

CREATING A SUCCESSFUL BEST INTEREST CONTRACT (BICE) PRACTICE



The battle may be lost or at best, the odds of winning are low. The Obama administration's proposal for financial advisors to forfeit compensation unless the FA can demonstrate that his/her actions are in the client's best interest seems certain. The January 1, 2016 article, ["Wall Street Got Burned In Washington This Year, For Once"](#), claims that the battle is already over. The financial advisor community must decide whether to meet the new requirements by overlaying current practices or by new practices that embrace and take advantage of the new best interest standard. This brief is intended to inform the decisions and the course of action of distributors, product and service providers and financial advisors affected by the regulatory changes requiring the use of a Best Interest Contract Exemption for ERISA plans and IRAs. The alternative practices, policies and consequences are highlighted for all affected areas.

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Introduction:

As the regulatory changes under consideration by the Labor Department and IRS get closer to reality the discussion about them needs to shift to operating successfully in the new environment. These discussions should focus on how to comply with the changes and possible side effects of the Best Interest Contract Exemption ("BICE"). These side effects are forecasted to be devastating to the public and to the industry practitioners, assuming there are no changes to existing business models.

The discussions to date begin and end with the assumption that the current practice of financial advice remains unchanged. With this assumption, the forecasts may well be true but as the reality of the changes appears more certain, it is time to examine the “status quo” assumption and find alternative paths to success.

While not explicitly outlawing them, the changes required to comply with BICE are often incompatible with current practices in a number of critical areas. New changes are applicable to 401(k) & IRA business and therefore affect all advisors with such business. Some of these current practices are:

- ❑ Use of the same process for a client’s IRA business as other assets. Under BICE, the standard of care given to IRAs is superior to the general standard. The advisor is faced with attempting to use two different concurrent standards with the same client or converting all of the client’s business to the higher BICE standard.
- ❑ No separate service contract required for broker of record arrangements. Terms of BICE require clients to concur by signing a new contract.
- ❑ Identical pricing applies to all clients within the same products and account types. The BICE requirement to act in the client’s best interest will limit the products or account types that can be used within IRAs.
- ❑ Products are selected based on the advisor’s repertoire of knowledge, familiarity and licensing. The argument that a product that is in the client’s best interest is not available through an advisor may force the client to choose another advisor.
- ❑ Risks are mitigated by rejecting orders that are unsuitable or by themselves represent unacceptable risk. BICE risk can only be mitigated by being able to demonstrate that initial recommendations are prudently made based on understanding the client’s best interests.

While current practices can be amended to accommodate these changes, the consequences might mean more time spent for the same compensation, loss of clients, higher cost of operation, limits to growth and increased business risks.

Time will be required to present and explain the BICE and to make the determination that each client’s holdings is in his or

her best interest.

Some clients may seek lower cost alternatives after learning how much compensation is paid in relation to the visible work performed by the advisor.

Cost of operations will increase in order to track the basis for deciding what is in the client's best interest.

Growth is limited by specific prohibitions against certain rollover recommendations.

Risks are increased by introducing the potential of merely violating the BICE arrangement, even without provable losses.

Affected Areas

It is evident that these changes will be far-reaching and affect all who support financial advisors and businesses that rely on them. These include:

- ✓ **FIRM MANAGEMENT...** must develop BICE compatible policies and educate financial advisors to new standards. New measurements to evaluate organizational and individual performance must be established.
 - **Compliance...** must integrate new standards into the current oversight and procedures.
 - **Risk Management...** must adopt new risk mitigation practices and revise insurance coverage.
 - **Systems and Operations...** must make changes needed to implement the firm's BICE policies.
 - **Product Managers...** must revise criteria for "approved" products to be consistent with the firm's BICE policies.
- ✓ **PRODUCT PROVIDERS...** must adapt pricing and promotion to be consistent with the BICE standard and the changed practices of financial advisors and their firms. Phone centers and other points of contact with clients must also be examined and controlled to avoid the accidental assumption of unwarranted responsibilities based on revised rules.
- ✓ **RECORD KEEPERS...** must make changes to accommodate the policies created by each firm. As with product providers, record keepers must adapt points of service contact to avoid assuming unwarranted responsibilities.

New Business Models

The most important decision for the advisor is whether to segregate the 401(k) and IRA business from other activity that is not subject to BICE. Most advisors have both BICE and non-BICE business with the same client, thus creating the dilemma of committing to acting in the clients best interest in only a portion of the relationship.

This dilemma is addressed if all the business is put under a BICE type of arrangement, but that expands the scope of bringing all the business into alignment with the BICE. This alignment can mean changes to the client's portfolio and tax consequences (for non-tax deferred business) and reduced compensation.

The alternative is a fee leveling approach, in which the compensation from the client is considered in its totality in the BICE and the commissions and other compensation is used to fund the overall compensation. With such an arrangement, the client's portfolio need not change and compensation remains stable. (This and other arrangements are covered in detail in [DALBAR's RF™ Self Study](#).)

Small Accounts

The profitability of small accounts has been an overarching concern in the debate about the BICE regulations. This is based on the assumption that at some point, compensation from small accounts cannot fund the same level of advice that is provided in the client's best interest. While this conclusion is true with the given assumptions, it is not true that all clients require the same level of advice. Prescribing the appropriate level of advice at an appropriate price provides a practical path to complying with BICE regulations for any size account.

The fact of the matter is that this compensation conundrum has existed since the dawn of financial advice and BICE only highlights the need for a more effective method of serving small accounts. Small accounts have always been excluded for lack of adequate compensation to serve them. The exclusion has been implemented by requiring minimum account sizes. In cases where small accounts have been served, they are treated as loss leaders or as "investments" in the hope that they will grow or are linked to larger, profitable clients.

The exclusion of small accounts can be addressed by first recognizing that the benefit derived by a client from financial advice can only be as large as the size of the account itself. If financial advice yields a 5% higher return or prevents a 5% greater loss, the small account has a very small benefit. It stands to reason that the level of advice that is worthwhile for a one million dollar account would not be as valuable for a one thousand dollar account. Prudence (the cornerstone of financial advice) would dictate that the level of effort to produce \$50,000 should be 1,000 times greater than the effort to produce \$50. Costs should be somewhat aligned with the potential benefit.

Relating the cost to the benefit is fundamental in determining the reasonableness of compensation.

The small account is best accommodated by a tiered service that is based on the economic benefit that can be expected. This approach makes even very small accounts viable through varying levels of advice. Small account advice can focus on advice to accumulate contributions in very low risk investments until a threshold for the potential benefit of investment advice is achieved.

Winning New Business

When BICE sets the standard of care, all financial advisors will be presumed to operate at this level. The result is that those who operate at the BICE standard of care will lose the competitive advantage they have today. By BICE regulations, all affected financial advisors are required to promise to act in the client's best interest.

By removing this important differentiator, BICE makes the choice of financial advisor less important since all will be perceived as being satisfactory. In such a ubiquitous environment, winning business will require a superior standard of care, presented in such a way as to be both appealing and credible.

Offering higher returns or lower losses may be appealing but would not be credible and would introduce risks of over-promising.

Successful financial advisors will find ways to add valued services and find ways of certifying the superiority of their services. Valued services may include assuming greater responsibility for decision making (discretionary relationships), more comprehensive and frequent risk tolerance adjustments, responsiveness and proactivity in times of crisis, independent reviews, etc.

Financial advisors can achieve credibility for such enhanced services by providing independently prepared assessments, prepared by experts. Under certain circumstances, assessments may include testimonials from existing clients.

Client Facing Communications

The terms of a BICE arrangement will materially affect client communications with respect to what must be removed and what must be added. The review process for approving new materials and changes must also be revised. Applying the overall requirements to be complete and non-deceptive, it will be necessary to review all verbal, electronic and printed materials for consistency with the standards on completeness and non-deception.

Important considerations include disclosure of the BICE arrangement and practices that are adopted or prohibited by the resulting policies. Required practices such as determining what is in each client's best interest and the vetting process used to determine the appropriate solution need to be included.

Managing BICE Risk

BICE regulations increase the business risk in two ways for financial advisors and their firms. They are non-compliance risk and the risk of investment loss. Each of these two types of risk should be mitigated and protection provided through insurance. Mitigating the risk materially reduces the cost of insurance.

BICE increases non-compliance risk by new requirements and the introduction of two additional regulators into the traditional compliance framework. Mitigation of the non-compliance risk requires introducing new agreements,

cessation of prohibited practices (particularly in the area of rollovers), practices that demonstrate that all advice is in the client's best interest, training of advisors on BICE practices, new oversight procedures and methods of correction. Essential to mitigating risk is the ability to demonstrate practices that can reasonably be expected to achieve the client's best interest.

Proof that these mitigation steps have been thoroughly performed enables insurance coverage and reduced premiums.

The risk of investment loss arises from the contractual agreement to act in the client's best interest. Such contracts rely on the financial advisor and firm to take prudent steps to avoid large losses, high expenses, credit failures or other conditions that are clearly not in the client's best interest.

This risk is mitigated by a well-documented and frequently reviewed process of prudent selection for investments that are recommended to clients. The process used must have some reasonable expectation of success and is most effective if independently examined and certified before any failure occurs.

In Conclusion

The BICE regulation forces each financial advisor and every related institution into making a major decision of how to respond. FAs, firms and service/product providers must decide on one of the following to retain revenue/compensation under BICE:

- Adopt the BICE standard for the entire business.
- Avoid the BICE requirements by acting in a fiduciary capacity for all business.
- Escape BICE entirely by ceasing all practices that might trigger BICE.
- Use BICE practices only in cases where explicitly required by regulations.
- Transfer or sell business that requires BICE.
- Some combination of the above.

The choice of which course to take should be based on a



combination of factors pertinent to existing and future business. Factors include the current business mix, client base, availability of support, willingness to take risks, and ease/cost of changing. The first step is to become familiar with the implications of each of the choices. A self-study program is being provided to help with the choice and implementation of BICE.