The New DOL Rule and Jack and the Beanstalk: Fee-Fi-Fo-Commissions

By Trent Davis |October 12, 2016

One of the main reasons that FIAs were thrown into the DOL rule at the last minute was a total misunderstanding by the authors of the FIA compensation and product design. FIAs are designed to guarantee principal and a minimum interest with some upside of an index with safety as a main component. The authors had only limited knowledge of the moving parts of compensation, fees, commissions and surrender charges. The authors of DOL rule concluded, paraphrasing, that fees are good and commissions are bad.

Fee versus commission: What's the difference?

Historically the word fee, or the French-Anglo "fie" in Shakespeare's play "King Lear," was a word to express disapproval: "fie, fie, fie," said the King in his disapproval of the British. And who could forget the giant from "Jack and the Beanstalk," angrily proclaiming, "Fee, fie, fo, fum!" as he ran after Jack. Today, the Oxford Dictionary defines fee as a payment made to a person or public body in exchange for advice or services.

Historically, the word commission, Latin for commit, meant the authority entrusted to someone. Today, commission is defined in the Oxford Dictionary as a payment for an instruction, command or duty given to a person or group of people.

A fee in the financial services industry is a charge paid by the buyer (consumer) to a financial institution that, in turn, pays an advisor a percentage of the fee. According to the definition, that sounds a lot like a commission.

The word commission in the financial services business is a fee paid by the seller (Insurance Company), not the consumer, to an advisor. That sounds a lot like a fee.

So, which form of advisor compensation is better for the consumer?
Answer: They are by definition the very similar--

- A fee is paid by the buyer!
- A commission is paid by the seller!

Does the DOL rule really make FIAs better for consumers?

Ask a consumer this question: "Would you rather pay me out of your funds (fee) or have an insurance company pay me (commission) for the use of your funds? Understand that if the insurance company pays me, your funds are 100% whole from day one.*

*Explain surrender charges, index strategies and guarantees.

Something the DOL rule overlooks is the obvious tax differences between annuities versus managed fee accounts when it comes to long or short-term capital gains for non-qualified accounts. Simply put,

fees for purchasing FIAs under the new DOL rule can be expensive, and those fees will be paid by the consumer. And if the client takes a distribution of the annuity funds to pay the fee, anyone under 59.5 years old faces a 10% penalty. Fortunately, the vast majority of annuity buyers are well over that age, but the problem is still relevant.

Also, what about surrender charge on FIAs? Even if FIAs paid **zero** commissions, the insurance companies would still have to require a surrender charge. Why? To guaranty principal and minimum guaranteed interest, an insurance company has to purchase bonds with options. Any savvy financial advisor knows that, generally speaking, a longer duration should produce a higher return than a shorter duration bond option. Therefore, to protect that longer duration option, some sort of early cancellation fee must be inserted to protect the promise of the duration of the bond option. In our current market a no-surrender annuity would return less than 1%.

What it all means

A fee-only (FO) advisor is really no different than a commission-only (CO) advisor. Both commissions and fees for the advisors are simply paychecks. The paycheck is bigger on the front end of a transaction if paid by an insurance company, or bigger on the back end of a transaction if paid by the consumer, yet they are both the same paycheck. There is a place for both systems of compensation, but the DOL rule is friendlier to the fee system, where the consumer pays the advisor, versus the commission system, in which an insurance company pays the advisor. The DOL rule still allows for up-front commissions, but they will likely look like a trail commission (fee), and you do not have to be a registered rep.

If you are a FO advisor, great! You are an important part of American's financial wellbeing.

If you are a CO advisor, up-front commissions will be smaller, and you will become a "trail" commission advisor.

Changing rules in the middle of the game is foul. If the rule sticks, they need to at least give consideration and time to review the impact on CO advisors. Up-front commissions are not evil. If you are a CO advisor you are Jack, the DOL is the Giant, and the truth is your axe.

Call your representatives, especially those who are vocal in their support of the DOL rule, to get FIAs out of the DOL rule before you are hi-Jacked. Go to www.NAFA.com for more information. The government needs to re-examine this rule regarding FIAs and make it reasonable, both for advisors and consumers.

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