Deciphering the DOL Rule
Implementation Essentials

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AALU Alert on the Revised Prohibited Transaction Exemption 84-24:
What the Changes Mean for the Industry

"PTE 84-24" likely was an unfamiliar term to many producers until the Department of Labor ("DOL") released its new regulatory package redefining fiduciary investment advice several months ago. It was familiar to the lawyers and compliance officials because for nearly 40 years the insurance industry has relied on Prohibited Transaction Exemption 84-24 ("PTE 84-24") and its predecessors to compensate agents and brokers selling annuities and insurance contracts to retirement plans and Individual Retirement Accounts ("IRAs"). But for producers, the "legal-ese" term "PTE 84-24" long-ago faded into the background because it became part of the regulatory backbone that was "baked-in" to the sales contracts and documentation.

That relative obscurity is over. The changes made by DOL in the final regulatory package fundamentally alter how PTE 84-24 operates and what products it covers, thrusting it front and center into the debate (and into the litigation) surrounding the DOL fiduciary rule. As most producers now know, the industry cannot rely on PTE 84-24 for sales relating to variable and fixed index annuities, and must instead use the Best Interest Contract Exemption ("BIC Exemption"). By itself, that is a major change for the industry, and especially for independent producers who are insurance-licensed only (who need a financial institution to enter into a BIC Exemption contract for them—see the discussion of this issue in the October AALU Alert on Financial Institutions Under the BIC Exemption [link to Alert]).

But that's not all the DOL changed in PTE 84-24—it also modified some key compensation and disclosure issues. In this alert, we are going to examine what changes were made (including the October 27, 2016 FAQ guidance), some of the issues they present, and what it all means for the industry when the modified exemption (and the fiduciary rule) go into effect on April 10, 2017.[1]

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[1] Several trade associations, individual businesses, and others are challenging the DOL fiduciary rule and its

Why Do We Need PTE 84-24 in the First Place?

The Employee Retirement Income Security Act ("ERISA") regulates private-sector retirement plans, like 401(k)'s and pension plans ("Plans"). The Internal Revenue Code ("Code") regulates IRAs, and it also regulates ERISA plans. Plans and IRAs operate under a variety of specific legal requirements and restrictions in part because of their particular tax treatment. As part of these rules and restrictions, both ERISA and the Code impose very broad "prohibited transaction" rules on Plans and IRAs. The intent of these prohibited transaction rules is to keep persons close to a Plan or IRA (called "parties in interest" or "disqualified persons") from taking advantage. To prevent this, the plan or IRA is prohibited from engaging in certain transactions with these persons, like providing services or holding plan assets.[2] The prohibited transaction rules also prohibit fiduciaries from self-dealing, such as dealing with the assets of the Plan or IRA for the fiduciary's own interest, receiving payments from third parties, or receiving compensation that varies from one investment to another.

The prohibited transaction rules are so broad they actually prohibit a lot of ordinary and useful activity that is perfectly legal under insurance or securities laws. One example is the receipt of commissions by a fiduciary to a Plan or IRA—technically, commissions are prohibited because they are third party payments that typically vary from carrier to carrier. To allow commissions and other useful activities to continue, there are special rules, called "exemptions," that allow them anyway, subject to some additional conditions. Some of these special rules were written into the law by Congress, while others were added by DOL through a regulatory process.

PTE 84-24 is an exemption DOL first created in 1979 (and then rewrote in 1984) for traditional insurance transactions involving the sale of annuities and insurance contracts. The basic function is simple— PTE 84-24 allows producers, brokers, and carriers to receive traditional commissions and other compensation typical of the insurance industry, and to provide services despite being "parties in interest," all of which would otherwise be prohibited under the prohibited transaction rules of ERISA and the Code.

The need for such special exceptions to the rules like PTE 84-24 is even more important now that DOL has expanded the definition of fiduciary "investment advice" so that most producer recommendations to purchase an annuity or insurance contract connected with a plan or IRA will become fiduciary advice, subject to the full weight of the prohibited transaction rules.

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[2] *See.,* ERISA Secs. 3(14) and 406(a). While the Code contains parallel provisions for the prohibited transactions contained in ERISA, this article will refer only to the ERISA provisions.

The Effect of the New Fiduciary Rule: Annuity and Insurance Sales Relating to Plans or IRAs Will Be Fiduciary Advice

The new fiduciary rule redefines and significantly expands the scope of the definition of "investment advice," which, if offered to a Plan, Plan participant, or IRA owner, makes the advisor (such as an insurance agent) a "fiduciary" subject to the prohibited transaction rules of ERISA and the Code. Under the new expanded definition, many individuals and businesses that were not formerly considered fiduciaries will now be fiduciaries after April 10, 2017, when the new rules apply.

It is important to note that the DOL fiduciary rule applies regardless of what kind of license an advisor holds—whether an agent, a registered representative, or a consultant, the DOL rule applies to you based on whether you give what the rule defines as fiduciary advice. In other words, the DOL rule applies based on what you do, not what kind of advisor you are. Further, the DOL rule applies simultaneously with your "normal" regulatory requirements. For example, if a producer advises an IRA owner to buy a fixed-rate annuity, the producer will have to show compliance with both the suitability requirements under any applicable state law and with the DOL fiduciary rule (and applicable exemptions) under Federal law.

There are three basic ways producers will become fiduciaries under the DOL rule:[3]

1. Recommend to a Plan fiduciary, a Plan participant, or an IRA owner that he or she purchase an annuity or insurance contract within the plan or IRA;
2. Recommend to a Plan participant or IRA owner that he or she rollover/transfer assets from a Plan or IRA into a new IRA (including an Individual Retirement Annuity); or
3. Recommend to a Plan participant or IRA owner that he or she take a distribution from a Plan or IRA as the source of funds to purchase an annuity or insurance contract.

As a result of these changes, most producers will now be considered fiduciaries when recommending an annuity or insurance contract if the recommendation is related to a Plan or IRA. Unfortunately, this also means that commission payments that were appropriate before the producer became a fiduciary are now prohibited and must comply with an exemption, likely either PTE 84-24 or the BIC Exemption, depending on which products the producer recommended.

[3] This is a simplified illustration of the fiduciary rule for the purposes of explaining the modified PTE 84-24. A fiduciary recommendation includes products besides annuities and insurance contracts, and includes recommendations to other types of accounts besides Plans and IRAs. Please see the April AALU Alert Deciphering the DOL Rule [link to Alert] for a more complete review of the rule itself.

Why Did DOL Make These Changes?

DOL restricted the scope of PTE 84-24 as part of what DOL described as its "regulatory initiative to mitigate the effects of harmful conflicts of interest associated with fiduciary investment advice."[4] In the DOL's view, the market for retirement advice drastically changed since the release of the current regulation in 1975, and the original version of PTE 84-24 in 1977 (then known as PTE 77-9). In the Preamble to the final amendment to PTE 84-24 (which is a narrative accompanying the regulatory text where DOL explains what the text means and how it addressed comments to the rule), DOL explained that the "growth of 401(k) plans and IRAs has increasingly placed responsibility for critical investment decisions on individual investors" and concurrently "the complexity of investment products and range of conflicted compensation structures have likewise increased" to the point where the approach in the prior PTE 84-24 relief is no longer appropriate and should be revised.[5]

PTE 84-24 – What's in the "Old" Version:

The "Old" version is still the current version until April 10, 2017. It applies to annuities (including fixed, index, and variable annuities) and to insurance contracts. The current exemption has a number of general conditions that must be met. These include:

- The sale of an insurance or annuity contract must be transacted in the ordinary course of business for the insurance company, insurance agent, insurance broker, or pension consultant;
- The terms of the sale must be at least as favorable to the Plan or IRA as they would be in a neutral transaction where the parties have no relationship with one another (an arm's length transaction);
- The party relying on the exemption must receive "reasonable" compensation under the sale;
- The Plan's fiduciary or the IRA-owner must approve the transaction; and
- Certain disclosures must be made to the employee benefit plan or IRA in connection with the sale. These disclosures include the relationship between the insurance agent, insurance broker, or pension consultant and the insurance company underwriting the insurance or annuity contract; any commission these parties will receive (including renewal compensation); and a description of any charges, fees, discounts, penalties, or adjustments that may be imposed in connection with the purchase, holding, exchange, termination, or sale of the insurance or annuity contract.

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[4] Amendment to and Partial Revocation of Prohibited Transaction Exemption (PTE) 84-24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, and Investment Company Principal Underwriters, 81 Fed. Reg. 21147 (April 8, 2016).

[5] Id. at 21153.

PTE 84-24 can't be used by the insurance agent, insurance broker, pension consultant, or insurance company for its own Plan, or where they make the decisions for the plan as discretionary trustees or fiduciaries.

<u>The "New" PTE 84-24 – the Rules after April 10, 2017:</u>

Most of the general conditions above are retained in the new version of PTE 84-24. However, DOL narrowed some provisions and expanded others, materially changing how the exemption works. Here are the most significant changes:

- <u>No Relief for Variable or Indexed Annuity Transactions</u>

While PTE 84-24 still permits the receipt of commissions by insurance agents, insurance brokers and pension consultants in connection with the recommendation and sale of an insurance or fixed-rate annuity contract, the DOL revoked relief under PTE 84-24 with respect to transactions involving variable annuities, indexed annuities, any annuity registered as a security under federal securities laws, and other annuity products where contract values vary based on the investment of a separate account maintained by the insurer or an index or investment model. The DOL determined that due to the complexity, investment risks, and conflicted sales practices associated with these types of annuities, relief for such transactions should be sought under the new BIC Exemption.

- <u>New Impartial Conduct Standards Apply</u>

In a major amendment to PTE 84-24, the Impartial Conduct Standards are now conditions of the exemption. This requires written acknowledgment of fiduciary status by producers in connection with using PTE 84-24. There are three primary components of the Impartial Conduct Standards.

The Best Interest Standard of Care

All advice provided under the "new" PTE 84-24 must now adhere to a fiduciary standard of care called the "Best Interest" standard. Based on the ERISA "Prudent Man" standard applicable to ERISA plans, the Best Interest standard requires the advisor to act in the Plan or IRA's best interest, "with the care, skill, prudence and diligence that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances and needs of the plan or IRA without regard to its own financial or other interests, or those of any affiliate or other party."

In other words, the advisor must employ a prudent process in recommending a fixed-rate annuity or insurance contract that takes into account all relevant factors to the recommendation. This requires gathering all of the relevant information necessary to make a prudent recommendation.

In the case of rollovers from a plan, this includes information about the plan, including the fees, expenses, available investments, distribution options, and other services offered by the plan. If the producer is recommending an annuity or insurance contract, additional relevant factors should include consideration of the insurance carrier's solvency, likely ability to pay under the contract, and the specific features and restrictions of the insurance product.

It is important that contemporaneous documentation show that this information has been gathered and considered, and carriers/intermediaries will likely need to make changes to their suitability forms and other materials to ensure this data has been gathered and documented.

Reasonable Fees and No Materially Misleading Statements

In addition, the Impartial Conduct Standards require that advisors must charge no more than reasonable fees and not make any misleading statements about the recommended investment, fees, material conflicts of interest, and any other matters relevant to the investment decision. Failure to disclose a material conflict of interest is considered a "misleading" statement by the DOL.

- <u>Enhanced Disclosure Requirements</u>

The revised PTE 84-24 makes a variety of changes to the required disclosures, including the use of dollar amounts, and annual disclosures. It also requires affirmative consent from the purchaser.

Dollar-Amount Disclosure

The "old" PTE 84-24 provided that disclosures must be made of "the sales commission, expressed as a percentage of gross annual premium payments for the first year and for each of the succeeding renewal years, that will be paid by the insurance company to the agent, broker or consultant in connection with the purchase of the recommended contract."

The "new" PTE 84-24 substantially revises this to require insurance commissions to be expressed in dollar amounts unless it is not "feasible" to do so. In the DOL's view, the change was necessary because a dollar amount is an "accurate, salient and simple disclosure that facilitates a clearer understanding of the conflicts associated with the investment…" If disclosure as an exact dollar figure is not feasible, then the DOL does permit disclosure in the form of a percentage of gross annual premium payments, asset accumulation value, or contract value. The new standard of feasibility is fairly high—concerns that it will be difficult for producers to calculate a dollar amount accurately, for example, are unlikely to make disclosure infeasible. Carriers and others involved in the sales and documentation process will need to consider how to make sure the correct disclosures are provided.

The disclosure of insurance commissions must also separately identify, if applicable, the amount that will be paid to any other person as a gross dealer concession, override, or similar payment. The plan's fiduciary or IRA owner must affirmatively acknowledge their receipt of these disclosures—this cannot be done using a "negative consent" procedure.

Frequency of Disclosure

Further, the DOL revised the requirements related to additional purchases of insurance and annuity contracts. Under the revised condition, disclosures must be provided again if more than one year has passed since the disclosure was made with respect to the purchase of the same kind of insurance or annuity contract. The one-year requirement runs from the date of the original purchase of the annuity or insurance contract. This was revised from three years in the original exemption.

Other Disclosures

PTE 84-24, as amended, retains the requirement that the insurance agent, insurance broker, or pension consultant must disclose if they are an affiliate of the insurance company whose contract is being recommended and if the ability of such agent to recommend insurance or annuity contracts is limited by any agreement with the insurance company and the nature of such affiliation, limitation, or relationship.
It also retains the requirement that the insurance agent, insurance broker, or pension consultant provide a description of any charges, fees, discounts, penalties, or adjustments that may be imposed in connection with the purchase, holding, exchange, termination, or sale of the insurance or annuity contract.

- <u>Definition of Commission</u>

The "old" PTE 84-24 exempted commissions received in connection with the purchase of an insurance or annuity contract, but it did not specifically define "commission." As a result, a wide range of commission compensation was viewed as covered by the exemption.

New Definition Excludes Certain Types of Compensation

The "new" PTE 84-24 specifically defines "insurance commissions" eligible for relief under the exemption, applying a more narrow definition. The new definition includes renewal fees and trailers, and gross dealer concessions and overrides. However, it excludes revenue sharing payments, administrative fees, or marketing payments from the kinds of commissions that are permitted under the exemption. In explaining its rationale for these changes, DOL stated that these types of excluded commission payments cause conflicts of interest that the BIC Exemption is intended to address. However, DOL does allow commissions to be paid by sources other than the insurance carrier.

In the Preamble, DOL noted that it did not intend “to disrupt the practice of paying commissions through a third party, such as an independent marketing organization.” Accordingly, DOL wrote, it did not include “payments from parties other than the insurance company” in the list of excluded payments in the definition of “Insurance Commission.” Read together with the allowance for “direct or indirect” payments under the exemption, it appears that these types of payments are allowed relief under PTE 84-24.

Incentive Compensation Issues

One significant practical effect of the new definition is that incentive compensation cannot be based on sales made using PTE 84-24. The only compensation that is permitted under the exemption is the “insurance commission.” As a result, any compensation not part of that insurance commission is not exempted. For example, if a bonus is based on total production among all types of products, the portion of production related to PTE 84-24 should be excluded from that calculation. Otherwise, the producer will receive additional, non-commission compensation related to the sale of the fixed-rated annuity or insurance contract, and that additional compensation would be a prohibited transaction.

Carriers, insurance marketing organizations, and other intermediaries need to consider how this redefinition will affect their commission and compensation arrangements. While the BIC Exemption is much more onerous to comply with, and brings with it additional liability risks, it does permit a broader range of permissible compensation to producers. There are some significant differences between the two exemptions, though both can be used in some circumstances.

Some Practical Differences between PTE 84-24 and the BIC Exemption

PTE 84-24	BIC Exemption
Does not require a Financial Institution to sign for the advisor.	BIC exemption must be signed by a Financial Institution.
No new special contracts, website disclosure requirements, or class action litigation rights.	For IRAs, must sign special contract, and comply with extensive requirements including class action litigation rights.
84-24 broadly permits variable compensation to the producer if in the form of an insurance commission. Can vary between products as well as product providers.	BIC Exemption generally requires level compensation to the advisor with respect to providers—may be some variation among identifiable product categories if based on neutral factors. Cannot vary based on product providers.
84-24 narrowly restricts other incentive compensation (compensation other than an insurance commission). Insurance commission does not include revenue sharing, marketing payments, or administrative fees.	BIC Exemption permits incentive compensation that the Financial Institution determines does not cause the advisor to act against the Best Interest of the advice recipient.
Burden on producer/agent to produce disclosures and otherwise comply (though likely carriers and intermediaries will assist).	Burden on Financial Institution to produce contract and to follow additional requirements related to policies and procedures, supervision, and disclosure.
Must adhere to Best Interest Standard—gather, evaluate, and document relevant factors to make prudent recommendation.	Must adhere to Best Interest Standard—gather, evaluate, and document relevant factors to make prudent recommendation.

- Recordkeeping Requirements

The "old" PTE 84-24 required records of the disclosures made, any additional information provided to the fiduciary related to insurance commissions, and the written acknowledgement of receipt of the disclosures by the fiduciary. The "new" PTE 84-24 expands the existing record-keeping requirements. Under the new regime, the DOL requires that all records illustrating that the conditions of PTE 84-24 have been met must be retained and they must be made reasonably available for inspection or audit.

Recent DOL FAQ Guidance on the Exemption:

On October 27, 2016, DOL released the first of what it promised would be three sets of guidance regarding the fiduciary rule. The first addresses the exemptions, and while most of the FAQs dealt with the BIC Exemption, a few were applicable to PTE 84-24:

- "Insurance-only" agents (those licensed only to sell insurance) can rely on PTE 84-24. However, DOL cautioned that "a prudent adviser should be careful to disclose any limitations on the types of products he or she recommends and would refrain from recommending an annuity if it were not a prudent choice for the retirement investor."[6]
- Relief granted by PTE 84-24 is available for purchases of a fixed rate annuity contract or other insurance contract through a rollover.[7]
- Although the definitions of "reasonable" compensation in PTE 84-24 and in the BIC Exemption are slightly different, DOL advises that they do not differ substantively and that it intends to interpret the provisions in the same way.[8]

Conclusion

The DOL amendments to PTE 84-24 substantively change the landscape for advice related to insurance contracts and annuity products provided to employee benefit plans and IRAs. Insurance agents, insurance brokers, and pension consultants must now employ a fiduciary process when recommending these products, and will need to comply with either the BIC Exemption or PTE 84-24 to receive commissions for their services. Which exemption to use depends on the product, the conditions of the exemption, and other factors.

We will continue to monitor any additional guidance produced by the DOL in future Alerts.

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[6] Department of Labor, Employee Benefits Security Administration, Conflict of Interest Exemptions FAQs, October 27, 2016, Q-21.

[7] Conflict of Interest Exemptions FAQs, Q-32.

[8] Id., Q-33.