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An Overview of the Fiduciary Rule

By Fred Reish *Fri, Apr 15, 2016*

The ERISA attorney at the firm of Drinker Biddle & Reath believes that 'broker-dealers will be affected the most by new DOL rule. Insurance companies will also need to make changes. Most RIAs will only need to adjust to the new rules regarding recommendations of distributions and rollovers from plans and withdrawals and transfers of IRAs.'

The DOL's fiduciary rule has been published in the Federal Register. Based on our review of the regulation and conversations with our clients, here are some overview thoughts about the regulation and the two "distribution" exemptions (84-24 and BICE).

The Fiduciary Definition

The rule is much as expected. The definition of fiduciary advice continues to be very broad, capturing almost all common sales practices for investments and insurance products. It includes investment recommendations to plans, participants and IRA owners, as well as recommendations about distributions from plans and transfers and withdrawals of IRAs. All of those will be fiduciary activities.

As a result, those recommendations will be subject to the fiduciary standard when made to plans or participants, and subject to the Best Interest standard of care when made to IRA owners (if the adviser needs the prohibited transaction relief provided in BICE or 84-24).

Much of the conversation has been about the requirements of the exemptions. Because of that, we are concerned that the impact of the fiduciary and Best Interest standards of care has not been adequately considered. In our opinion, those standards of care will be more impactful than generally thought.

In both cases (that is, the prudent man rule and the Best Interest standard), the adviser's recommendations will be measured by what a hypothetical prudent and knowledgeable investor would do. In other words, it is the standard of a hypothetical knowledgeable person, and not the standard of the actual adviser or the investor.
What were the most notable changes in the final regulation from the proposal?

The "applicability" date for the regulation was deferred until April 10, 2017. Most people thought that compliance would be required on January 1, 2017, so that gives the financial services sector an additional three months to comply with most of the requirements. (See the additional extension of time for certain BICE requirements below.)

Advisers will continue to be able to provide participant education for retirement plans, using asset allocation models (AAMs) that include specific designated investment alternatives. (“Designated investment alternatives” are those investments that are selected by the plan fiduciaries for participant direction in 401(k) or 403(b) plans. As a result, they must be prudently selected and monitored by the plan fiduciaries.)

However, populated asset allocation models are not permitted as a part of investment education for IRA owners. In that case, AAMs that include the names of investments would be fiduciary investment advice.

Platform providers (that is, recordkeepers) will be allowed to provide additional assistance, within limits, to respond to requests for proposals and similar inquiries from plan sponsors.

When an adviser becomes a fiduciary, the adviser’s conduct is also governed by the fiduciary prohibited transaction rules in ERISA and the Internal Revenue Code. Generally speaking, those rules prohibit advisers (or their affiliates) from receiving payments from third parties (such as 12b-1 fees or insurance commissions) and from making investment recommendations that affect the levels of their compensation. Those transactions are literally prohibited.

However, the DOL has issued prohibited transaction exemptions which, if their requirements are satisfied, would allow the receipt of those types of payments. There are two exemptions that could apply to fiduciary advisers to mid-sized plans, participants, and IRAs. Those are 84-24 and BICE, which are discussed below.

Prohibited Transaction Exemption (PTE) 84-24

The current version of 84-24 covers the sale of all insurance products by fiduciary advisers. The proposed amendment to the exemption would have continued to cover those sales to plans and IRAs, but would have transferred the sale of individual variable annuity contracts from the 84-24 exemption to BICE.

That was a significant change, because 84-24 is generally viewed as less burdensome than BICE. As a result, many in the insurance industry urged the Department of Labor to return individual variable annuities to 84-24 when the final rules were issued.

But, that didn’t happen. In fact, sales of other types of insurance were moved from 84-24 to BICE. Before getting into that, though, let’s look at the most important requirements of 84-24. Those are:

- The adviser must acknowledge in writing that he is a fiduciary and must agree to adhere to the best interest standard of care. (As a practical matter, the best interest standard of care is a combination of ERISA's prudent man rule and ERISA's duty of loyalty. In other words, those concepts are being extended from ERISA to IRAs.)
- Think about the consequences of that. For example, the recommendation of a particular insurance company must be prudent and the recommendation of the particular insurance contract must also be prudent.
- The adviser's compensation must be no more than reasonable and the adviser cannot receive any additional financial incentives, for example, trips, awards, or bonuses.
- The adviser's statements cannot be materially misleading. The failure to describe a material conflict of interest is deemed to be misleading.
- The adviser must disclose his compensation.

The 84-24 exemption also limits the commissions that can be paid to advisers to "reasonable" amounts. As a result, we believe that advisers who recommend or sell insurance and annuity contracts should obtain benchmarking information about similar sales and the commissions that are reasonable under those circumstances.

Before the sale is made, those disclosures must be delivered to the plan fiduciary or IRA owner in writing, and the fiduciary or IRA owner must acknowledge the disclosures and approve of the transaction in writing.

What are the most important changes in the final 84-24 exemption?

The types of insurance products covered by 84-24 were further limited. That is because group variable annuity contracts and fixed indexed annuities were transferred from 84-24 to BICE. As a result, 84-24 now covers only fixed rate annuities and insurance policies.

The compensation payable to advisers was expanded from just commissions to include accruals of health benefits and retirement benefits, but other payments and benefits are prohibited.

The applicability date will be April 10, 2017. Many people thought that it would be January 1, 2017, so that allows another three months to develop compliant procedures and practices.

Best Interest Contract Exemption (BICE)

The most significant changes were made to the Best Interest Contract Exemption. The changes were so great that it is not possible to describe them in this short article. So, we will just mention a few. (But, we will be doing a separate article on BICE in the coming weeks.)

BICE provides an exemption for prohibited transactions resulting from recommendations of any investment or insurance products to plans or IRAs. (In that sense, it provides an alternative exemption for the insurance products within the scope of 84-24.)
Generally speaking, it requires a contract or similar writing that is signed by a financial institution and that is given to the investor. (The financial institution is the bank, insurance company, broker-dealer or RIA, who oversees the adviser.)

The financial institution contractually agrees that it and the adviser will serve as fiduciaries and will adhere to the best interest standard of care. The financial institutional also must agree to disclose material conflicts of interest and represent that none of its statements are misleading. In addition, a host of other disclosures must be made.
What are the most noteworthy changes in the final BICE?

The final version of BICE requires a contract that is signed by the financial institution and an IRA owner. However, for plans, the financial institution can deliver a written disclosure, but it is not required that the plan fiduciaries sign a contract with the financial institution.

The contract and disclosures do not have to be delivered or signed at the time of the first conversation. Instead, that requirement can now be satisfied at point of sale.

The proposal had demanded disclosure requirements at point of sale and annually thereafter. Those disclosures were liberalized and can now be made with information that is more general, but which has to be clearly and conspicuously provided to the plans or IRA owners. The investor has the right to obtain detailed information on request.

The proposal had a website requirement that was difficult, and perhaps impossible, to satisfy. The final has a less burdensome website disclosure requirement.

The final version of BICE has simplified compliance procedures for level fee advisers who are (i) capturing distributions and rollovers from plans, (ii) recommending withdrawals or transfers of IRAs, or (iii) recommending transfers from commission-based accounts to fee-based accounts.

As finalized, BICE has provided greater relief for investment accounts that are already in existence at the time of the applicability date of the new rules. For example, an adviser can now make a hold recommendation without becoming subject to the prohibited transaction rules.

The applicability date has largely been deferred to January 1, 2018. However, some of the requirements become applicable on April 10, 2017. Those include, for example, the best interest standard of care and reasonable compensation limitation.

BICE requires that the compensation paid to the adviser, the financial institution, and affiliates be no more than reasonable. We believe that financial institutions (such as broker-dealers and insurance companies) will need to develop or obtain benchmarking information in order to evaluate the reasonableness of the compensation of their advisers. In due course, we suspect that benchmarking services will develop for sales to IRAs, much as they have already developed for advice to plans.

While the proposal excluded some assets (e.g., illiquid investments) from its relief, the final BICE is available for all types of investments.

Conclusion

The final rules will require structural changes for some financial services companies. For example, we believe that broker-dealers will be affected the most. Insurance companies will also need to make changes. At the other end of the spectrum, most RIAs will only need to make changes to adjust to the new rules regarding recommendations of distributions and rollovers from plans and withdrawals and transfers of IRAs.

Recordkeepers fall in between those two groups. Recordkeepers who have insurance companies or mutual fund manager affiliates will be impacted more than independent recordkeepers.

While not directly affected by the new rules, mutual fund management firms need to understand their impact, for example, the needs of broker-dealers in this new environment. Some broker-dealers may decide to shift many of their accounts to level fee advisory accounts. In that case, they may not be able to receive 12b-1 fees or other payments. Instead, they will likely want share classes that are specifically designed for advisory accounts. Those share classes could resemble a retail version of institutional shares.

At this point, though, it is impossible to know all of the repercussions. Stay tuned.