**The DOL’s Fiduciary Rule and its Impact on Advice to IRAs and Plans**

Fred Reish

The US Department of Labor’s (DOL) fiduciary regulation applied on June 9, 2017. The fiduciary regulation greatly expands the definition of *fiduciary advice*, resulting in most advisors to ERISA retirement plans, participants, and IRAs being classified as fiduciaries. As a result, those advisors will be subject to a higher “best interest” standard of care and, in many cases, to prohibited transaction rules.

The Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (Code) prohibit certain financial conflicts of interest that result from fiduciary investment advice (known as “prohibited transactions”). However, there are exceptions, called “exemptions,” from those prohibitions, if the conditions of the exemptions are satisfied. The Department of Labor initially issued prohibited transaction exemptions that were complicated, burdensome, and expensive to satisfy. However, transition versions of those exemptions were subsequently issued and became applicable on June 9, 2017. Those transition exemptions are effective until July 1, 2019, when it is expected that revised final exemptions will be issued by the DOL.

Fortunately, the transition exemptions are much less difficult to satisfy.

This program discusses the new fiduciary regulation and transition exemptions and the impact on advisors and agents when providing advice to ERISA retirement plans, participants, and IRA owners.

## The Continuing Development of these Rules

During the transition period from June 9, 2017 to July 1, 2019, the Department of Labor will review the fiduciary regulation and the exemptions to determine whether they need to be modified in light of the Trump administration’s directive to review all regulatory projects. In addition, the DOL will coordinate with the Securities and Exchange Commission (SEC) to develop compatible, if not identical, rules. It is likely that both the SEC and the DOL will also coordinate with the National Association of Insurance Commissioners (NAIC).

While the outcome of that work and coordination is uncertain, it now appears that a best interest standard of care will be developed by the SEC, which could be similar to the DOL’s rule. In addition to developing a standard of care, the regulators will focus on the treatment of conflicts of interest. It is possible that the SEC will take the leadership in that area, and, if so, those conflicts will be primarily managed through additional disclosures.

However, for “qualified accounts” (that is, plans, participants, and IRAs), some of the requirements are statutory and may not be modified by rules or regulations. For example, ERISA has statutory provisions for a prudent standard of care, a duty of loyalty to retirement investors, and a limitation on compensation to reasonable amounts. That would apply to ERISA-governed retirement plans. Similarly, the Internal Revenue Code has statutory provisions that limit the compensation of service providers to reasonable amounts. That applies to both qualified plans and IRAs. And, both ERISA and the Code have statutory prohibited transactions on financial conflicts of interest resulting from fiduciary recommendations. As a result, the DOL will continue to be responsible for the conditions that apply for avoiding the adverse consequences of prohibited transactions.

That raises the obvious question: Why are these rules being developed at this time? What is the public policy interest that is driving the DOL, SEC, and NAIC?

While there are a number of reasons, one of the most important is the aging of the baby boomers in a defined contribution environment. As millions of baby boomers retire, their retirement plan accounts will be rolled over into IRAs. As a result, those accounts will be taken out of relatively low-priced and fiduciary-protected vehicles and placed in a retail environment where conflicts of interest are more common, and expenses are usually higher.

The research firm Cogent Research estimates that, for 2014, $280 billion was rolled over to IRAs and, for 2015, $382 billion was in play for the rollover market (“Investor Rollover Assets in Motion” studies from Cogent Wealth Reports).

In its preamble to the 2016 fiduciary regulation, the DOL noted that rollovers are expected to approach $2.4 trillion cumulatively from 2016 through 2020.

To compound the issues related to the movement of the money from institutional retirement plan accounts into retail accounts, the life expectancies of older Americans are rapidly increasing. As a result, the retirement money in IRAs will need to last longer. For example, the Society of Actuaries has reported that the life expectancy for 65-year-old women has increased from 86.4 years in 2000 to 88.8 years in 2014. As a result, 65-year-old women would, on average, need their retirement money to last for 23.8 years. Similarly, the life expectancy of a 65-year-old man in 2000 was 84.6 years, but that increased by two years to 86.6 by 2014.

Cannex Financial Exchange, using data from the Society of Actuaries, estimated that, for a married couple aged 65, there was a 31.2 percent chance that one of them would be alive at age 95. In that case, the retirement money in the IRA would need to last for at least 30 years.

Obviously, the government has a public policy interest in ensuring that the retirement money in plans and IRAs is not depleted by excessive expenses or conflicts of interest and that it provides lifetime income to retirees.

The problem is further compounded by a lack of understanding of investment returns and withdrawal rates. For example, one article in *Money Management Executive* reported that a study showed that 33 percent of the people interviewed did not know how much they could safely withdraw from their IRA to last for their lifetime. And, roughly 25 percent believed that they could withdraw more than 10 percent per year from their retirement money and continue to withdraw at that rate for their lifetime. As a result, there is a risk that retirees will exhaust their savings while they are still alive.

## The Fiduciary Rule and Exemptions

As a result of the new fiduciary regulation, recommendations of investments and insurance products to IRAs, plans, and participants are now considered to be fiduciary advice, implicating both the fiduciary standard of care and the prohibited transaction rules. Further, the definition of *investments* is very broad. It includes, for example, recommendations of investments, investment managers and advisors, investment strategies, and investment policies. It also includes recommendations to participants to take plan distributions, to roll over to IRAs, to transfer IRAs, and to withdraw money from plans or IRAs.

Note that the Best Interest Contract Exemption and PTE 84-24 apply to nondiscretionary investment advice. Prohibited transactions resulting from discretionary investment management are not entitled to relief under those exemptions.

As mentioned earlier, the rules in ERISA (section 406(b)) and the Code (section 4975) generally prohibit recommendations that result in financial conflicts of interest. A financial conflict of interest can occur in two ways. Those are:

1. Where the recommendation causes the advisor (or its supervisory entity or affiliates) to receive payments from the third party that would include, for example, commissions received from insurance companies, 12b-1 fees and front-end loads received from mutual funds, and solicitors’ fees from RIAs.
2. Where recommendations by a fiduciary advisor cause the advisor (or his or her supervisory entity or an affiliate) to receive additional compensation. That would include, for example, securities recommendations with commissions on the transactions. It would also include recommendations to transfer IRAs and to take a distribution and roll over to an IRA.

Those types of recommendations are prohibited under both the Code and ERISA. However, there are exceptions, which are called “prohibited transaction exemptions.” The two exemptions relative to this program are the Best Interest Contract Exemption (BICE) and 84-24. Prohibited Transaction Exemption (PTE) 84-24 applies to recommendations of life insurance and annuities (other than insurance products that do not have an investment element, for example, term insurance). BICE applies to all types of investments, including life insurance and annuities. However, for BICE, an advisor or agent needs a broker-dealer, RIA firm, bank or trust company, or insurance company to agree to serve as a fiduciary for the advisor’s services. While most broker-dealers, RIAs, and bank and trust companies have agreed to do that for their representatives, very few, if any, life insurance companies have agreed to serve as fiduciaries for insurance agents (and particularly for independent insurance agents).

While the exemptions provide considerable relief, they are not “free.” Each of the exemptions has conditions that must be satisfied in order for an advisor to be protected.

Before looking at the requirements of the new rules, let’s spend a few minutes examining the impact on non-discretionary investment advice by different types of advisors.

First, let’s look at “pure” level-fee advisors. Typically, this would be a registered investment advisor and his or her representative, who are providing fiduciary advice for a set fee and who do not receive any other payments or financial benefits. In terms of the impact of the new fiduciary regulation and exemptions on advice to plans, participants, and IRAs by level-fee advisors, there is none. In other words, the new rules do not add to the burden of compliance for those advisors, since they were already fiduciaries under the old rules, and since they were already subject to the prohibited transaction exemption rules. However, where an advisor charges a level fee (and the amount of the fee is reasonable), the advisor is not committing a prohibited transaction. As a result, while the advisor is subject to ERISA’s fiduciary provisions, the advisor does not need the relief provided by an exemption.

However, I have seen situations where RIAs did not understand how these rules apply to IRAs. In those cases, the advisors were receiving payments in addition to their advisory fee. As a result, those payments were prohibited, but in many cases, they could be permitted under BICE (which is described in more detail later).

What about advice to participants to take distributions and roll over to an IRA with the advisor or advice to transfer an IRA from another advisor? Both of those would be prohibited transactions, even if the advice to the IRAs would be provided for a pure level fee. That is because if the participant or IRA owner did not accept the recommendation, the advisor would not receive any fees. On the other hand, if the IRA owner or participant accepts the recommendation and transfers the money, the level-fee advisor would then earn a level fee. The difference between no fee and a fee is a prohibited transaction. However, there is relief under BICE (which is discussed later).

How do these rules apply to advisors or agents (collectively, “advisors”) who receive commission compensation (or so-called “variable” compensation)?

For advice to plans, participants, and IRAs, the receipt of payments from a third party (for example, insurance commission or 12b-1 fee) would be a prohibited transaction. However, the BICE provides relief if the conditions of the exemption are satisfied.

What about advice to an IRA owner to transfer his or her IRA, or advice to a participant to take a distribution and roll it over to an IRA with the advisor? In this case, the consequences for a commissioned advisor are the same as for a level-fee advisor. In other words, it’s a prohibited transaction, and the protection of an exemption will be needed.

With that background, let’s look at the standard of care that will apply to advisors, plans, participants, and advisors to IRAs.

The prudent man rule and duty of loyalty under ERISA applies to advice to plans and participants. The best interest standard of care (in BICE and 84-24) applies to conflicted advice to plans, participants, and IRAs. Fortunately, the prudent man rule and duty of loyalty, and the best interest standard of care, are virtually identical. As a result, we can discuss them as a single rule.

For our purposes, I divide the best interest standard of care into three separate parts, each of which has its own importance. The first part is ERISA’s prudent man rule, with the change of only one word: *Man* is changed to *person*. That part of the best interest standard of care is:

Investment advice is in the “best interest” of a retirement investor when the fiduciary advisor acts with 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.

This part of the rule requires that the advisor (and the advisor’s supervisory entity, if there is one) act prudently and diligently to develop the recommendation. It applies the standard of a hypothetical person who is knowledgeable about the particular investment and the retirement investor. In ERISA, it is sometimes referred to as the “prudent expert” rule, because the standard is not whether the advisor acted with the prudence of an ordinary person, but instead whether the advisor acted with the prudence and knowledge of “a prudent person familiar with such matters.” Also, it requires that the advisor consider that the retirement vehicle is “an enterprise of a like character and with like aims.” While that language is not explained in the DOL’s guidance, the safe assumption is that it refers to money being invested for retirement purposes. In other words, an advisor should consider how money would prudently be invested for the retirement of the particular investor (which could vary based on a number of factors, for example, age, other assets, and so on).

In that regard, in ERISA litigation and guidance, the DOL and courts have applied generally accepted investment theories (such as modern portfolio theory and diversification) and prevailing investment industry practices (such as qualitative and quantitative issues related to the investment or insurance products).

The best interest standard of care continues to say that the advisor should develop his or her recommendations “based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor.”

In effect, this standard is similar to the rules regarding suitability and “know your customer.” In other words, the advisor needs to gather the information necessary to make a recommendation that is appropriate to the particular retirement investor.

The third and final part of the best interest standard of care says that the recommendations must be developed “without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.”

In effect, this is the best interest version of the duty of loyalty. It says that the advisor must place the interest of the investor above the advisor’s. However, it does not preclude differing forms of compensation. Stated slightly differently, the compensation of the advisor (and supervisory financial institution, if any) must be reasonable, but it can be variable in the sense that it could depend on the number of transactions, or it could be based on the amount of the recommended investment or insurance or annuity purchase.

With that understanding of the standard of care, let’s turn to the prohibited transaction exemptions. Keep in mind that the relief provided by an exemption is only needed where there is a financial conflict of interest resulting from the investment or insurance recommendation.

The transition version of the Best Interest Contract Exemption, which applies to investment recommendations of any type of insurance or investment product, requires only that the advisor adhere to the Impartial Conduct Standards. There are three Impartial Conduct Standards:

1. Application of the best interest standard of care
2. Avoidance of materially misleading statements
3. Receipt of only reasonable compensation

As a comment on reasonable compensation, the DOL’s position is that it is established by the marketplace, where the marketplace is competitive and transparent. Also, it is based on the services delivered to the retirement investor, rather than the particular product. However, as a practical matter, different types of investments and insurance products require different levels of services. For example, it is commonly conceded that it is more work to assist a retirement investor with an individual variable annuity contract than to assist with a mutual fund portfolio. Assuming that is correct, an advisor would be entitled to more compensation for the recommendation and placement of the variable annuity contract.

The reasonable compensation limitation applies to both the first year and to subsequent years. Therefore, where an advisor provides greater services on an ongoing basis, the advisor would be entitled to higher ongoing compensation.

Turning to PTE 84-24, which applies only to recommendations of life insurance and annuities, the burden of compliance is on the advisor. That is because, unlike BICE, 84-24 does not contemplate a supervisory financial institution, which shares the responsibility. As a result, the 84-24 requirements should be viewed as duties of the individual advisor. In that regard, PTE 84-24 generally requires the following:

* Compliance with the Impartial Conduct Standards
* Disclosure of sales commission for initial and succeeding years
* Description of any charges, fees, discounts, penalties, or adjustments
* Signed approval by “independent fiduciary”

While BICE does not require any written disclosures, 84-24 requires both disclosures and an affirmative sign-off by the retirement investor (for example, by the IRA owner). Advisors will need to obtain compliant forms for that purpose and will need to understand the procedures that are involved in terms of the documentation and approval.

Since 84-24 also requires that the advisor comply with the Impartial Conduct Standards, the advisor will need to have a prudent process for developing recommendations, including the allocation of the retirement investor’s assets, the financial stability of the insurance company, and the appropriateness of the contract and its provisions (including features recommended to the retirement investor). Also, under the Impartial Conduct Standards, the advisor can receive no more than reasonable compensation. The burden of proving compliance with that requirement is placed on the advisor. As a result, advisors will need to obtain information about the reasonableness of compensation for various sets of services and products. One source of that information is from benchmarking services.

Also, there is some helpful information when it comes to compliance with the best interest standard of care. For example, when recommending investment products, which can include asset allocation within variable annuity contracts, advisors should take into account generally accepted investment theories and prevailing investment industry practices. Since the burden of proof of compliance with those standards will be on the advisors, they should consider using an approach that provides documentation that can be retained and retrieved. For example, that can include collecting suitability information, use of reputable software and databases, and the preparation of reports.

In addition to the allocation of money within a variable annuity among the subaccounts, advisors should consider other factors that a diligent and knowledgeable investor would consider. Those include the following:

* Financial stability of insurance company
* Terms and features of annuity contract
* Expenses of contract
* Quality and expenses of underlying investments
* Need of investor for guaranteed income
* Allocation of investor’s financial assets to contract
* Selection of contract features, options, and investments
* Ongoing services and monitoring

With regard to fixed indexed annuities, the DOL provided guidance in the preamble to the 84-24 exemption about the issues to be considered in making a recommendation. Those factors include “Assessing the prudence of a particular indexed annuity requires an understanding of:

* Surrender terms and charges
* Interest rate caps
* The particular market index or indexes to which the annuity is linked
* The scope of any downside risk
* Associated administrative and other charges
* The insurer’s authority to revise terms and charges over the life of the investment
* The specific methodology used to compute the index-linked interest rate and any optional benefits that may be offered, such as living benefits and death benefits.”

Now, let’s move to issues related to recommendations to participants to take plan distributions and roll them over to IRAs. As background, there are usually three ways that advisors can receive a rollover for assistance with investing in an IRA. Those are:

1. Unsolicited
2. Education
3. Recommendation

If an advisor receives an unsolicited rollover, the distribution from the retirement plan was a decision by the participant, and the advisor did not make a fiduciary recommendation to take the money out of the plan. However, when the advisor subsequently makes a recommendation about how to invest an IRA, that will be a fiduciary recommendation subject to the rules discussed in this program.

Similarly, if an advisor provides distribution and rollover education and information, that is not fiduciary advice, if the education is properly done. As a general statement, to qualify as “education,” the materials and conversations need to be complete in material regards and unbiased. In other words, they should provide the participant with the information that he or she needs to make a decision but should not suggest any particular outcome.

If properly done, the education would not be fiduciary advice about taking a distribution, and, therefore, the advisor would not be a fiduciary for that purpose. However, similar to unsolicited rollover IRAs, any subsequent recommendations about how to invest the IRA would be fiduciary advice, subject to the requirements discussed in this program.

When the advisor makes a recommendation to a participant to take a distribution from the plan and to roll over to an IRA with the advisor, that is fiduciary advice. Since the advisor will earn income from the IRA but not from the plan (in most cases), it is also a prohibited transaction. As a result, the advisor will need to adhere to ERISA’s prudent man rule and duty of loyalty and to the Impartial Conduct Standards.

The starting point for doing that is for the advisor to consider the participant’s alternatives. In the typical case, those are:

* Leave the money in the plan.
* Transfer the money to the plan of a successor employer.
* Take a taxable distribution.
* Roll the money over into an IRA.

As a part of that evaluation, the Best Interest Contract Exemption explained that the advisor must take into account the following:

* The investments, expenses, and services in the participant’s plan
* The investments, expenses, and services in the proposed rollover IRA
* The retirement investor’s needs and financial circumstances

The DOL has explained that the information about the plan’s features should be readily available from the participant’s 404a-5 statement. (These disclosures are also known as the Investment Comparative Chart and the Participant Investment Disclosures.) Plans are required to provide participants with their 404a-5 disclosures when they first become eligible to participate in the plan and annually thereafter.

Unfortunately, in the real world, many advisors have found that participants have difficulty in finding the disclosures or even understanding what they are. As a result, this rule has proven to be more difficult to satisfy than contemplated.

Fortunately, though, the DOL provided an alternative. As DOL FAQs about the new rules explained:

If, despite prudent efforts, the financial institution is unable to obtain the necessary information or if the investor is unwilling to provide the information, even after fair disclosure of its significance, the financial institution could rely on alternative data sources, such as the most recent Form 5500 or reliable benchmarks on typical fees and expenses for the type and size of plan at issue.

In other words, under appropriate circumstances, advisors can also use information from Form 5500 filed by plans and from benchmarking services. (Note that Form 5500 only requires detailed investment disclosures if the plan has over 100 participants. Unfortunately, that diminishes the value of Form 5500 for smaller plans.)

When performing the analysis in order to recommend a distribution and rollover, some of the factors that the advisors should consider are:

* What are the services that the advisor will provide to IRA owners?
* Do they provide enough additional value to offset the probably higher expenses in the IRA than the plan?
* Does the participant need investments or guarantees above and beyond those provided in the plan? That could include, for example, the guarantees provided by annuities.
* Does the plan allow for periodic (e.g., monthly) distributions, and, if so, does it charge for those distributions? Many plans do not permit monthly distributions, other than required minimum distributions beginning at 70½. For a participant who plans to live on periodic distributions of his or her retirement money, those plans would not be a viable alternative.

With regard to recommending IRAs, the considerations are very similar to recommendation distributions in plans. However, the process is somewhat simpler. That is because, at least in the typical case, the investments and expenses in competing IRAs are relatively similar. (Of course, that doesn’t apply if you are comparing securities investments to insurance guarantees.) As a result, where IRAs will be invested in similar fashions, the tipping point may be the additional services offered by the advisor. As a result, advisors should develop business models to provide valuable services to IRA owners.