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An Overview of the Department of Labor's New Fiduciary Rule

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CONTENTS

Department of Labor 2016 Final Fiduciary and Conflict of Interest Regulations 1
First, Let's Level Set 2
The Fiduciary Rule 4
Next in the Series 8
About 9

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.

FIRST, LET'S LEVEL SET

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 new Fiduciary Rule and is intended to provide a foundation upon how fiduciary investment advice will be determined once the rule goes into effect with respect to retirement plans and IRAs.

In subsequent reports, we will take a deeper dive into the Best Interest Contract Exemption, Prohibited Transaction Exemption 84-24, and the Impartial Conduct Standard requirements that apply to them both.

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 FIDUCIARY RULE

> ***"With this regulatory action, the Department will replace the 1975 regulations with a definition of fiduciary investment advice that better reflects the broad scope of the statutory text and its purposes and better protects plans, participants, beneficiaries, and IRA owners from conflicts of interest, imprudence, and disloyalty."***
>
> \- U.S. Department of Labor, Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice

Currently, both ERISA and the Internal Revenue Code define an "investment advice fiduciary" as a person who renders investment advice for a fee or other compensation with respect to moneys or other property of an employee benefit plan or a tax-favored retirement savings account such as an IRA.

Since 1975, the DOL has prescribed that a person is an investment advice fiduciary only if the advice provided met a fairly narrow five-part test, requiring that

1. the advice is rendered as to the value of securities or property or as to the advisability of investing in securities or property,
2. on a regular basis,
3. pursuant to a mutual agreement or understanding between the adviser and the client,
4. that the advice will serve as the primary basis for investment decisions and
5. that it will be particularized to the individual needs of the retirement investor.

Adopted prior to the existence of participant-directed 401(k) plans, the widespread use of IRAs, and now routine rollover of plan assets from ERISA-protected plans to IRAs, the five-part test was seen as too narrow and inconsistent with the realities of our current marketplace. Accordingly, the DOL has argued that those criteria left many investment professionals, consultants, and advisers with no obligation to adhere to ERISA's fiduciary standards or to the prohibited transaction rules, despite the important role they play in guiding plan and IRA investments. Under ERISA and the Code, if these advisers are not fiduciaries, they are permitted to operate with conflicts of interest that they do not have to disclose and have limited liability under federal pension law for harms resulting from the advice they provide.

The new Fiduciary Rule abandons the current five-part test and replaces it with a principles-based approach that describes the types of communications that would constitute "investment advice" and outlines the types of relationships in which those communications

would give rise to "fiduciary investment advice" and the resulting fiduciary responsibilities under the new regulations.

New Required Elements for Fiduciary Investment Advice	
Covered Investment Advice	Two broad types of investment advice as detailed in the rule.
Recommendation	Defined as a communication that would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action.
Compensation	Defined as any explicit fee or compensation for the advice received by the person (or by an affiliate) from any source.
Relationship	Certain types of relationships must exist for recommendations to give rise to fiduciary investment advice

Covered investment advice is broadly defined by the DOL and falls into two main categories. In both categories, the advice provided includes recommendations to a plan, plan fiduciary, plan participant and beneficiary or IRA owner for a fee or other compensation, direct or indirect, as to:

- the advisability of buying, holding, selling or exchanging securities or other investment property, including recommendations as to the investment of securities or other property after the securities or other property are rolled over or distributed from a plan or IRA, and,
- the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., brokerage vs. advisory); or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer, or distribution should be made.

It is important to note that life insurance sales can also be affected by the new fiduciary rule. Investment advice covered under the rule includes "recommendations with respect to rollovers, transfers, or distributions from a plan or IRA". Providing advice to use these funds to purchase life insurance will be covered by the new rule. Even though this only covers a small amount of life insurance sales, advisors need to be prepared.

While not specifically addressed under the fiduciary rule, recommendations to purchase life insurance or annuities as an alternative to funding a qualified plan could also fall under the new rule depending upon interpretation. This could affect advisors who recommend a "LIRP" strategy (life insurance retirement plan) to their clients as a retirement savings vehicle.

A fundamental element in establishing the existence of "fiduciary investment advice" is if a "recommendation" has occurred. The new rule specifically defines a recommendation as:

> *"a communication that, based on its context, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action."*

The DOL has communicated in its guidance that the more individually tailored the communication is to a specific advice recipient or recipients, the more likely the communication will be viewed as a recommendation. The Department took an approach to defining "recommendation" that is consistent with and based upon the approach taken by the Financial Industry Regulatory Authority (FINRA), however the new rule does not adopt the FINRA standard for a recommendation as it was noted that potential future FINRA interpretations of the term may not comport with the DOL's view.

Additionally, for a recommendation to be subject to the rule, the Department has outlined the types of relationships that must exist to give rise to the level of fiduciary investment advice. To qualify, a recommendation must be made either directly or indirectly by one of the following persons (through or together with an affiliate):

- Persons who represent or acknowledge that they are acting as fiduciaries within the meaning of ERISA or the Internal Revenue Code;
- Persons who pursuant to a written or verbal agreement, arrangement or understanding that the advice is based on the particular investment needs of the advice recipient; or
- Persons who direct the advice to a specific recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.

It is important to note that the DOL has specifically identified certain recommendations that will not be considered as fiduciary investment advice. In the new rule, the Department has detailed certain activities that are included within a "safe harbor" category of activities deemed not to involve a "recommendation" and therefore, would not to give rise to fiduciary status. These activities include:

- Providing **Investment Education** about retirement savings and general financial and investment information. Notably, there are differences in the new rules for providing investment education between plan and IRA markets.
- **General Communications** not reasonably viewed as an investment recommendation, including, among other things, general circulation newsletters; commentary in publicly broadcast talk shows; remarks and presentations in widely attended speeches and conferences; research or news reports prepared for general distribution; general marketing materials, and general market data.
- **Platform Providers**. The offering of or making available a platform of investment alternatives that will be made available to participants' individual accounts to an independent plan fiduciary.

- **Communications or Transactions with Independent Plan Fiduciaries with Financial Expertise**. ERISA fiduciary obligations are not imposed on advisers communicating with independent plan fiduciaries who are licensed and regulated providers of financial services or those that have responsibility for the management of $50 million in assets, and other conditions are met.
- Communications and activities made by advisers to ERISA-covered employee benefit plans in **Swap or Security Based Swap Transactions** do not result in the advisers becoming investment advice fiduciaries to the plan if certain conditions are met.
- **Employees of Plan Sponsors, Affiliates, Employee Benefit Plans, Employee Organizations, or Plan Fiduciaries**, which include a company's payroll, accounting, human resources, and financial departments who routinely develop reports and recommendations for the company and other named fiduciaries of the sponsors' plans or staff who communicate information to other employees about the plan and distribution options in the plan, provided certain conditions are met.

As previously noted, in order to fall under the new rule, recommendations must be provided in exchange for a fee or other compensation. "Fee or other compensation, direct or indirect" is defined under the rule as any explicit fee or compensation for the advice received by the person (or by an affiliate) from any source, and any other fee or compensation received from any source in connection with or as a result of the recommended purchase or sale of a security or the provision of investment advice services including, though not limited to, such things as commissions, loads, finder's fees, and revenue sharing payments.

The main significance of the change from the narrow, five-part test to the new principles-based approach is that the DOL has substantially expanded the universe of entities and persons who will qualify as fiduciaries in the context of providing investment advice to plan and IRA investments.

It is clear to see that one of DOL's key objectives in writing the Final Regulation was to capture any person or entity making recommendations with respect to taking (or not taking) a rollover distribution from a plan or IRA, or making any distribution or transfer from a plan or IRA, and subject them to fiduciary standards.

From a practical standpoint, once the new Fiduciary Rule becomes applicable in June of 2017, if a Financial Adviser makes recommendations to retirement plans or IRAs in exchange for compensation (even absent a recommendation on how to invest the assets), both the Adviser and her employer will be considered to be providing fiduciary investment advice—thus subjecting them to the fiduciary standards under ERISA.

In our next issue, we will cover the details of the new Best Interest Contract Exemption and highlight the considerations for firms as they develop their strategies to both serve existing and future clients.

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.

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