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**TOPIC: DOL Issues Proposed Regulation Revising the Definition of Fiduciary and the Prohibited Transaction Exemptions for Adviser Compensation.**

**MARKET TREND:** The vast majority of retirement assets are now held in retirement plans and IRAs that give participants the ability to direct the account investments, increasing their need for investment advice. The Department of Labor ("DOL") is seeking to update ERISA's definition of an investment advice fiduciary in the context of this environment.

**SYNOPSIS:** The DOL recently proposed new regulations that expand the definition of who is a "fiduciary" for ERISA purposes by virtue of providing investment advice to plan participants, plan sponsors of small qualified plans, and IRA owners. Advisers falling under this definition generally would be prevented from receiving "conflicted interest" compensation for investment advice, such as commissions or revenue-sharing proceeds, which would be classified as prohibited transactions unless an exemption applies. In this regard, the DOL also has proposed modified and new exemptions to such prohibited transactions, including a broad-based "best interest contract exemption." Taking advantage of this exemption, however, could be extremely difficult and require significant changes to existing compensation structures, likely at substantial administrative costs to financial institutions and advisers, which could be passed on to consumers.

**TAKE AWAYS:** If implemented in their current form, the proposed investment fiduciary regulation and revisions to the prohibited transaction exemptions would have a significant impact on commission-based compensation for advisers. Yet, despite its intentions, the DOL's approach could actually limit the availability and/or increase the cost of investment advice and services for retail investors, as advisers and financial institutions pass on new administrative costs. Further, many consumers may prefer to pay charges only at the point of sale of an asset, rather than being required to pay level annual fees, such as a set percentage of annual asset values. Currently, the proposed rules are subject to a recently extended comment period ending on July 21st, which will be followed by a hearing and a reopening of the record after the hearing. The AALU will remain active and vigilant in its monitoring of and advocacy on this important issue during the comment and hearing process.

***MAJOR REFERENCES:*** *DOL Proposed Definition of the Term "Fiduciary," Conflict of Interest Rule - Retirement Investment Advice; DOL Proposed Best Interest Contract Exemption; DOL Proposed Amendment to and Proposed 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.*

The DOL recently re-issued proposed rules to expand the definition of "fiduciary" under ERISA for advisers who provide investment advice to plan participants, IRA owners, and plan sponsors of small qualified plans (i.e., fewer than 100 participants). This is an extremely critical issue for affected advisers, because not only is a fiduciary generally subject to enhanced standards of conduct with increased liability, but certain transactions involving benefit plans and IRAs, such as the payment of certain commission-based or revenue-sharing compensation to the fiduciary, will be prohibited as self-dealing unless an exception applies. This *Washington Report* discusses the highlights of the proposed new definition of investment advice fiduciary as well as the changes to the prohibited transaction rules and exemptions, particularly as they relate to insurance advisers.

## PROPOSED RULE

### Definition

The DOL does not believe ERISA's current definition of fiduciary[1] is expansive enough to encompass all parties that it believes should be considered fiduciaries in the current marketplace. Its proposed regulation purportedly addresses those concerns by defining a fiduciary (hereafter, an "**investment advice fiduciary**") as a person who meets the following requirements:

1. Advises Covered Investors. The person provides investment advice to any specified retirement plans, their fiduciaries or participants or any IRA owners.

2. Provides Investment Advice. The person provides any of the following types of advice:

    - Makes investment recommendations, including recommendations to take distributions, or how to invest the distributions or rollovers, from a plan or IRA;

    - Make investment management recommendations including with regard to assets to be rolled over or distributed from a plan or IRA;

    - Provides asset appraisals or similar valuation statements (verbal or written) in connection with the plan's or IRA's acquisition, disposition, or exchange of such assets; **or**

    - Recommends another person who will also receive a fee or other compensation for providing any advice described above.

3. Receives Compensation. The person receives, directly or indirectly, a fee or other form of compensation for the advice provided (including brokerage fees, mutual fund sales, and insurance sales commissions).

4. Makes Representations or Agreements. The person either, directly or indirectly:

    - Represents or acknowledges that he or she is acting as a fiduciary within the meaning of ERISA with respect to the advice provided; **or**

- Renders the advice per a written or verbal agreement, arrangement, or understanding that the advice is individualized or specifically directed to the recipient for consideration in making investment or management decisions with respect to plan or IRA assets.

**Carve-Outs**

There are seven carve-outs to the definition, which include: (1) certain counterparties to transactions with the plan or IRA, (2) swap and security-based swap transactions, (3) employees of the plan sponsor, (4) providers of investment platforms, (5) selection and monitoring assistance provided pursuant to objective standards, (6) certain financial reports and valuations, including those rendered to employee stock ownership plans, and (7) investment education.[2]

## IMPLICATIONS FOR INVESTMENT ADVICE FIDUCIARY COMPENSATION

For fiduciaries, ERISA and the Internal Revenue Code ("**Code**") generally classify, as a prohibited transaction, the payment of fiduciary compensation that varies based on their investment recommendations, which generally includes commission-based and revenue-sharing compensation. The DOL views this as "conflicted interest" compensation. ERISA's current fiduciary rule, however, provides longstanding exemptions that allow advisers, despite their fiduciary status, to receive commissions in connection with mutual funds, securities, and insurance products.

The proposed rule continues to classify conflicted interest compensation as a prohibited transaction, but as discussed below, the DOL has modified or partially revoked some existing prohibited transaction exemptions and proposed two new prohibited transaction exemptions that are intended to allow investment advice fiduciaries to continue receiving their typical forms of compensation. Compliance with these exemptions, however, could prove costly and burdensome to advisers, and potentially unworkable, from an administrative perspective.

- ***Practical Note:*** Based on DOL comments in the preamble to its proposed regulation, it appears the DOL is targeting commission-based compensation, as it views commission payments in a negative light.

## NEW & REVISED PROHIBITED TRANSACTION EXEMPTIONS

**Best Interest Contract Exemption**

BICE Scope. The most significant of the new prohibited transaction exemptions is the Best Interest Contract Exemption ("**BICE**"), which is designed to provide relief for a broad range of transactions. The BICE would permit advisers and financial institutions (and their affiliates and related entities) to receive otherwise prohibited compensation for services provided in connection with the purchase, sale or holding of an asset by a plan, participant, beneficiary account, or IRA as a result of advice to a plan participant or beneficiary, the beneficial owner of an IRA, or a plan sponsor of a small qualified plan (i.e., fewer than 100 participants) who holds plan investment authority (collectively, "**Retirement Investors**").[3]

- ***Practical Note:*** BICE's definition of "Retirement Investor" excludes ERISA plans with more than 100 participants or plans of any size that allow participant direction of investments. Only other existing exemptions will be available for transactions with these plans.

<u>BICE Requirements</u>. Financial institutions seeking to rely on BICE must ensure compliance with several requirements, **<u>generally before the provision of advice and point-of-sale</u>**, primarily through execution of a written contract and the provision of other disclosures:

1. ***Acknowledgement of Fiduciary Status.*** The parties must agree that the adviser and financial institution are fiduciaries under ERISA or the Code with respect to the plan or IRA. This contractual acknowledgment applies solely to the advice regarding the Retirement Investor's purchase, sale or holding of the Asset, not to advice with regard to any other conduct.

2. ***Compliance with Standards of Impartial Conduct.*** The adviser and financial institution must agree to, and comply with, the following "impartial conduct standards" when rendering investment advice to a Retirement Investor with regard to an asset:

    - <u>Best Interest</u>. The investment advice provided will be in the Best Interest of the Retirement Investor (*i.e.*, advice that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the adviser, financial institution, or any affiliate, related entity, or other party);

    - <u>Reasonable Compensation</u>. The investment advice will not recommend an asset if the total amount of anticipated compensation to the adviser, financial institution, etc. in connection with the transaction will exceed reasonable compensation for the total services they provide to the Retirement Investor; **<u>and</u>**

    - <u>No Misleading Statements</u>. Statements about the asset, fees, "material conflicts of interest" (discussed below), and any other matters relevant to a Retirement Investor's investment decisions, will not be misleading.

➢ ***Practical Note:*** This concept is **<u>fairly revolutionary for IRAs</u>**, as they are not covered by ERISA and, therefore, transactions with them are not subject to these prudence standards. The BICE causes **<u>advisers dealing with IRAs to subject themselves contractually to these ERISA-like standards of conduct, thereby creating a private cause of action on behalf of an IRA owner</u>** to seek a remedy for a breach of these standards. Also, by making the violation of these standards a prohibited transaction, it subjects such violations to the excise taxes applicable to prohibited transactions.

3. ***Provision of Warranties.*** The BICE requires the following warrants in the contract of the adviser and financial institution, but interestingly, the BICE's application is not conditioned on compliance with these warranties. Accordingly, while the failure to comply could result in contractual liability for breach of warranty, it would not result in loss of the BICE if the breach did not involve a violation of another BICE condition.

➢ ***Practical Note:*** The BICE creates the possibility for lawsuits against advisers and financial institutions for contractual claims that may not otherwise exist.

    - <u>Adoption of Policies and Procedures</u>. The Financial Institution must warrant that it has adopted written policies and procedures reasonably designed to mitigate the impact of "material conflicts of interest" with respect to the provision of investment advice to Retirement Investors and to ensure that individual advisers adhere to the impartial conduct standards (a "material conflict of interest" is

deemed to exist when an adviser or financial institution has a financial interest that could affect the exercise of its best judgment as a fiduciary in rendering the investment advice). This warranty must state that in formulating its policies and procedures, the financial institution specifically identified material conflicts of interest and adopted measures to prevent those material conflicts of interest from violating the impartial conduct standards.

- <u>Compensation Structures</u>**.** The financial institution (and affiliates or related entities) must warrant that they **<u>will not use quotas, appraisals, performance, bonuses or other differentiated compensation or incentives</u>** that tend to encourage individual advisers to make recommendations not in the Retirement Investor's best interest ("**conflicted interest compensation**").
    - In the preamble to the proposed BICE exemption, the DOL suggests (but does not mandate) various examples of acceptable compensation structures – level-fee structure, independently certified computer models, asset-based compensation, fee offsets, and differential payments based on neutral factors. It also suggests several policies and procedures for adviser compensation:
        - Avoid creating compensation thresholds that enable an adviser to increase his or her compensation disproportionately through an incremental increase in sales;
        - Monitor activity of advisers approaching compensation thresholds such as higher payout percentages, back-end bonuses, or participation in a recognition club, such as a President's Club;
        - Maintain neutral compensation grids that pay advisers a flat payout percentage regardless of product type sold (so long as they do not merely transmit the financial institution's conflicts to the adviser);
        - Refrain from providing higher compensation or other rewards for the sale of proprietary products or products for which the firm has a revenue sharing arrangement;
        - Stringently monitor recommendations around key liquidity events in the investor's lifecycle where the recommendation is particularly significant (e.g. when an investor rolls over his pension or 401(k) account); and
        - Develop metrics for good and bad behavior (red flag processes) and use clawbacks of deferred compensation to adjust compensation for employees who do not properly manage conflicts of interest.

➢ ***Practical Note:*** Compensation structures involving differentiated commissions, bonuses, and incentives are prevalent throughout the insurance industry, and it is difficult to know when such forms of compensation will violate the DOL's subjective standard. Thus, it could be difficult to warrant that the use of certain compensation structures would not constitute conflicted interest compensation. These rules could require a wholesale re-evaluation of compensation models for insurance companies looking to rely on the BICE. Implementation of BICE's recommended policies and procedures also would likely require a restructuring of insurance company compensation practices, as well as impose

enormous burdens on those companies to establish and administer the systems for monitoring producer activities, possibly at additional costs passed down to consumers.

- Compliance with Applicable Law. The adviser and financial institution must warrant that they and their affiliates will comply with all applicable federal and state laws in the rendering of the investment advice and payment of related compensation.

4. ***Contractual Disclosures.*** The BICE requires the contract to disclose in writing all material conflicts of interest, inform the Retirement Investor of the right to obtain complete information about all fees currently associated with the assets in which it is invested, disclose to the Retirement Investor whether the financial institution offers proprietary products or receives third party payments with respect to the purchase, sale or holding of any asset, and the web address of the website required by the BICE (as described below). Unlike the warranties described above, failure to include these disclosures vitiates reliance on the BICE.

5. ***Prohibited Provisions***. The contract may not contain exculpatory provisions disclaiming or limiting the liability of the adviser or financial institution for a violation of the contract's terms, or a provision under which the plan, IRA or Retirement Investor waives or qualifies its right to bring or participate in a class action or other representative action in court in a dispute with the Adviser or Financial Institution. The parties may, however, agree to binding arbitration pre-dispute with respect to individual contract claims.

6. ***Per-Transaction Disclosure***. Before executing a purchase, the adviser must give the Retirement Investor a chart that provides, with respect to each asset recommended, the total cost to the plan, participant or beneficiary account or IRA of investing in the asset for one-, five- and ten-years periods.

7. ***Annual Disclosure.*** An **adviser must provide the Retirement Investor, within 45 days after the end of each year, a single disclosure** containing a list of each asset bought or sold during the year and the purchase or sale price, a statement of the total dollar amount of all fees and expenses paid by the plan, participant or beneficiary account, or IRA with respect to each asset purchased, held or sold during the year, and a statement of the total amount of all compensation received by the adviser and financial institution directly or indirectly from any party as a result of each asset purchased, held or sold during the year.

8. ***Web Page***. The financial institution must maintain a web page that is freely accessible to the public that shows the direct and indirect material compensation payable to the adviser, financial institution and any affiliate for services provided in connection with each asset (or each class of assets) that a Retirement Investor is able to purchase, hold or sell through the adviser or financial institution, and that a Retirement Investor has purchased, held or sold within the last 365 days.

9. ***Range of Investment Options***. The financial institution generally must offer, and the adviser must make available, a range of assets that is broad enough to enable the adviser to make recommendations with respect to all the asset classes reasonably necessary to serve the best interests of the Retirement Investor in light of its investment objectives, risk tolerance and specific financial circumstances.

    - Exceptions.

- A Financial Institution may offer a limited range of investment options based on whether the assets are proprietary products, generate third party payments or for other reasons, provided: (a) the financial institution makes a specific written finding that the limitations do not prevent the adviser from providing best interest advice, (b) the compensation received for the services is reasonable and not in excess of fair market value, (c) the Retirement Investor is given written notice of the limitations that may be placed on the assets the adviser may offer, and (d) the Adviser notifies the Retirement Investor if the adviser does not recommend a sufficiently broad range of assets to meet the Retirement Investor's needs.

- Participant-directed plans in which a fiduciary other than the adviser has established a limited menu of investment options also are excepted.

10. ***Notice to Department of Labor.*** Financial institutions wishing to rely on the BICE must notify the DOL of their desire to do so **before receiving the exempt compensation**.

11. ***Data Retention, Requests and Recordkeeping.*** The adviser and financial institution musts agree to retain documents and data relating to investment recommendations regarding assets. Specifically, for a period of six years, the financial institution must maintain records of inflows, outflows, holdings and returns that would enable it to satisfy data requests that may be made by the DOL or requests for examination by the DOL, the IRS, a Retirement Investor or any employer who maintains a plan covering its employees that engaged in a transaction under the BICE.

- ***Practical Note:*** The data request and recordkeeping requirements, along with the pre-transaction and annual disclosure requirements, may require the creation and maintenance of data files not maintained by insurance companies and insurance producers under their current systems, potentially at significant effort and costs.

**Modification & Partial Revocation of Insurance And Annuity Contract Exemption**

In addition to the new BICE, one of the prohibited transaction exemptions that the DOL is proposing to modify and revoke in part is PTCE 84-24, which provides an exemption for purchases by ERISA plans and IRAs of insurance and annuity contracts and for the receipt by an insurance agent, broker, pension consultant or other service provider or fiduciary to a plan or IRA of a sales commission in connection with these purchases.

Partial Revocation. Specifically, with respect to IRAs, the DOL is proposing to revoke PTCE 84-24 for purchases by IRAs of variable annuities and other annuity contracts that are securities under the federal securities laws. PTCE 84-24 would continue to apply to purchases of insurance and annuity contracts that are not securities under federal securities laws.

Supplemental Exemption to BICE. To ensure an exemption remains available that covers the purchase of annuity contracts that are securities, the DOL is proposing a "supplemental exemption" to the BICE. This supplemental exemption would require that (1) the transaction be effected by the insurance company in the ordinary course of its business as an insurance company, (2) the combined total of all fees and compensation received by the insurance company not exceed reasonable compensation under the circumstances, (3) the purchase is for cash only, and (4) the terms of the purchase are at least as favorable to the plan as the terms generally available in an arm's length transaction with an unrelated party. This supplemental exemption applies only to the prohibitions of ERISA §§406(a)(1)(A) and (D) and Code

§§4975(c)(1)(A) and (D). For relief from the self-dealing provisions of ERISA §406(b) and Code §§4975(c)(1)(E) and (F), the requirements of the general BICE must be satisfied.

Impartial Conduct Standards Similar to BICE. With regard to the purchase of insurance and annuity contracts that are not securities, the DOL proposes to amend PTCE 84-24 to make it a condition of the exemption that, if the insurance agent, broker, pension consultant, insurance company or investment company principal underwriter ("insurance advisor") is an investment advice fiduciary, such advisor must comply with impartial conduct standards similar to those under the BICE to receive the benefit of this exemption. Although the insurance advisor does not need to enter into the same pre-sale contractual agreement with all the provisions and warranties required under BICE, the insurance advisor must provide certain written disclosures to the plan fiduciary, who must, before the transaction, provide written acknowledgement of receipt of the disclosures and approval for the transaction. The disclosures include: (1) any limitations on the products recommended by the insurance advisor if he is an affiliate of the insurance company issuing the recommended contract, (2) the commission the insurance advisor will receive, expressed as a percentage of the gross annual premium payments, and (3) a description of any charges, fees, discounts, penalties, etc. that may be imposed under the recommended contract in connection with its purchase, holding, exchange, termination or sale.

Amendment to Definition of Insurance Commission. The DOL proposes to amend PTCE 84-24 to add a specific definition of "insurance commission" to mean a sales commission paid by the insurance company or an affiliate to the insurance agent or broker or pension consultant for the service of effecting the purchase or sale of an insurance or annuity contract, including renewal fees and trailers, but not revenue sharing payments, administrative fees or marketing payments, or payments from parties other than the insurance company or its affiliates.

**TAKE-AWAYS**

- If implemented in their current form, the proposed investment fiduciary regulation and revisions to the prohibited transaction exemptions would have a significant impact on commission-based compensation for advisers.
- Yet, despite its intentions, the DOL's approach could actually limit the availability and/or increase the cost of investment advice and services for mainstream consumers, as advisers and financial institutions pass on new administrative costs.
- Further, many consumers may prefer to pay charges only at the point of sale of an asset, rather than being required to pay level annual fees, such as a set percentage of annual asset values.
- Currently, the proposed rules are subject to a recently extended comment period ending on July 21st, which will be followed by a hearing and a reopening of the record after the hearing.

***NEXT STEPS***

The AALU continues to work with a broad coalition of industry partners to articulate the significant problems with the DOL proposal, and push back significantly against the rule as constructed. There are several aspects to this response. In addition to continued conversations with DOL and the submission of a formal AALU comment letter before the July 21st deadline, the AALU will be encouraging our members to comment to the Department as well.

The AAU will also be engaging the broader membership going forward in a grassroots effort to let Congress know about negative implications of the DOL proposal for both life insurance producers and retirement savers. AALU is working with industry partners to consider alternatives that would frame what a workable approach would actually entail.

**NOTES**

[1] The existing regulation, implemented in 1975, contains a five-part standard for determining when a party renders investment advice for a fee and, therefore, is considered a fiduciary. Specifically, the regulation defines as a fiduciary one who (1) renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property, (2) on a regular basis, (3) pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary that (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and that (5) the advice will be individualized based on the particular needs of the plan or the IRA. All five of these elements must be present for the adviser to be considered a fiduciary.
[2] A detailed description of these carve-outs is generally beyond the scope of this *WR Marketplace.*
[3] For purposes of the BICE, the proposed regulation specifically defines these terms as follows: (1) an "Adviser" is generally an individual investment advice fiduciary of a plan or IRA who is an employee, independent contractor, agent or registered representative of a "Financial Institution," (2) a "Financial Institution" is a registered investment adviser, bank, insurance company or registered broker-dealer that employs an Adviser; (3) "Assets" are intended to encompass those investments that are needed to build a basic diversified portfolio and include only: bank deposits; certificates of deposit; shares or interests in registered investment companies, bank collective funds, insurance company separate accounts, exchange-traded REITS, or exchange-traded funds; corporate bonds offered pursuant to a registration statement under the Securities Act of 1933; agency debt securities as defined in FINRA Rule 6710(l) or its successor; U.S. Treasury securities as defined under FINRA Rule 6710(p) or its successor; insurance and annuity contracts; guaranteed investment contracts; and equity securities within the meaning of 17 C.F.R. §230.405 that are exchange-traded securities within the meaning of 17 C.F.R. §242.600, and (4) a "Retirement Investor" may be a plan participant or beneficiary with the authority to direct the investment of assets in his or her account or to take a distribution, the beneficial owner of an IRA, or a plan sponsor of a non-participant-directed ERISA plan that has fewer than 100 participants to the extent that it acts as a fiduciary who has authority to make investment decisions for the Plan.


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