonqualified sales if the broker-dealer requires all sales to be run through broker-dealer approval as a condition to be an associated person). Last, the broker-dealer would have to be wholly owned by the IMO because it is extremely unlikely that an affiliated broker-dealer will want to take on liability of insurance-only agents.

Convincing the DOL it made a mistake

Another option is to convince the DOL it made a mistake by not including IMOs as a **part of the original definition of financial institution**. This process would require the IMO to seek an individual or class exemption from the DOL — and because the DOL did not originally grant this exemption in its final rule, a very high bar for the granting of the exemption will likely be set.

But it may not be impossible.

The IMO will first need to satisfy a few administrative hurdles, including a demonstration that the requested exemption would be administratively feasible and in the interests of affected plans (IRA owners). It would then require the IMO to prove its ability to effectively supervise its agents' compliance with the BICE.

The DOL will ask tough questions of the IMO, especially about its supervision expertise, its ability to adequately cover and pay any future claims from a capital perspective, and its capacity to build out a robust compliance framework similar to that of a broker-dealer.

This pathway to compliance may be the toughest, but also potentially creates the biggest opportunity for those IMOs that have the resources to make it a reality. Imagine a world where there were only a handful of IMOs that could sign the BICE contract — they'd be at an enormous competitive advantage over the hundreds of other IMOs that have to work through an affiliated broker-dealer or RIA.

But will the DOL grant the exemption? That's a great question. Another question is how long it could take? With the potential precedential value of such an exemption, it is likely the DOL will take its time creating a checklist of requirements and questions for the IMO to answer.

So how does the IMO get paid in a post-DOL rule world?

As we all know by now, the fiduciary rule seeks to curb perceived conflicts of interest in sales practices and advice given in the retirement space. IMOs, at their core, do not provide such advice to retirement investors. Instead, they largely act as intermediaries between agents and carriers, assisting with recruiting, scrubbing applications, marketing, training, policy servicing and more. In return for such services, they receive commissions from the carriers, just as the writing agent does.

Under the DOL rule, this "override commission" paid to the IMO is at risk because it is directly tied to the sale. Some carriers may take the position that differential, transaction-based compensation is too closely tied to the compensation payable to the agent, and it will thus fall under rule requirements.

Also at risk are the so-called "production bonuses" many carriers pay to IMOs that hit certain sales thresholds. The problem is that carriers may be concerned the IMO is steering agents to certain products in order to hit those IMO bonus thresholds. While this issue is not directly contemplated by the rule, some carriers may take a conservative approach and try to find alternative ways to compensate IMOs.

One possible **compensation** structure would be to create a bonus payment based on neutral factors, such as how well the IMO scrubs applications and point-of-sale documents (e.g., maintaining a low NIGO or Not-In-Good-Order percentage). Another way would be to compensate the IMO with a marketing stipend that helps pay for recruiting, marketing, training and servicing related to the carrier's products. Both would be paid outside the scope of any individual sales transactions.

One thing is clear, though. Carriers will eventually find a way to compensate IMOs — especially those carriers that rely heavily on the IMO channel for distribution. Some carriers will take a conservative approach to IMO compensation under the rule — others less so. The dividing line will likely be how important the IMO channel is to the carrier's bottom line.

IMO bonuses, trips, incentives and NFL Super Bowl-style rings

As Senator Elizabeth Warren noted in her 2015 report on the indexed annuity industry's use of soft-cash compensation, IMOs are known for providing their agents with trips and other perks and bonuses for hitting certain sales goals. Some IMOs are reviewing their current planned trips and are wondering whether they can continue in a post-DOL rule world.

There is an argument to be made that such trips and bonuses are not necessarily conflicts of interest because they are based on total sales, irrespective of the product or carrier that is sold. However, some carriers may require their IMOs to take a more conservative approach under the rule and remove that carrier's sales from incentive calculations (see above). This issue does not have full clarity yet, and may not for some time.

All that said, the bottom line on IMO trips is this — if one IMO is offering them, multiple IMOs will be offering them. In the hypercompetitive world of agent recruitment, it may be a bigger risk to the bottom line to completely eliminate trips, especially if other IMOs have found a way to keep them.

An uncertain future

The DOL rule presents a challenging proposition for IMOs, specifically with regard to BICE contract issues, compensation changes and potential strained relationships with carriers as tough decisions are made. Those IMOs that are well-established and have significant resources and bargaining power are more likely to be successful in the post-DOL rule world than those that cannot find a pathway to compliance in the short term. That said, IMOs are an extremely creative and innovative lot. Most will find a way to survive under the DOL rule, though significant pivots may be necessary.

See also:

DOL clarifies fiduciary rule for insurance companies

What does the DOL rule mean for your future?

3 exciting unintended consequences of the DOL rule