

StayCurrent

A Client Alert from Paul Hastings

Department of Labor Opinion Letter Affords Welcome Relief to the Financial Services Industry

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On November 27, 2006, the U.S. Department of Labor ("DOL") issued its first formal opinion on the application of the administrative exemption to the overtime requirements of the Fair Labor Standards Act (the "FLSA") to financial advisors, stockbrokers and other "registered representatives" in the financial services industry who perform similar duties. The DOL issued the opinion in response to a specific request for guidance by the Securities Industry Association ("SIA," now called the Securities Industry and Financial Markets Association), an organization dedicated to representing the interests of the financial services industry.¹ The DOL's conclusion that financial advisors can in fact qualify for the administrative exemption² provides some long-awaited guidance on the proper interpretation and application of regulations interpreting the FLSA exemption, particularly in an industry that has become a popular target of wage-and-hour class and collective action lawsuits.

2004 REVISED FLSA REGULATIONS

In 2004, the DOL issued revised regulations interpreting the FLSA. *See* 29 C.F.R. § 541.0 *et seq.* Although the DOL explained in the preamble to the revised regulations that the revisions were intended to be consistent with previous regulations, the addition of Section 541.203(b) (hereinafter "Section 203(b)") has caused considerable confusion for the financial services industry and litigants.

The first sentence of Section 203(b) states that employees in the financial services industry generally qualify for the administrative exemption if their duties include work such as "collecting and analyzing information regarding the customer's income, assets, investments or debts; determining which financial products best meet the customer's needs and financial circumstances; advising the customer regarding the advantages and disadvantages of different financial products; and marketing, servicing or

promoting the employer's financial products." According to the regulations, employees whose duties fall within this first sentence of Section 203(b) are considered to be performing work that is "directly related to the management or general business operations of the employer or the employer's customers," a requirement for exempt classification as an administrative employee. 29 C.F.R. §§ 541.203(b), 541.200(a)(2).

The second sentence of Section 203(b), however, states: "[A]n employee whose primary duty is selling financial products does not qualify for the administrative exemption." 29 C.F.R. § 541.203(b) (emphasis added). Thus, the regulations at first provide a helpful explanation of the duties that will exempt certain employees in the financial services industry from the FLSA's overtime requirements, and then proceed to carve out an exception that, at first blush, might appear to materially diminish the applicability of the rule. The unavoidable tension between the first and second sentences of Section 203(b), coupled with the plaintiffs' bar's reliance upon the second sentence, has troubled the financial services industry since the regulations were issued in August of 2004.

THE DOL'S NOVEMBER 27, 2006 OPINION LETTER³

In the November 27, 2006 opinion letter, the DOL made several significant findings based upon the facts presented in the SIA's request. The SIA described the registered representative's primary duty as providing investment advice, as opposed to making sales, and the opinion letter is premised on this important distinction. Indeed, the DOL describes the registered representative's purchase or sale of an investment for a client and execution of a transaction as "incident" to the representative's financial advice. The DOL concludes as follows:

- (1) Registered representatives who perform the duties set forth in the first sentence of Section 203(b) can meet the duties requirement of the administrative exemption even if they engage in some sales activity, provided that sales activity is not their *primary* duty. Promotion and business development activities, including the marketing, servicing and promoting of the employer's financial services and products, do not defeat the exemption;
- (2) Registered representatives may use computer software programs and other tools to assist in the performance of their duties and still qualify for the administrative exemption, so long as these tools do not replace the exercise of discretion and independent judgment by selecting the particular investment alternative for the client, and provided the registered representative is still responsible for assessing the alternatives and making investment recommendations to the client;
- (3) The salary basis portion of the administrative exemption is satisfied by compensation structures that provide for a guaranteed minimum salary or "draw" that meets or exceeds the \$455/week minimum under the FLSA, coupled with an added component of commissions, fees or some combination thereof, provided that employees are never "asked to repay the guaranteed minimum salary/draw payments if he or she does not earn enough credits in excess commissions or fees above the minimum salary/draw amount."⁴
- (4) Registered representatives who meet the administrative exemption under the 2004 revised regulations also meet the administrative duties test under the old regulations applicable to periods of employment prior to August 2004.

WHAT DOES THE OPINION LETTER MEAN FOR EMPLOYERS IN THE FINANCIAL SERVICES INDUSTRY?

The recent opinion letter is the first authority conclusively applying Section 203(b) to financial advisors and the like.⁵ It provides much needed guidance both as to the types of duties that will meet the requirements of the administrative exemption, and as to which compensation structures the DOL considers lawful. Although an employee's exempt or non-exempt status always is determined based on an individualized analysis of his or

her job duties and salary, the opinion letter bolsters the argument that the financial services industry has been making for the past two years – that employees who perform the traditional duties of financial advisors are properly classified as exempt from federal overtime requirements.

Several important questions remain unanswered, however, in the wake of the opinion letter, including:

- *What level of deference will the courts, both state and federal, give the recent opinion letter?* DOL opinion letters, though persuasive, are not binding legal authority. It is unclear how much deference the federal courts will give to the DOL's opinions. More importantly, it is unclear whether and to what degree the DOL's conclusions will be useful in interpreting state law, particularly in states that apply a different exemption analysis than the FLSA regulations. Although it appears more likely than not that most states will reach the same conclusion that the DOL has, the general lack of legal authority directly addressing these issues does engender some uncertainty.
- *What practical implications will the recent opinion letter have for the financial services industry as it defends against future lawsuits?* There is little question that the opinion letter will be helpful with respect to misclassification claims under the FLSA involving financial advisors. Because many states (like New York and California) apply longer statutes of limitation than the two-year period typically applicable under the FLSA, plaintiffs' attorneys in these states tend to bring claims under state law either in addition to or rather than under federal law. Therefore, as noted above, there remains some uncertainty as to the practical consequence of the opinion letter for employers who must meet more stringent state law standards.
- *How will the DOL and the courts interpret the second sentence of Section 203(b) in the future?* The recent opinion letter is helpful in that it clearly points out that some sales activity by financial advisors does not preclude qualification under the administrative exemption. However, the DOL has not provided (and may never provide) meaningful guidance on how particular duties performed by financial advisors should be categorized (for example, as sales activity versus marketing and promoting), or at what level

sales activity will be considered to be the financial advisor's primary duty.

- **How will the states treat "recoverable" draw compensation structures?** The recent opinion letter makes it clear that the DOL approves of compensation structures providing for a guaranteed weekly minimum: (1) regardless of whether the minimum is characterized as a "draw," "salary," or something else, and (2) even if deficits in earned commissions/fees (commissions/fees that are less than the guaranteed draw) are carried forward and deducted from future commission payments – as long as the minimum is irreducible (except by taxes and other authorized deductions). However, many states

apply their own "salary basis" test. While it appears likely that most states will follow the DOL's reasoning in interpreting state law, the question remains largely unanswered.

While employers in the financial services industry should be encouraged by the DOL's recent opinion letter, this certainly is not the final word on the subject. Nor does the opinion letter obviate the need for financial services industry employers to examine carefully their compensation plans for registered representatives. Compensation structures and, in particular, compensation adjustment practices, remain the focus of the plaintiffs' bar.

If you have any questions, please do not hesitate to contact any of the authors, or your local Paul Hastings office, for further guidance.

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¹ The SIA described the duties of the "registered representatives" at issue as follows: "The primary duty of registered representatives is to use their expertise and knowledge of the securities industry and markets to analyze, interpret and make recommendations that meet specific client objectives based upon varying facts and circumstances Registered representatives engage in promotion and business development activities. Different registered representatives do this in different ways, but generally speaking, registered representatives – like lawyers, accountants, and doctors – try to make themselves visible to the appropriate segments of the public in order to meet and retain potential new clients for their employing firms. (Footnote omitted.) In addition to providing investment advice, a registered representative will service clients by implementing or executing the actual trades or other transactions, including the purchase and sale of securities and other investments, which may result from the financial advice he or she has given Notwithstanding that registered representatives engage in some sales activities, however, their primary duty is *not* sales."

² Under 29 C.F.R. § 541.200(a), the term "employee employed in a bona fide administrative capacity" means any employee: (1) compensated on a salary or fee basis at a rate of not less than \$455 per week; (2) whose primary duty is the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers; and (3) whose primary duty includes the exercise of discretion and independent judgment with respect to matters of significance.

³ The full text of the opinion letter will soon be available at www.wagehour.dol.gov.

⁴ In reaching this conclusion, the DOL acknowledged that several of its prior opinion letters have caused confusion by concluding or suggesting that certain types of compensation plans (including ones under which draw deficits are carried forward) do not meet the requirement that a salary or draw be made "free and clear." The DOL declared four prior opinion letters withdrawn to the extent that they are inconsistent with the interpretation of the "salary basis" test set forth in the November 27, 2006 opinion letter. The withdrawn opinion letters are dated March 27, 1969; May 4, 1971; February 11, 1980; and June 2, 1980.

⁵ In August 2006, a California federal district court in *Takacs v. A.G. Edwards and Sons, Inc.*, 444 F. Supp. 2d 1100 (S.D. Cal. 2006), interpreted Section 203(b) in the context of a summary judgment motion. In its lengthy opinion, the court made two important findings. First, the court found that A.G. Edwards had not met its burden of showing that its compensation structure, which appears to be similar in many respects to the compensation structure described in the recent DOL opinion letter, satisfies the federal administrative exemption. Second, in a holding that implicates the administrative/production dichotomy, the court found that there was a question of fact as to whether A.G. Edwards' "financial consultants" were "engaged in work that results from the product that [the company] profits from, in this case the sales of securities and other financial offerings, rather than in the administration of [the company's] business or that of its existing customers." Because its ruling was in the context of plaintiffs' summary judgment motion, however, the court did not decide conclusively whether the duties of the A.G. Edwards financial consultants met the duties requirement of the administrative exemption. Moreover, in reaching its decision as to the salary basis portion of the exemption, the court relied heavily on a May 4, 1971 opinion letter by the DOL, which has now been withdrawn by the DOL's November 27th opinion letter.

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