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Implementation Essentials

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June 9th is Coming: How Do You Make a Best Interest Recommendation & Comply With the Right Exemptions?

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Though AALU and many other groups are working diligently to try to persuade the Trump Administration to further delay the Fiduciary Rule, June 9th is fast approaching. As a result, our members need to ensure they are prepared if the Fiduciary Rule becomes applicable as scheduled. In this alert, we provide an overview of the fiduciary Best Interest process that producers need to employ to make compliant recommendations, and the required conditions of the new transitional prohibited transaction exemptions that permit receipt of insurance commissions and certain other types of compensation.

When Does the Fiduciary Rule Apply?

Beginning on June 9th, the Fiduciary Rule will apply to investment recommendations, made for a fee (which includes insurance commissions and other forms of compensation), to ERISA plans; plan participants and beneficiaries; and IRA owners.[1] Recommendations of annuities, insurance products, and investments that were sales activity in the past will begin to be treated as fiduciary advice.

[1] The legal definition includes entities subject to ERISA Title I, Part 4, as well as any entity subject to the prohibited transaction rules in Internal Revenue Code Sec. 4975. This includes not just plans and IRAs, but HSAs, Coverdell ESAs, Archer MSAs and similar entities. For simplicity, this alert will refer to plans and IRAs, as these are the vast majority of covered arrangements.

Specifically, producers are giving fiduciary advice if they:

- Recommend rolling retirement plan benefits over to IRAs, including individual retirement annuities;
- Recommend transferring existing IRAs from other institutions;
- Recommend taking distributions from retirement plans or IRAs (such as to purchase annuities or insurance with the proceeds—an example would be to recommend using an upcoming required minimum distribution to buy a life insurance policy for estate planning purposes); and
- Recommend purchasing annuities or other investments within IRAs.

<u>What is the Fiduciary Process Necessary to Make a "Best Interest" Recommendation?</u>

To make a recommendation that complies with the Fiduciary Rule, you have to employ a thorough, prudent, and well-documented process that takes into account all relevant factors regarding the investment recommendation and the client's needs. The producer needs to collect the relevant information about the client, analyze it, and proceed accordingly. Documenting the information collected and the basis for your recommendation is essential to demonstrate compliance--if you don't properly document your advice, you won't be able to prove that your recommendation was prudent or in the client's Best Interest if a dispute arises.

Existing forms and questionnaires used to document sales, such as suitability forms or "Know Your Customer" forms can form the foundation for a "Best Interest" fiduciary process, but it is likely they will need to be augmented with additional and more comprehensive questions. Two specific situations requiring additional documentation are rollover recommendations and annuity recommendations.

- Required Rollover Information

In order to make a prudent or Best Interest recommendation, the producer will need to gather and consider information about the plan that the rollover is coming from. This information includes the available investments under the plan, the available services (such as individual investment advice) under the plan, the distribution options available under the plan, and the administrative and investment fees and expenses of the plan. This information must be considered in determining that the rollover recommendation is prudent and in the Best Interest of the participant.

For example, most 401(k) plans have a limited investment menu, don't offer individual advice, and often offer only a "lump-sum" distribution, while the IRA you recommend may offer a wide array of investments (including guaranteed income), individualized investment advice, and monthly distribution. Investments and fees may be higher or lower in the plan than the IRA. All of this information is necessary to determine what is in the client's "Best Interest" based on the client's needs. If the necessary information can't be collected from the participant, alternative means can be used, such as the plan's most recent Form 5500, or benchmark information for similar plans.

- Annuity Carrier Information

With respect to annuities, the producer will need to be able to show that information related to the ability of the carrier to make the promised annuity payments was considered. This review does not have to be performed by the producer—for example, an intermediary organization may do that screening and analysis on behalf of the producer. While this does not mean the producer is guaranteeing the carrier cannot fail, it does mean that at the time the recommendation was made, there was no reason to believe that the carrier's product was an imprudent choice.

<u>Why Do We Need to Use an Exemption to Receive Commissions?</u>

The result of being a fiduciary is that traditional insurance commissions, and compensation that varies depending on which investments you recommend, are generally prohibited. This is because a fiduciary may not use its position to benefit itself, such as by recommending an investment that pays more to the producer than another investment.

However, the Fiduciary Rule does not ban all commissions—it provides special rules, called exemptions, that allow you to receive commissions and variable compensation if you meet the required conditions of the exemption.

From June 9 until December 31, 2017, the Trump Administration has created new, streamlined, transitional versions of two exemptions producers will most commonly rely on, the Best Interest Contract Exemption ("BIC Exemption") and Prohibited Transaction Exemption 84-24 ("PTE 84-24").

<u>What are the Conditions of Transition PTE 84-24 and the Transition BIC Exemption?</u>

The transitional exemptions have relatively few requirements compared to the "full" exemptions that are scheduled to apply in 2018. Though the transition PTE 84-24 has certain disclosure requirements (these have always been part of the exemption), the transition BIC Exemption does not.[2] Transition BIC requires a financial institution (a bank, broker-dealer, insurance company, or registered investment advisor), while PTE 84-24 does not.

<u>Requirements of Transition PTE 84-24</u>

PTE 84-24 is an existing exemption used by the insurance industry since the late 1970's for sales of annuities and insurance contracts to plans and IRAs. The transition PTE 84-24 reverts back to the pre-Fiduciary Rule version of the exemption, except for the addition of the Impartial Conduct Standards (described below). Therefore, producers may use PTE 84-24 for recommendations of all types of annuities throughout 2017, including fixed-rate, fixed indexed. and variable annuities. PTE 84-24 has always included certain disclosure requirements, and these requirements remain in the transitional version.

[2] To the extent you are advising an ERISA plan, new fiduciary status typically would require amending previously provided 408(b)(2) disclosures to disclose your fiduciary status. These amendments should be delivered to plan clients as close to June 9th as possible.

Here are the basic conditions of PTE 84-24 during the transition:

- The transaction is effected by the insurance agent, broker, pension consultant, or insurance company in the ordinary course of its business;
- The transaction is at least as favorable to the plan or IRA as an "arm's length" transaction with an unrelated party would be;
- The combined total of all fees, commissions, and other payments received by the various parties to the transaction does not exceed reasonable compensation;
- Written disclosure of:
    - Any affiliation with the recommended insurance company, or any limitations on recommendations resulting from an agreement with the insurance company;
    - The sales commission, expressed as a percentage of the gross annual premium payment for the first year, and for each renewal year; and
    - A description of any charges, fees, discounts, penalties or adjustments which may be imposed under the contract related to holding, exchange, termination, or sale of the contract.
- Written approval of the transaction by the plan or IRA before execution.

In addition to the requirements above that have been part of PTE 84-24 for many years, the producer must meet the Impartial Conduct Standards (described in more detail below):

- A recommendation in the Best Interest of the recipient;
- No more than reasonable compensation; and

- No materially misleading statements at the time the recommendation is made. While the text of PTE 84-24 notes that a failure to disclose a material conflict of interest may constitute a materially misleading statement, the disclosures already required by the exemption and other laws would appear to address items that would suggest a material conflict (fees received, affiliations or agreements with the insurance carrier, etc.). The Department has not identified any examples of material conflicts not already disclosed.

<u>Requirements of the Transition BIC Exemption</u>

The BIC Exemption is very broad—while PTE 84-24 covers advice regarding annuities and insurance contracts, the BIC Exemption covers these as well as other transactions, including rollovers and compensation not involving insurance products. It can be used instead of PTE 84-24—insurance carriers may be able to choose which exemption to utilize if they can meet the conditions of both.

The transition BIC Exemption's only requirements are the Impartial Conduct Standards. These are:

- Advice must be in the client's "Best Interest" – the fiduciary duties of prudence and loyalty are observed by employing a thorough, well-documented fiduciary process that takes into account all the relevant factors going into the recommendation;

- All compensation must not exceed a reasonable level – this typically is measured by comparison to industry standards in light of the services being provided; and

- All statements to the client about products, material conflicts of interest (e.g., compensation incentives), fees, and other relevant matters must not be materially misleading.

Producers, carriers, and others need to document that they have reviewed their fees and found them reasonable. Please note that "reasonable" is not a synonym for "cheapest"—rather, reasonable fees can be found within a fairly broad range, and are measured in light of the market rates for services provided.

Conclusion

The core requirement of the June 9th deadline is the prudent, thorough, and well-documented fiduciary Best Interest process. The prudent process behind your Best Interest recommendation is doubly important because it not only governs the development of the recommendation, but is required by the exemptions permitting the receipt of commissions. If you are affiliated with a financial institution, such as a broker-dealer, your institution likely will provide you with new requirements for process and documentation.

While AALU continues to press the Trump Administration to further delay the Fiduciary Rule, producers need to make sure they are taking steps to comply by June 9th if the Rule becomes applicable. AALU will also keep pushing for change after June 9th as the Trump Administration considers what to do next. Compliance with the June 9th deadline may end up being a necessary first step, but it is not the end of the journey regarding the Fiduciary Rule.