



INSIGHT

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The DOL Conflicts of Interest Ruling Impartial Conduct Standards

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DEPARTMENT OF LABOR FIDUCIARY AND CONFLICT OF INTEREST REGULATIONS

“The Department’s conflict of interest final rule and related exemptions will protect investors by requiring all who provide retirement investment advice to plans and IRAs to abide by a “fiduciary” standard—putting their clients’ best interest before their own profits.”

- U.S. Department of Labor

On April 6, 2016, the US Department of Labor (DOL) issued its final version of its new fiduciary and conflict of regulations that apply to most tax-qualified retirement plans. These new rules usher in significant changes to the regulations governing retirement plans covered under the Employee Retirement Income Security Act of 1974 (ERISA) and individual retirement accounts (IRAs), making this the first major overhaul since the passage of the ERISA over forty years ago.

For the first time since ERISA’s passage, the new fiduciary rule will subject many of the investment and asset management recommendations from banks, broker dealers and other financial organizations to IRAs and other retail retirement investors to the fiduciary standards and remedies found in ERISA.

The new rules will impact a myriad of areas for financial institutions, including compensation practices, new client contracts, new “impartial conduct” policies and procedures, websites and additional disclosures to both investors and the DOL. Additionally, the rules also increase the litigation risks to financial institutions who are providing investment advice and other services to retail retirement clients.

While the implications of the new regulations will apply to a variety of investment products, this series will focus on the profound effect the DOL rule will have on the sale of annuities inside of retirement accounts and the funding of life insurance with premiums coming from required minimum distributions (RMDs) and other distributions from qualified retirement accounts to pay life insurance premiums.

Courtesy of **AimcoR Group, LLC**, we are publishing a series of papers to outline the main provisions and impacts of the new rules as they relate to financial institutions and their continuing efforts to provide annuity and life insurance solutions to clients.

A SUMMARY OF THE NEW REGULATIONS

In order to better understand the new regulations that will be in place, we should level set on the Department of Labor's role with respect to retirement plans and individual retirement accounts (IRAs) and what has changed under the new rules.

The Department of Labor (DOL) is responsible for ensuring that the retirement savings vehicles used by America's workers are secure and operated in accordance with federal pension laws and regulations. This responsibility includes setting the rules that govern conflicts of interest for both IRAs and employer-based plans and enforcing rules and regulations under the federal pension law, including the Employee Retirement Income Security Act of 1974 (ERISA).

The DOL is charged with interpreting the ERISA and Internal Revenue Code (Code) provisions relating to fiduciary status and prohibited transactions. Among other things, ERISA prescribes fiduciary standards applicable to those with responsibility for the maintenance and operation of employee benefit plans and the investment of plan assets. Also, ERISA prohibits certain transactions, called "prohibited transactions," which have been deemed to pose dangers to plans and participants. Prohibited transactions include "party in interest" transactions with, and fiduciary self-dealing with respect to ERISA-covered plans. The Code also has parallel provisions that apply similar prohibited transaction rules to transactions involving IRAs.

In April of 2016, the DOL issued new and amended regulations in an effort to better align the interests of financial advisers with those of plan participants and IRA owners. The new "Fiduciary Rule" effectively broadened the scope of entities and persons who are deemed as ERISA fiduciaries as a result of giving investment advice to an ERISA-covered retirement plan or its participants or beneficiaries and to IRAs. Also, the DOL introduced new prohibited transaction class exemptions meant to help preserve many existing compensation practices used by the financial services industry while managing conflicts of interest, and made amendments to a number of existing prohibited transaction exemptions.

The new and amended set of regulations included the following:

The Fiduciary Rule: A final regulation re-defining who is a "fiduciary" by reason of providing investment advice to a plan or an IRA.

Best Interest Contract Exemption (BIC Exemption): A new Prohibited Transaction Exemption (PTE) which allows financial institutions and advisers to retail retirement clients to receive forms of compensation that would otherwise be prohibited by ERISA and the Code, subject to compliance with a number of conditions.

Prohibited Transaction Exemption (PTE) 84-24: As amended, this PTE provides relief for certain transactions that occur when investment advice fiduciaries and other service

providers receive compensation for recommendations that plans or IRAs purchase insurance and fixed rate annuity contracts.

Principal Transaction Exemption: A new PTE which allows a financial institution to purchase or sell certain assets in “principal transactions” or “riskless principal transactions” with plans, plan accounts or IRAs, and to receive a mark-up, mark-down or other similar payments as a result of the advice.

Prohibited Transaction Exemption (PTE) 75-1: As amended, this PTE permits broker-dealers that are investment advice fiduciaries to receive reasonable compensation when they extend credit to plans and IRAs solely for the purpose of avoiding a failed securities transaction.

Prohibited Transaction Exemption (PTE) 86-128: As amended, this PTE no longer allows fiduciaries to receive compensation from IRAs in connection with certain securities transactions and mutual fund transactions under PTE 86-128 and instead shifts that to the BIC Exemption.

The Fiduciary Rule, changes to existing class exemptions, and certain elements of the Best Interest Contract Exemption will be applicable to financial institutions and the financial advisers employed by them upon the DOL’s implementation of the rule, no earlier than one year after the April 2016 effective date.

However, in response to implementation concerns raised by the financial services industry, the DOL has adopted a “phased” implementation approach for the Best Interest Contract Exemption and the Principal Transaction Exemption so that firms will have more time to come into full compliance. The full disclosure provisions, the policies and procedures requirements, and the contract requirement for these new exemptions go into full effect on January 1, 2018.

This report focuses on the details of the Impartial Conduct Standards. The Impartial Conduct Standards are now required elements of the DOL’s new and amended exemptions under the rule and are characterized by the DOL as “fundamental obligations of fair dealing and fiduciary conduct.”

In the other reports in this series, we take a deeper dive into the Best Interest Contract Exemption, Prohibited Transaction Exemption 84-24, as well as the Fiduciary Rule itself.

It is important to understand that the DOL ruling will have profound impact across the financial services industry and that while certain products may appear to be “exempt”, any recommendations regarding retirement planning and funding can create an immediate fiduciary responsibility on any advisor with or without intent depending upon funding and recommendations. We will discuss this in greater detail in later pieces.

THE IMPARTIAL CONDUCT STANDARDS

"...the Impartial Conduct Standards represent, in the Department's view, baseline standards of fundamental fair dealing that must be present when fiduciaries make conflicted investment recommendations to Retirement Investors."

- U.S. Department of Labor

As detailed in our first paper, the DOL's new regulations for providing Fiduciary Investment Advice cast a much wider net in determining who is subject to being a fiduciary with respect to working with retirement accounts. At their essence, these new regulations are centered around the concept that as a fiduciary, one must provide investment advice that must be in the best interest of the client while managing and mitigating any conflicts of interest that could influence the advice provided.

As we have previously discussed in prior papers, both ERISA and IRS Code regulations related to IRAs have long considered the receipt of compensation by a fiduciary that varies based upon the investment advice given and/or the receipt of compensation from third parties in connection with advice as a conflicted form of compensation and by extension, a prohibited transaction under the fiduciary rules.

While these forms of compensation are generally prohibited for fiduciaries, the DOL has the legal ability to create exemption rules, (known as "Prohibited Transaction Exemptions") which allow fiduciaries that provide advice to plans and IRAs to receive certain forms of compensation that would otherwise be prohibited, provided that the conditions of the exemption are met.

The Impartial Conduct Standards are a common required element of the DOL's new and amended exemptions (including the Best Interest Contract Exemption and Prohibited Transaction Exemption 84-24), and are designed to ensure that Retirement Investors, plans and IRAs are consistently protected against conflicted advice, regardless of the particular exemption upon which an adviser relies.

At their most basic level, the Impartial Conduct Standards include obligations for fiduciaries to act in the customer's best interest, avoid misleading statements, and receive no more than reasonable compensation.

As a common thread that runs through the DOL's exemptions, proper compliance with the Impartial Conduct Standards is a critical element for firms dealing with retirement investors

OBLIGATIONS OF THE IMPARTIAL CONDUCT STANDARDS

In its final conflict of interest regulations, the DOL determined that broad relief can be provided to fiduciaries receiving conflicted compensation only if such fiduciaries provided advice in accordance with the Impartial Conduct Standards and comply with the other requirements to the specific exemption being employed. The Impartial Conduct Standards represent, in the DOL's view, baseline standards of fundamental fair dealing that must be present when fiduciaries make conflicted investment recommendations to Retirement Investors, plans or IRAs.

In fact, the DOL feels so strongly about the Impartial Conduct Standards, the Best Interest Contract Exemption (BIC Exemption) generally requires the Financial Institution to commit to the Impartial Conduct Standards in an enforceable contract with Retirement Investor customers when dealing with IRAs and non-ERISA plans (ERISA plans already have similar protections; thus, no separate contract is required). However, unlike the BIC Exemption, there is no requirement to contractually commit to the Impartial Conduct Standards under Prohibited Transaction Exemption 84-24 (PTE 84-24)— but compliance with them is required when using the exemption.

The DOL has stated that the Impartial Conduct Standards are necessary to ensure that Advisers' recommendations reflect the best interest of their Retirement Investor customers, rather than the conflicting financial interests of the Advisers and their Financial Institutions. As a result, Advisers and Financial Institutions bear the burden of showing compliance and face liability for engaging in a non-exempt prohibited transaction if they fail to provide advice that is prudent or otherwise in violation of the standards.

The Impartial Conduct Standards include three fundamental obligations for fiduciaries:

- to act in the customer's best interest,
- avoid misleading statements, and
- receive no more than reasonable compensation.

With respect to annuities, life insurance, and the related exemptions associated with their recommendation (specifically the BIC Exemption and PTE 84-24), we will now take a look at each underlying obligation of the Impartial Conduct Standards as they apply to the applicable exemptions.

Best Interest: The Best Interest Standard is meant to express the concept that a fiduciary is required to act "solely in the interest" of the Retirement Investor, plan or IRA and not factor in any considerations for it or its affiliate's benefit. As an example, an investment advice fiduciary, in choosing between two investments, could not select an investment based on the factor that it is better for the investment advice fiduciary's bottom line.

With respect to the exemptions applicable to annuities and life insurance (the BIC Exemption and PTE 84-24), the best interest standard is fundamentally the same with only

small differences in terminology used to identify the parties under the exemption. Best Interest is defined under these two exemptions as follows:

- Advice in the [BIC: Retirement Investor's] [PTE 84-24: the plan or IRA's] Best Interest means advice that, at the time of the recommendation reflects:

The care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the [BIC: Retirement Investor] [PTE 84-24: plan or IRA] without regard to the financial or other interests of the [BIC: Adviser, Financial Institution or any Affiliate, Related Entity] [PTE 84-24: fiduciary, any affiliate] or other party.

The Best Interest standard is intended to effectively incorporate the objective standards of care and undivided loyalty that have been applied under ERISA for more than forty years. Under these objective standards, the Adviser must adhere to a professional standard of care in making investment recommendations that are in the Best Interest of Retirement Investor, plan or IRA. An Adviser may not base his or her recommendations on the Adviser's own financial interest in the transaction, nor can they recommend the investment, unless it meets the objective prudent person standard of care.

The duties of loyalty and prudence embodied in ERISA are objective obligations, and do not require proof of fraud or misrepresentation to be considered to be in violation. In addition, the simple disclosure of conflicts or other pertinent information is not a defense to making an imprudent recommendation or favoring one's own interests at the client's expense.

Further, the prudence element within the Best Interest standard, requires investment advice fiduciaries to investigate and evaluate investments, make recommendations, and exercise sound judgment in the same way that other knowledgeable and impartial professionals would. What is important to understand is that whether or not the fiduciary is actually familiar with the sound investment principles necessary to make particular recommendations— the expectation is that the adviser will adhere to an objective, professional standard. Having insufficient knowledge and making recommendations based on "good faith" alone is not a defense to a claim of a breach of fiduciary duties.

"A good heart and an empty head are not enough."

- *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984); see also *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 418 (4th Cir. 2007) ("Good faith does not provide a defense to a claim of a breach of these fiduciary duties; 'a pure heart and an empty head are not enough.'").

Important Considerations

- The DOL did not incorporate the FINRA suitability obligation as an element of the Best Interest standard even though many aspects of suitability are elements of the Best Interest standard.
- An investment recommendation deemed not suitable under FINRA would not meet the Best Interest standard. This does not mean that every suitable FINRA recommendation meets the Best Interest standard.
- The DOL confirmed that the Best Interest standard is not a hindsight standard, but rather is based on the facts that exist at the time of recommendation. This is consistent with long-existing ERISA jurisprudence, the standard does not measure compliance by reference to how investments subsequently performed.
- The standard does not impose an obligation to identify the “single best” investments out of all investments available.
- The Best Interest standard does not impose monitoring requirement nor does it mandate an ongoing or long-term relationship. Instead, that is left to the agreements, arrangements, and understanding of all parties involved.

Reasonable Compensation

The Impartial Conduct Standards also include a reasonable compensation standard, under which, the fiduciary must not recommend a transaction that will cause the Fiduciary, Financial Institution, Adviser, or their Affiliates or Related Entities, to receive, directly or indirectly, compensation for their services that is in excess of reasonable compensation within the meaning of ERISA section 408(b)(2) and Code section 4975(d)(2).

At the most basic level, the standard requires that compensation not be excessive, as measured by the market value of the particular services, rights, and benefits the Adviser and Financial Institution are delivering to the plan, IRA or Retirement Investor. Given the potential conflicts of interest associated with commissions and other payments covered by the BIC Exemption and PTE 84-24, and the potential for self-dealing, it is particularly important that firms pay close attention to this obligation and adhere to the standard.

That said, this standard is not easy to wrap one’s arms around. Even though under current law the “reasonable compensation” obligation has long been a feature of ERISA and the Code, the DOL has never published specific guidance on what exactly “reasonable” means. And despite being pressed for more clarity on the standard throughout the comment process associated with the new rules, the DOL has held steady in its position to not provide specific guidance as to levels of compensation that would be deemed “reasonable.”

However, in the preambles published with the new rules the DOL did provide some general guidance for firms to consider when making their own determinations of reasonableness, including:

- Firms may want to seek impartial review of their fee structures and to include such reviews in their policies and procedures.
- The reasonableness of fees depends on the particular facts and circumstances at the time of the recommendation
- Several factors inform whether compensation is reasonable including, among other things, the market pricing of service(s) provided and the underlying asset(s), the scope of monitoring, and the complexity of the product.
- In the case of a charge for an annuity or insurance contract (where fees cover both the service(s) provided and the purchase of the guarantees or financial benefits under the contract), it is appropriate to consider the value of the guarantees and benefits in assessing the reasonableness of the arrangement, as well as the value of the services.
- No single factor is dispositive in determining whether compensation is reasonable— the essential question is whether the charges are reasonable in relation to what the investor receives.

Important Note: the new Impartial Conduct Standards in PTE 84-24 (which were not present in the exemption prior to the recent amendment) do not include a requirement that the compensation received by the fiduciary and her affiliates be reasonable. The reasonable compensation requirement already existed in the pre-amended PTE 84-24, and remains as a requirement of the final, amended exemption. As such, the obligation for compensation to not “exceed reasonable compensation” is required for PTE 84-24— it is just not a part of the newly added Impartial Conduct Standards within the exemption.

Important Considerations

- The reasonableness of the fees depends on the particular facts and circumstances at the time of the recommendation.
- Several factors inform whether compensation is reasonable including, the market pricing of service(s) provided and the underlying asset(s), the scope of monitoring, and the complexity of the product.
- No single factor is dispositive in determining whether compensation is reasonable; the question is whether the charges are reasonable in relation to what the investor receives in exchange.
- The DOL confirms that an Advisor and Financial Institution do not have to recommend the transaction that is the lowest cost of that generates the lowest fees without regard to other relevant factors.
- It is appropriate to consider the value of the guarantees and benefits assessing the reasonableness of the arrangement, in addition to the value of the services.
- When assessing the reasonableness of a charge, one generally needs to consider the value of all the services and benefits provided for the charge, not just some.
- Ultimately, the “**reasonable compensation**” standard is a market based standard.

No Misleading Statements

The final Impartial Conduct Standard requires that statements made by the Financial Institution and its Adviser, insurance agent or broker, pension consultant, insurance company or investment company Principal Underwriter about recommended investments, fees, Material Conflicts of Interest, and any other matters relevant to a Retirement Investor's, a Plan's or an IRA owner's investment decisions, are not materially misleading at the time they are made.

The DOL stated that clients are best served by statements and representations that are free from material misstatements and that Fiduciaries can avoid liability and promote the interests of Retirement Investors by ensuring that accurate communications are a consistent standard in all their interactions with their customers.

In the DOL's preamble to the amended exemption, it details that the failure to disclose a Material Conflict of Interest relevant to the services it is providing or other actions it is taking is considered a misleading statement. The DOL defines the term Material Conflict of Interest as follows:

When considering annuities and/or certain life insurance recommendations along with the concept of not making any misleading statements, it is a reasonable concern that the underlying complexity of some products and their associated benefit riders could pose a potential risk to firms. While adverse consequences have always been present when firms make misleading statements regarding investment recommendations (either innocently or on purpose), the risk associated with such an error is exacerbated under the new Fiduciary Rule, its associated exemptions and the liabilities presented for non-compliance. Ensuring that both Advisers and clients have a full and clear understanding of how the recommended annuity or life insurance policy will function— including any associated guarantees, charges or limitations— will go a long way to prevent violations of the Impartial Conduct Standard.

TIMING & CONSIDERATIONS

Impartial Conduct Standards Compliance begins on June 9, 2017.

PTE 84-24: Unlike certain elements of the new BIC Exemption and Principal Transactions Exemption, the new changes to PTE 84-24— including the requirements to comply with the Impartial Conduct Standards— will go into full effect on June 9, 2017. As previously stated, the requirement for reasonable compensation was already present in the pre-amended exemption, so the new requirements related to the Impartial Conduct Standards that go into effect on April 10, 2017 include providing advice that is the client's Best Interest and not making any misleading statements to the plan or IRA about recommended transactions.

BIC Exemption: Despite the fact that the DOL has adopted a “phased” implementation approach for the BIC Exemption (so that firms will have more time to come into full compliance), Financial Institutions seeking relief under the BIC Exemption will be required to comply with the Impartial Conduct Standards when making recommendations to Retirement Investors starting on January 1, 2018, otherwise known as “the Applicability Date”. The full disclosure provisions, the policies and procedures requirements, and the contract requirement for the new BIC Exemption does not go into full effect until January 1, 2018. The time between the Applicability date and January 1, 2018 is known as the “Transition Period”.

Specifically, the requirements associated with the Impartial Conduct Standards within the BIC Exemption that will be in full effect as of April 10, 2017 include:

- The Financial Institution and its Advisers are required to comply with the Impartial Conduct Standards when making recommendations to Retirement Investors.
- The Financial Institution must state in writing that it and its Advisers will comply with the Impartial Conduct Standards and disclose any Material Conflicts of Interest.
- The Financial Institution must designate a person or persons, identified by name, title or function, responsible for addressing Material Conflicts of Interest and monitoring Advisers' adherence to the Impartial Conduct Standards.

After the Transition Period, the limited conditions applicable to the BIC Exemption Transition Period will no longer be available. Starting on January 1, 2018, Financial Institutions and Advisers must satisfy all of the applicable conditions described in the BIC Exemption for the relief to be available for any prohibited transactions occurring after that date. This includes an affirmation within the enforceable, written contract between the Financial Institution and the Retirement Investor that the Financial Institution and its Advisers will adhere to and comply with the Impartial Conduct Standards.

NEXT STEPS TO CONSIDER

Full compliance with the Impartial Conduct Standards will begin on June 9, 2017. Many decisions have to be made in relatively short order to be prepared to comply with the obligations required by these new standards before the quickly approaching Applicability Date.

With respect to your firm's annuity and life insurance business, we would like to offer a few suggestions of advice when considering your next steps with respect to the Impartial Conduct Standards.

1. **Help the firm's leadership understand how to properly consider annuities within the Best Interest Standard.** Processes and procedures for determining Best Interest will most likely be developed in a centralized manner at the firm, with broad considerations beyond just what's important for annuities and life insurance. Establish a dialogue early with key stakeholders at your firm to articulate where and when annuities and life insurance recommendations make the most sense for clients— and to convey the value of any commensurate retirement income or other guarantees associated with the products.
2. **Take a fresh look at your annuity and life insurance commissions.** Use this as an opportunity to better align the commissions received for the sale of annuities and/or life insurance with other investments available through your firm. Where possible and within logical categories, consider leveling commission options to the greatest extent possible. Examine the marketplace to ensure the commissions your firm will receive will not be outside of the norm. Finally, determine and document the rationale used to illustrate your firm's efforts to ensure that commissions received by the firm are not in excess of what is reasonable.
3. **Take steps to reduce unnecessary complexity in your offerings** and confirm your Advisers fully understand the products they are recommending. Firms that can reduce product complexity within their available offerings will be better positioned to avoid unintentional misleading statements made by Advisers. Reassess the firm's product menu and consider areas where you can reduce redundant offerings or offerings with unnecessarily complex mechanics. Consider establishing refresher courses or other instructive methods to confirm that your Advisers have a full grasp of the features, benefits and mechanics of the products they offer.
4. **Identify and document all Material Conflicts of Interest.** Take a hard, honest look at where these types of conflicts may exist. Take proactive steps to eliminate or mitigate them if possible and be clear how they are communicated to clients.
5. **Appoint the proper staff to oversee compliance with the new Standards.** Firms will need to determine the person or persons who will be tasked with monitoring

Advisers' adherence to the Impartial Conduct Standards in time for the June 9, 2017 Applicability Date.

6. **Develop a dialogue with the DOL.** The DOL has publicly stated that they stand ready to assist firms as they transition to new the requirements— including the Impartial Conduct Standards— so they are expecting your call. As in most endeavors, the earlier you start doing this, the better.
7. **Consider working with an institutional insurance provider and introducing your Advisors to experts that can become an extension of their and provide the protection / risk mitigation service offerings they need to be offering their clients.** There are many institutional insurance organizations and normally they come with no up-front cost to you or your advisors. Traditionally, Financial Institutions have a number of “aligned / approved” insurance relationships. While this may work well for some, most of the time finding an insurance provider with national reach, consistent rules of engagement and multiple carriers creates a better, more unified approach. This will become more important as these new regulations take effect and as due diligence and documentation requirements continue to increase.

NEXT IN THE SERIES

We have published a series of papers to outline the main provisions and impacts of the DOL's 2016 Final Fiduciary and Conflict of Interest Regulations as they relate to financial institutions and their continuing efforts to provide annuity and insurance solutions to clients. The series of papers include the following topics:

- The Fiduciary Rule
- The Best Interest Contract Exemption
- Prohibited Transaction Exemption 84-24
- The Impartial Conduct Standards

ABOUT

AimcoR Group, LLC

AimcoR Group, LLC is a leading national insurance marketing organization consisting of 45 member companies that focuses on distributing and servicing insurance and retirement products through a variety of channels and platforms including independent financial advisors, broker-dealers, property and casualty firms, banks and direct-to-consumer marketers.



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Saltzman Associates, LLC

Saltzman Associates is a strategic marketing consultancy focused on institutional distributors and underwriters of insurance and investment products.

We work with banks, credit unions, broker-dealers, insurance companies and related financial services companies to provide market intelligence, business development, and product development. Saltzman Associates facilitates a number of very popular industry roundtable groups focused on helping banks, credit unions and broker dealers grow their investment and insurance business through the use of research, best practices and benchmarking tools.

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