NAIFA Fact Sheet: DOL Expands Fiduciary Definition

The Department of Labor (DOL) has released its long anticipated “Proposed Regulation to Address Conflicts of Interest”, and is accepting public comments until July 6. The comment period will be followed by a public hearing, and a subsequent supplemental comment period.

The proposed regulation is lengthy, complex, includes two new prohibited transaction exemptions (PTE), modifications to four existing PTEs, and a request for comments on another possible new PTE that the Department hopes to finalize with the final rule, if enacted.. This fact sheet provides a general overview of the portions of DOL’s proposal that are most likely to significantly impact NAIFA members.

Definition of Investment Advice Fiduciary

Under current law, a person is considered an investment advice fiduciary if she satisfies a five-part test. Historically, under this test, NAIFA members generally have not considered themselves fiduciaries. DOL’s proposed rule significantly expands the investment advice fiduciary definition to include anyone who receives a fee or other compensation, directly or indirectly, for individualized investment advice to retirement plan sponsors (e.g., employers), plan participants or IRA owners. “Investment advice” includes: investment recommendations; investment management recommendations; appraisals, fairness opinions, and other statements on value provided in connection with specific transactions; and recommendations of other persons who provide investment advice or manage assets for a fee.

The proposed rule carves out several exceptions from the “investment advice” definition (i.e., activities that will not trigger fiduciary status). Among the most important exceptions for NAIFA members are the education exception, seller’s exception, and employee exception. Under the education exception, retirement plan and investment education is permitted without triggering fiduciary status ONLY if the education is general in nature and not specific to a plan or participant. As drafted, the education exception is very narrow, in that an advisor could discuss general allocation models but could not provide any specific examples of products or investment options in those models.

The seller’s exception, which is only available for communications between advisers and large plans (over 100 employees or over $100 million in assets), not small plans or IRAs, carves out incidental advice and “sales pitches” provided in connection with an arm’s length sale, purchase, loan, or bilateral contract (not services such as agency trading, futures trading, or prime brokerage) to a sophisticated plan investor (e.g., plan fiduciary) with sufficient expertise to evaluate whether the transaction is in the best interest of the plan participants. Under this exception, the plan’s fiduciary retains legal responsibility to protect the plan and participants and understands that the broker is acting in a pure sales capacity.

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And finally, the employee exception carves out statements or recommendations provided to a plan fiduciary of an ERISA plan by an employee of the plan sponsor, if the employee receives no fee beyond her normal compensation.

Once an advisor becomes an investment advice fiduciary, she is subject to numerous fiduciary-specific rules and restrictions under ERISA and/or the Code, including restrictions on the type of compensation she may receive. Generally, under existing ERISA/Code prohibited transaction rules, investment advice fiduciaries may not receive compensation that varies based on the consummation or size of a recommended transaction or compensation from third parties in connection with recommended transactions. Thus, *without an exemption*, investment advice fiduciaries may not receive commissions, revenue sharing fees, or 12b-1 fees. Violating prohibited transaction rules exposes the advisor to personal liability, taxes and other sanctions.

The Best Interest Contract Exemption

DOL's proposal includes a new exemption from ERISA/Code prohibited transaction rules called the Best Interest Contract Exemption. If the exemption's eligibility requirements and conditions are satisfied, it allows certain investment advice fiduciaries, including broker-dealers, insurance agents, and financial institutions, to receive fees and compensation common in the retail market (e.g., brokerage and insurance commissions, 12b-1 fees, and revenue sharing payments) that, without the exemption, would be prohibited.

Eligibility for the exemption –

The exemption only applies when advice is given to *non-participant-directed* small plans (fewer than 100 participants), plan participants or IRA owners, and it only applies to advisor services provided in connection with the purchase, sale or holding of certain specified assets (including insurance and annuity contracts, and mutual funds). Thus, as drafted, the exemption does not appear to cover advice related to rollovers or distributions. Additionally, the exemption does not appear to cover advice to plan sponsors regarding design of the plan's menu (instead, it seems that DOL means to stop third-party compensation in this context and force plans to pay their advisors through flat-fee arrangements or fee arrangements based on a percentage of portfolio assets). The exemption also contains specific exclusions. For example, the exemption is not available for fiduciaries with discretionary authority over plan/IRA assets, for named fiduciaries or plan administrators of ERISA plans, or for principal transactions.

Conditions of the exemption –

The exemption has several conditions, including written contract requirements and extensive disclosure requirements. First, the advisor and her firm/financial institution (e.g., broker-dealer, insurance company, and bank) must enter into a contract with *each* investor specifying, among other things, that the advisor:

1) is acting as an investment advice fiduciary;
2) agrees to act in the client's best interest, which means: acting with 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 investor, without regard to the financial or other interests of the adviser (or any other related party);
3) will not make any misleading statements about information pertinent to a transaction (e.g., fees, assets, conflicts of interest);
4) warrants that the firm/financial institution has adopted policies and procedures designed to mitigate conflicts of interest, including avoiding compensation arrangements like quotas, bonuses, contests, differential

compensation, etc. that would encourage its advisors to make recommendations that are not in the best interest of the investor (examples from DOL on how to comply with this requirement include: leveled compensation, percent-of-assets compensation, flat fees, and cessation of incentives like trips, bonuses, etc.); and
5) has clearly and prominently disclosed any conflicts of interest, including proprietary products, hidden fees, and backdoor payments.

The exemption's contract requirements will give rise to a private state cause of action for breach of contract for IRA owners. While DOL will allow a contract dispute to be settled by arbitration, it does not allow any waiver of the right to a class action complaint (consistent with current FINRA guidance). For small ERISA plans and participants, the exemption's contract requirements will give rise to a federal cause of action under ERISA for engaging in a non-exempt prohibited transaction.

In addition to the contract requirements, the exemption requires several disclosures by advisors and their firms, including a point-of-sale disclosure, in chart format, that provides the "total cost" of investing in an asset for 1-, 5- and 10-year periods. "Total cost" includes acquisition costs, ongoing costs, disposition costs and any other costs. The costs must be expressed in dollar amounts and include reasonable assumptions about investment performance. The exemption requires annual disclosures as well. Annual disclosures must be provided within 45 days of the end of the plan year, and must include a list of each asset sold, the price of that asset sale, a statement of all fees paid by the plan, and a statement in dollars of all compensation received. Also, the advisor's firm must create and update quarterly a free public web page that includes copious amounts of information about the compensation formulas and exact dollar cost for each and every asset that a plan, participant or IRA owner might purchase, plus detailed information about each and every asset that any plan, participant or IRA owner did buy, sell or hold during the year. And finally, firms intending to rely on the exemption must notify DOL of their intention and maintain certain data and records for six years.

Special insurance and annuity contract exemption within the Best Interest Contract Exemption –

Current party-in-interest/disqualified person rules prohibit the purchase by a plan, plan participant or IRA owner of an insurance or annuity product from an insurance company that is a service provider to the plan or IRA. So, for example, when an advisor is acting as agent of an insurance company while advising an IRA owner on purchasing insurance or annuity contracts, the insurance company is a disqualified person under the Code because it is offering services to the IRA owner through its agent. In this scenario, current Code rules would prohibit the advisor from recommending that the IRA owner purchase an insurance or annuity contract from the insurance company. This special exemption would allow the IRA owner, on the advisor's advice, to conduct such a transaction if: the transaction is effected by the insurance company in the ordinary course of its business; the total compensation received by the insurance company and its affiliates is reasonable; the purchase is for cash only; and the terms of the purchase are at least as favorable to the investor as a generally-available arm's length transaction.

A possible "low fee" exemption within the Best Interest Contract Exemption -

DOL is seeking comments on a new "low fee" exemption it is developing (which was not included in its proposal) that would relieve some of the contract requirements of the Best Interest Contract Exemption when recommending the lowest-fee products in a given product class.

Amendment of PTE 84-24

Currently, PTE 84-24 allows pension consultants, insurance agents, brokers, insurance companies, and mutual fund principal underwriters to receive sales commissions (that are reasonable under the circumstances) for selling insurance or annuity contracts, or mutual funds, to plans or IRAs, even when they are considered parties in interest/disqualified persons, provided they disclose the amount of their commission and other terms of the transaction to an independent fiduciary of the plan or IRA and obtain approval for the transaction.

DOL's proposed amendment to PTE 84-24 revokes the exemption for some transactions involving 401(k) type plans and IRAs and amends the conditions under which investment advice fiduciaries may rely on the exemption. First, the proposed amendment revokes PTE 84-24 for *IRA purchases of variable annuity contracts and other annuity contracts that are securities* under federal securities laws *and for IRA purchases of mutual fund shares*. Apparently, the Department intends for these types of transactions to be covered by the Best Interest Contract Exemption.

Second, the proposed amendment requires investment advice fiduciaries relying on the exemption (e.g., advisors selling *non-securities* annuity products) to meet new conditions, including: acting in the best interest of the plan or IRA and refraining from issuing any misleading statements regarding the recommended investments, fees, material conflicts of interest, or any other relevant matters. Other requirements to rely on the exemption are: the advisor does not have discretionary authority over management of plan/IRA assets; the transaction is effected by the advisor in the ordinary course of his business; the transaction is on terms at least as favorable to the plan/IRA as an arm's length transaction with an unrelated party would be; total compensation received by the advisor is reasonable; the advisor provides in writing to an independent plan/IRA fiduciary certain disclosures relating to the advisor's affiliation with the insurance company providing the contract, commissions, and other charges, fees or penalties that could apply to the purchase; and after receiving the disclosures, the independent fiduciary approves the transaction.

Concerns NAIFA will address:

1. Education carve out is too narrow – does not allow for specific examples. (Will websites and calculators be shut down to avoid potential fiduciary liability of financial institution?)

2. Distributions from plans, rollovers from current ER plan to new ER plan and rollovers to IRAs are not included in the BIC exemption, meaning advice can only be offered on a fee for service arrangement, if at all.

3. Advising defined contribution plan sponsors (401(k), 403(b), etc.) on establishment of plan, menu options, plan provisions is not included in the BIC exemption, meaning advice can only be offered on a fee for service arrangement, if at all.

4. The financial institution is required to establish policies and procedures to mitigate conflicts of interest. The examples included in the NPRM include levelized compensation, asset based comp agreements, and fee offsets. If the institution allows 3rd party compensation that differs based upon the

recommendation, will that be interpreted to mean policies and procedures are not in place? (Increasing the risk of litigation for breach of contract).

5. The overall cost increases necessary to comply with complex contracts, disclosures, website maintenance, exposure to frivolous lawsuits, record-keeping, copious amounts of data, etc. will result in less access, more consumer costs and less choices in how to engage a financial professional.

6. Increased legal liability and increases in errors and omissions coverage inevitable. Breach of contract in state courts plus breach of fiduciary duty under ERISA in federal courts, with the burden of proof on the financial professional may cause many to exit the market.

7. The disclosure data includes "all-in costs", in dollar amount, that includes a computation of future performance of the asset. FINRA and SEC rules do not permit future performance estimates so this potentially is in conflict with federal securities laws.

8. Creation and maintenance of a public website and quarterly records available to the DOL will be too burdensome and too costly for small firms, who will exit the market by preventing their registered reps from advising retirement savers.

9. Revocation of PTE 84-24, that currently allows an advisor to sell a variable annuity or mutual funds from the service provider (a self-dealing transaction), makes it unclear under what circumstances an advisor of a service provider could sell variable annuities.

10. Under PTE 84-24, the new rule does not revoke the ability to sell a fixed rate annuity (non-securities annuity) – but can an advisor who is not licensed to sell all investment options satisfy a best interests standard when product advice is limited to only non-securities choices?

11. Does fiduciary duty include co-fiduciary liability?

12. How long is an investment advice fiduciary required to monitor an account?

13. What will be the response of broker-dealers/financial institutions regarding minimum account balances, additional compliance/education requirements, changes in current compensation models, draft of prototype contracts between registered rep, client and financial institution?

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