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The Department of Labor Fiduciary Rule: Questions & Answers

On April 6, 2016, the U.S. Department of Labor (DOL) released a final package of rules, commonly referred to as the "Fiduciary Rule." A preliminary assessment of the DOL rule shows that between the proposal phase and release of the final rule the DOL made some changes and increased implementation time for the rule, in response to industry concerns. Much like the draft version released last year, the final rule is dense, complicated, and confusing. While arguably well intentioned, the rule will likely make retirement advice more costly and complicated—particularly for middle and low income consumers with small balance retirement accounts.

The rule is far reaching and will have a large impact on the insurance market, including certain retirement advice offered by insurance agents and brokers related to annuities and health savings accounts (HSAs), among other products. Generally, the rule will likely impact insurance products that have some type of retirement or investment component under the Employee Retirement Income Security Act (ERISA) and the tax code. The rule may also impact retirement plans offered by member agencies to their employees. How some parts of the rule will apply "in practice" and the full impacts of the rule on agents and brokers are not yet clear, due to the complexity of the rule as well as some ambiguities in the rule. However, Big "I" staff has prepared a preliminary Q&A document to provide general background information on some of the threshold questions surrounding the rule.

What is the DOL Fiduciary Rule?

The DOL fiduciary rule amends regulations related to ERISA and the tax code, originally promulgated by the DOL in 1975. The regulation now requires broker-dealers and their registered representatives to adhere to a heightened legal standard and act as a fiduciary (similar to the standard applied to investment advisers). The rule prohibits conflicted transactions, which are transactions that are not in the "best interest" of the client. Previously, broker-dealers and their registered representatives have been subject to a strictly-enforced suitability standard. Under the suitability standard broker-dealers can only offer or recommend products that are suitable for a customer based on that person's needs, objectives and financial situation.

When is a Fiduciary Obligation Triggered?

The DOL fiduciary rule will primarily impact certain Individual Retirement Accounts (IRAs), but many other retirement vehicles such as 401(k)s will also be impacted. Certain HSAs will also be impacted. Generally speaking, the rule is triggered whenever there is a recommendation to move or not move money (such as a recommendation to purchase or hold an annuity) connected to a covered retirement account.

To put it simply an individual is acting as a fiduciary when he or she:

1. Provides “investment advice” as defined by the rule;
2. The “investment advice” is given in connection with a covered ERISA employee benefit plan or IRA; and
3. The “investment advice” is given for a fee or other compensation (whether direct or indirect).

Under the final rule, the definition of investment advice is relatively broad. The fundamental threshold element in establishing the existence of fiduciary investment advice focuses on whether a “recommendation” occurred. A “recommendation” is a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action. The more individually tailored the communication is to a specific advice recipient(s), the more likely the communication will be viewed as a recommendation.

What Does Being a Fiduciary Mean?

Fiduciaries that provide investment advice must either avoid compensation arrangements that create a conflict of interest or comply with the terms of an exemption issued by the DOL. Certain transactions that do not comply with the rule directly may still be permitted if they comply with outlined “Prohibited Transactions Exemptions” (PTEs). In other words, individuals providing fiduciary investment advice to plan sponsors, plan participants, and IRA owners are not permitted to receive payments creating a conflict of interest without a PTE.

While it is hard to say exactly what the full implications of this new standard will mean for independent agents and agencies that offer retirement advice and products, in a broad sense the rule essentially leaves advisers with three choices:

1. Do not give “investment advice”, as defined under the rule, and avoid becoming a fiduciary (i.e. no longer service impact accounts and products).
2. Become a fiduciary and ensure that all of your compensation arrangements are non-conflicted (i.e. flat-fee-for service arrangements with no third party compensation).
3. Become a fiduciary, retain current compensation arrangements (assuming they are reasonable and permitted under the new rule) and comply with an available exemption.

Can Agents & Brokers Still Receive Commissions?

The regulation reflects a favoring of fee-based compensation over commissions. However, certain transactions that do not comply with the rule directly may still be permitted if they comply with outlined “Prohibited Transactions Exemptions” (PTEs). In other words, individuals providing fiduciary investment advice to plan sponsors, plan participants, and IRA owners are not permitted to receive certain reasonable payments creating a conflict of interest (i.e. commissions for the sale of an annuity or other retirement product) without a PTE. The rule and the PTEs do not impact the standalone sale of an annuity, unrelated to covered retirement accounts.

One of these PTEs is the “Best Interest Contract Exemption” (BICE). The purchase of variable annuities and fixed-indexed annuities, as the products are currently structured, will fall under the terms of the BICE. The BICE is essentially a legally enforceable contract with clients that: (1) commits you to providing advice in the client's best interest; and (2) warrants that the agency has adopted practices and procedures designed to mitigate potential conflicts of interest when providing advice.

The DOL also requires that certain disclosures be made under the BICE, including descriptions of material conflicts of interest, fees or charges paid by the retirement investor, and a statement of the types of compensation the firm expects to receive from third parties in connection with recommended investments. Agents and brokers must also direct clients to a webpage disclosing their compensation arrangements; and communicate that clients are entitled to complete information on the fees they charge. However, individualized information about a particular adviser's compensation is not required to be included on the website.

The DOL has also finalized an amendment to an existing exemption, PTE 84-24, which provides an option for insurance agents and brokers, and insurance companies, to receive commissions for recommending fixed annuities to plans and IRA owners. Variable annuities and fixed-index annuities can no longer be offered under the updated PTE 84-24. This exemption has more streamlined conditions than the BICE.

When Does the Rule Go Into Effect?
The rule will be phased in. Initial compliance obligations begin on April 10, 2017, and full compliance is expected by January 1, 2018. Starting in April 2017 firms and advisers must adhere to the" impartial conduct standards" as defined by the rule, provide a notice to retirement investors that, among other things, acknowledges their fiduciary status and describes their material conflicts of interest, and designate a person responsible for addressing material conflicts of interest and monitoring advisers' adherence to the impartial conduct standards. Full compliance with the BICE (i.e. variable and fixed-index annuities) and PTE 84-24 (i.e. fixed annuities) requirements will be effective on January 1, 2018.

How Will Agents and Brokers be Impacted?
As the rule is further analyzed and efforts to comply with the rule begin, the full impacts will become clearer. However, three major impacts for agents and brokers who offer covered retirement advice that are initially apparent:

1. Compliance with the rule will increase costs for agencies who give retirement advice to covered 401(k)s, IRAs, and some HSAs, as new disclosures need to be drafted and new procedures put in place quickly.
2. The rule and the BICE substantially increase legal exposure for impacted agencies, meaning that some will see an increase in E&O premiums needed to guard against potential lawsuits.
3. Given that commissions are more narrowly permitted than under current law, the rule will likely accelerate a shift from commission-based accounts toward fee-based accounts.

Of note on the third potential impact, the transition to fees may be challenging for some commission-based advisers, if they depend on up-front compensation to meet monthly expenses. The change will also likely prompt life insurers to reduce compensation for certain annuities. It is not yet clear how exactly the rule will impact compensation for the sale of health insurance plans with an HSA component.

How Will Existing Accounts be Impacted?
One of the changes that the DOL made from the proposed rule to the final rule was the grandfathering of certain accounts. The rule includes a grandfathering provision that allows for additional compensation

based on investments that are made prior to the applicability date of the rule, which is April 10, 2017. Post-April 10, 2017 additional advice to buy, sell or hold investments within current accounts must satisfy basic best interest standards and reasonable compensation requirements. How the grandfathering rules apply "in practice" remains to be seen. Currently, it appears to apply to hold decisions and systematic purchase decisions, but potentially, not asset reallocation, distribution or other types of recommendations.

How Does the Rule Limit Access to Retirement Advice?

First, some agents and brokers, and others who offer retirement advice and products may decide to stop doing so due to the new compliance requirements, or may establish or increase minimum account balances for clients. Firms may also respond by shifting business into fee-based accounts. Advisory accounts, which typically charge investors a flat fee of assets under management, are not appropriate for all investors—especially smaller balance accounts as the fees are often greater than commissions earned over time. Simply put this means less access, at least in the near term, to retirement advice for many who need it most.

However, the rule also is likely to limit access to advice in a number of other fundamental ways. For example, the promotion/marketing of certain products to large businesses/plans is not fiduciary advice, however, the same promotion/marketing provided to small businesses/plans is fiduciary advice and a prohibited transaction, thus potentially cutting off small businesses from access to information about available products. Under the final rule a plan has to have $50 million in assets under management to qualify as a large plan. So, for example, a plan with 1,000 participants with an average account balance of $40,000 would be a small plan. Or a new plan with 10,000 participants would likely be a small plan.

Also, IRA owners are treated differently under the final rule. Under current law, investment education (which is not advice) includes (1) guidance on the extent to which an individual should invest in different asset classes based on his or her age and other factors, and (2) examples of investments that fit within such asset classes. This definition of education has worked very well for 20 years. Under the final rule, however, providing examples of investments that fit within asset classes would be education for 401(K) plan participants but would be fiduciary advice with respect to IRAs. Thus, education for IRA owners would be limited to conversations about investment theory that will be of little practical use to most retirement savers.