The Final DOL Fiduciary Rule: What Producers Need to Know

This Finseca Flash Deep Dive publication was prepared exclusively for Finseca members by Alex Kim, Finseca VP Public Policy.

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The Department of Labor ("DOL"), through an unusually rapid and irregular regulatory process, finalized on April 25th a new "fiduciary investment advice" regulation (the "Fiduciary Rule") and related exemptions ("PTE 84-24" and "PTE 2020-02").

Beginning September 23, 2024, financial security professionals--including insurance producers and broker-dealer registered representatives—recommending securities, annuities, and certain life insurance products purchased with qualified assets will now be "fiduciary investment advisers." Producers will have to comply with new, additional standards of care, face new restrictions on commissions and other forms of compensation, face expanded legal liability, and review their arrangements with carriers and intermediaries.

The new DOL Fiduciary Rule will apply in addition to state insurance laws and the Security and Exchange Commission's ("SEC") Regulation Best Interest ("Reg BI").

If this sounds familiar, it's because this is not the first time DOL has tried to regulate producers and brokers. A previous regulatory attempt in 2016 was vacated in Federal court for exceeding DOL's authority, but that hasn't stopped DOL from trying again. While it is likely that the new Fiduciary Rule will be challenged in court, producers, insurance carriers, and intermediaries must begin planning to comply with the Rule because September is only a few months away.

Your Finseca Flash was produced by Brad Campbell, outside counsel to Finseca, and the Finseca Advocacy Team (Alex Kim, Jen Fox, Melissa Bova, and Armstrong Robinson). This analysis is intended for informational purposes and to assist in feedback from the profession to your team at Finseca. It is not intended as a compliance guide to the rule.

Finseca will provide multiple opportunities for member feedback on the impact of the rule. Any questions or comments can be shared with Alex Kim, VP Public Policy.

THE FIDUCIARY RULE BASICS EVERYONE MUST KNOW

- WHO DOES THIS IMPACT? Any financial security professional who makes a recommendation involving qualified funds will be subject to the Fiduciary Rule.

- WHEN DOES IT APPLY? Beginning September 23, 2024, any professional covered by the Fiduciary Rule must:
  - Provide a written acknowledgment of fiduciary status to the Retirement Investor;
  - Receive no more than reasonable compensation;
  - Make no materially misleading statements;
  - Meet the Care Obligation; and
  - Meet the Loyalty Obligation.
  - Comply with either Prohibited Transaction Exemption 84-24 or 2020-02

- WHAT RECOMMENDATIONS ARE COVERED? The Rule casts a wide net:
  - Recommendations regarding securities or other investment property related to an ERISA plan or IRA, including variable life insurance and variable annuities.
  - Recommendations regarding rollovers, transfers, or distributions involving plan or IRA assets.
  - Recommendations where the SOURCE OF FUNDS is a plan or IRA. Special Note: even if the financial professional is <u>not</u> recommending the rollover or transfer itself, a recommendation as to <u>how to invest the proceeds of a rollover, transfer, or distribution</u> is fiduciary advice under the Rule

- EFFECT ON COMP & COMMISSIONS? As an ERISA, Fiduciary compensation is affected, and commissions become more difficult through the PTEs. There are also new limits on incentives, bonuses, differential compensations, trips, etc…

- IS THERE A SALES EXCEPTION? No, <u>the "exception" is so narrow that it cannot apply to financial security professionals.</u>
  - While DOL makes a point of claiming to preserve an exception for sales, it cannot be met in practice by a financial security professional obeying the requirements of the SEC's Reg BI or the NAIC's Annuity Best Interest standard.

- EXPANDED LIABILITY AND PRIVATE RIGHTS OF ACTION? Yes, the Rule exposes financial professionals to new liability:
  - The Rule subjects financial security professionals to litigation liability under ERISA they did not previously face. In addition, fiduciary laws in some states may impose additional liability.
  - Many professional liability policies do not cover, and may expressly exclude, fiduciary advice under ERISA and the Tax Code. It is advisable to review your current professional liability policy to determine if you need an additional rider or new coverage to address fiduciary recommendations.

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DEEPER DIVE: A SUMMARY OF THE PRIMARY FIDUCIARY RULE ISSUES FACING FINANCIAL SECURITY PROFESSIONALS

To Which Producers Does the New Fiduciary Rule Apply?

Virtually every producer making a recommendation involving qualified funds will be subject to the Fiduciary Rule. Specifically, the Rule applies to any producer or other financial professional making a recommendation involving "securities or other investment property" to a "Retirement Investor."

The Fiduciary Rule applies to a producer if you:

1. make recommendations "on a regular basis" as part of your business,
2. apply "professional or expert judgment" that is "based on review of the Retirement Investor's particular needs" in making your recommendation, and
3. intend that your recommendation "may be relied upon by the Retirement Investor…to advance the Retirement Investor's best interest."

In other words, if you make individualized recommendations in the best interest of the Retirement Investor—which are the minimum requirements of the states' Best Interest annuity laws and the SEC's Regulation Best Interest—you are a fiduciary under the DOL Rule.

Isn't There a Sales Exception for Insurance Producers?

No. While DOL states that "merely executing a sale" is not fiduciary advice, this exception cannot be met by financial security professionals. To be a "sales-only" recommendation in the DOL's view, the recommendation cannot be individualized and cannot be intended for best-interest reliance. Because it is illegal under state insurance laws and under state and federal securities laws for a financial professional to recommend an annuity that is not based on an evaluation of the individual's needs and in the individual's best interest, you can't qualify under DOL's narrow definition of sales.

Who is a Retirement Investor?

A Retirement Investor includes ERISA-covered retirement plans, individual plan participants, and plan fiduciaries managing those plan assets. It also includes Individual Retirement Annuities and Individual Retirement Accounts ("IRAs"), IRA owners and beneficiaries, and fiduciaries managing IRAs. For most producers, this means recommendations to individual clients are subject to the Fiduciary Rule if you are making recommendations regarding funds related to their retirement plans or IRAs.

What Types of Advice are Covered by the Fiduciary Rule?

In addition to advising on the investment of securities or other investment property in the ERISA plan or IRA directly, the Fiduciary Rule also covers any recommendations regarding rollovers, transfers and distributions involving plan or IRA assets. Further, even if the financial professional is <u>not</u> recommending the rollover or transfer itself, a recommendation as to how to invest the <u>proceeds</u> of a rollover, transfer or distribution is fiduciary advice under the Rule.

For example, the Fiduciary Rule would apply when a producer:

- Recommends to the IRA owner a replacement of a qualified annuity in an IRA,
- Recommends a rollover from a 401(k) plan into an IRA,
- Recommends a transfer to a new IRA, or
- Recommends the purchase of an annuity or life insurance with the proceeds of a distribution from a plan or IRA.

However, there must be a recommendation to the Retirement Investor before there can be fiduciary advice. Providing educational and factual information that is not accompanied by a call to action is generally not fiduciary advice. For example, explaining the importance of retirement income or explaining what annuities are and how they work is not, by itself, fiduciary advice, unless accompanied by a recommendation to rollover or to purchase an annuity.

What Types of Investment Products are Covered by the Fiduciary Rule?

The Rule applies to recommendations of investments and investment strategies involving "securities and other investment property." Other investment property includes annuities (fixed, fixed-indexed, and variable), and life insurance with an investment component, such as whole life or variable life.

It does not include term life policies with no investment component or ordinary health or disability policies.

This broad definition highlights the importance of knowing the **SOURCE OF FUNDS** used to purchase the life insurance policy or annuity. For example, a recommendation to purchase a whole life insurance policy with a distribution from an IRA would be covered by the Fiduciary Rule, while recommending purchasing the same policy with the proceeds of a real estate sale would not be covered by the Fiduciary Rule.

What Does it Mean if a Producer is a Fiduciary under the Rule?

There are several consequences of being a fiduciary under the Rule, and producers, intermediaries, insurance carriers, broker-dealers and RIAs need to review their current operations to ensure they are prepared before September 23, 2024, to address these issues.

- You Need a Prudent, Thorough, and Well-Documented Recommendation Process:

As a fiduciary, you need to employ a prudent, thorough and well-documented process for gathering the necessary information and properly considering it in making a recommendation. Put another way, it is important that producers be able to "show their work" in how and why they decided what to recommend. In addition, there are specific documentation and disclosure requirements related to recommending rollovers from a 401(k) to an IRA (including to an annuity). You must gather specific information about the plan the rollover is coming from when considering whether it is in the plan participant's best interest to remain in, or to leave the plan.

- Prohibited Transactions Affect Conduct and Compensation, <u>including Commissions</u>:

When a producer or other financial professional becomes a fiduciary under the Rule, receiving your normal commission or other compensation becomes a "prohibited transaction." From the DOL's perspective, you are using your fiduciary advice to affect your own compensation or that of your affiliate, which is a form of prohibited self-dealing. To be able to receive a commission or other compensation, you must comply with an additional set of rules called "prohibited transaction exemptions" ("PTE"). These PTEs allow you to receive compensation for providing advice to a Retirement Investor—but only if you meet all the new conditions imposed by the PTE. The PTEs also impose limits on the amount and form of commissions and other compensation.

The final Fiduciary Rule package approved by DOL includes new amendments to the two primary PTEs available for investment advice by producers and other financial professionals. The first is PTE 84-24, which can only be used by certain independent producers recommending non-security insurance and annuity products, and the second is PTE 2020-02, which can be used by any financial professional affiliated with a RIA, broker-dealer, insurance company or bank/trust with respect to all types of investments. Both PTEs impose additional conditions on making, documenting, and disclosing your recommendation, and they provide additional restrictions on the type of compensation you can receive. (Each PTE is discussed in more detail below).

- Fiduciary Status Affects Legal Liability and Liability Insurance:

As fiduciaries, producers can be subject to new legal liability that has not been applicable to them as non-fiduciary financial professionals. For example, recommending a rollover from a 401(k) plan to an IRA could make you subject to ERISA's existing fiduciary cause of action. There may also be consequences of state law as a result of fiduciary status, though these are less clear and may vary by state.

Special Note: many professional liability policies for insurance producers do not cover, and may expressly exclude, fiduciary advice under ERISA and the Tax Code. It is advisable to review your current professional liability policy to determine if you need an additional rider or new coverage to address fiduciary recommendations.

What are PTE 84-24 and PTE 2020-02, and When Do I need to Use Them?

PTE 84-24 is for use only by certain independent producers recommending non-security insurance and annuity products. PTE 2002-02 can be used by all kinds of financial professionals if they have a financial institution that will be a co-fiduciary with them (only insurance companies, broker-dealers, RIAs or bank/trusts can serve as a financial institution). In addition, PTE 2020-02 must be used for the recommendation of any security—PTE 84-24 does not apply to securities.

Which exemption is available to a producer or other financial professional depends on several factors, including the compliance decisions made by the producers' affiliated insurance companies and broker-dealers/RIAs. Because of the complexity of the Rule's effects on different products and distribution channels, not all broker-dealers or insurance companies will make the same compliance decisions. For example, some insurance carriers may not be willing to use PTE 2020-02 at all and may only choose to use PTE 84-24. Some producers who hold securities licenses as well as insurance licenses may use PTE 2020-02 to recommend variable annuities but choose PTE 84-24 to sell fixed annuities. Producers will need to review their arrangements with their carriers, intermediaries, and other distribution partners to determine what makes sense for their individual circumstances.

Producers and other financial professionals must begin using an appropriate PTE on September 23, 2024, the same day the Fiduciary Rule goes into effect. However, the full requirements of each of the PTEs do not take effect immediately. A limited set of five immediate requirements common to both PTEs apply for one year, from September 23, 2024, to September 23, 2025. Full compliance with the detailed requirements of each PTE is not required until after September 23, 2025.

- **Immediate Requirements of Both Exemptions Beginning September 23, 2024**

Whether a producer or financial institution is relying on PTE 2020-02 or PTE 84-24, there is a common set of five specific requirements applicable in the first year. They are:

1. Providing a written acknowledgment of fiduciary status to the Retirement Investor by the independent producer (under PTE 84-24) or by the financial professional and the financial institution (under PTE 2020-02);
2. Receiving no more than reasonable compensation;
3. Making no materially misleading statements;
4. Meeting the Care Obligation (that the recommendation must reflect care, skill, prudence, and diligence based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor); and
5. Meeting the Loyalty Obligation (that the recommendation must not place the financial or other interests of the producer or its affiliates ahead of the Retirement Investor's interests).

How Do Producers Know Which Prohibited Transaction Exemption to Use?

There are several important differences between the two exemptions. For example, only certain independent producers recommending non-security insurance and annuity products may use PTE 84-24, while all financial professionals are eligible to use PTE 2020-02. PTE 2020-02 requires a financial institution—an insurance company, a broker-dealer, an RIA or a bank/trust—to be a co-fiduciary along with its affiliated financial professional, while there is no co-fiduciary requirement under PTE 84-24. Which best fits a producer depends in large part on what kind of investment or insurance policy you are recommending.

PTE 84-24—Only Fully Independent Producers May Use It, and Only for Non-Security Annuity and Life Contracts:

PTE 84-24 may only be used by a subset of independent insurance producers. To be eligible, the producer:

1. Must not be an employee of any insurance carrier,
2. Must sell products of two or more unrelated insurance carriers,
3. Must not be a statutory employee of the insurance carrier whose product they are recommending to the Retirement Investor, and
4. May recommend only non-security annuity and life insurance products (such as non-variable life insurance, or fixed and fixed-indexed annuities).

Key Point: Career and captive agents, and independent producers recommending the policy of a carrier for whom they are a statutory employee cannot use PTE 84-24 and must use PTE 2020-02 instead.

Starting on September 23, **2025**, additional key conditions for producers will include:

- Providing to the Retirement Investor, a written statement of fiduciary status, meeting the Care and Loyalty Obligations, making no materially misleading statements, and receiving only reasonable fees (the five elements discussed above);
- Providing written disclosures, including:
  - ✓ A statement explaining the Care and Loyalty Obligations;
  - ✓ All material facts related to conflicts of interest associated with the recommendation;
  - ✓ All material fees and cost related to the Retirement Investor's transactions, holdings, and accounts;
  - ✓ Notice of the Retirement Investor's right to request additional information regarding the producer's cash compensation;
  - ✓ Upon such request, providing a reasonable estimate of cash compensation the producer will receive, and a description of timing of payments (the estimate can be a range of amounts or percentages); and
  - ✓ Description of type and scope of services provided to the Retirement Investor, including any material limitations on the producer's recommendations with a list of the insurers and insurance products the producer is licensed and authorized to sell to the Retirement Investor.
- Documenting and providing the basis for the recommendation to the Retirement Investor and the insurance carrier; and
- In the case of a rollover from an ERISA plan, considering alternatives to the rollover, including leaving the money in the plan; the fees and expenses of the options, including any employer cost sharing in the plan; and the different levels of fiduciary protection, services, and investments available. The documentation providing the basis for the rollover recommendation must be provided to the Retirement Investor and to the insurance company.

While insurance carriers are not co-fiduciaries under PTE 84-24, they do have to implement enhanced supervision of independent producers using PTE 84-24 and conduct an annual review and assessment. Starting on September 23, 2025, additional key conditions for insurance carriers include:

- Written policies and procedures for reviewing each recommendation for compliance with the PTE before issuing the policy or contract.
- Written policies and procedures prudently designed to ensure producer compliance with the exemption conditions.
- ***Mitigating conflicts of interest****—the insurer may not use "quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other similar actions or incentives in a manner that a reasonable person would conclude are likely to result in recommendations that do not meet the Care Obligation or Loyalty Obligation."*
- A prudent, documented process for authorizing and annually reviewing independent producers to sell the company's products, including reviewing customer complaints, disciplinary history, training, education, and conduct.
- An annual retrospective review of each producer's recommendations to detect and prevent violations, including a review of rollover recommendations (the carrier may use sampling).

- Provide each producer with the results of the annual review, including instructions to correct any violations.
- Certified annual report signed by a senior executive documenting that the annual review was completed, and all necessary corrections addressed.

- **New 10-Year Disqualification Risk**

PTE 84-24 (and PTE 2020-02 discussed below) also contain an "eligibility" requirement that may prove to be a significant future issue. If the producer, the insurer, or a member of the insurer's control group, is convicted of one of a long list of crimes, domestic or foreign; or if the insurer or control group member reaches a settlement of certain crimes with certain government agencies; the producer or insurer cannot rely on the exemption for 10 years. **In other words, there is a 10-year ban on providing advice to any Retirement Investor.** For example, a producer could not recommend an ineligible insurer's products to a Retirement Investor, and an insurance carrier could not authorize an ineligible producer to sell their products. If a producer or insurance carrier becomes ineligible, there is a one-year transition period to unwind arrangements of current clients before the ban begins.

This very controversial provision does not require conviction of a crime related to providing investment advice - conviction of an insurance carrier's control group member for an unrelated bribery scheme, for example, would prevent the entire control group from being eligible for the exemption. While the ineligible entity can seek an individual exemption from DOL, the effects of this provision could cause significant future disruptions.

- **Educational Conferences**

As discussed above under insurance carrier duties to mitigate conflicts, PTE 84-24 (and PTE 2020-02 discussed below) limit compensation, especially incentive and non-cash compensation, such as trips for educational conferences. While DOL states that it does not ban educational conferences, and that there can be some reasonable qualification requirements for attending, it also explains that "…parties must take special care to ensure that training conferences held in vacation destinations are not designed to incentivize recommendations that run counter to Retirement Investor interests…[and] avoid creating situations where the training is merely incidental to the event, and an imprudent recommendation to a Retirement Investor is the only thing standing between an Investment Professional and a luxury getaway vacation."

PTE 2020-02—All Financial Professionals May Use for Any Type of Investment:

PTE 2020-02 is intended by the DOL to be used by all other financial professionals, including producers who are not eligible to use PTE 84-24. Both the financial professional, and the financial institution they represent, are fiduciaries for the recommendation to the Retirement Investor.

The basic requirements of the exemption are essentially the same as those in PTE 84-24, but without some of the issues that are specific to insurance producers. Those requirements include:

- Compliance with the five specific requirements (written statement of fiduciary status by the financial professional and the institution, meeting the Care and Loyalty Obligations, no materially misleading statements, and only reasonable fees);
- Disclosures (made by the financial institution) are largely similar to those under PTE 84-24 regarding conflicts, rollovers, and other matters. The most significant difference is that PTE 2020-02 does not require additional disclosure of cash compensation upon request of the Retirement Investor, which PTE 84-24 does require of producers.
- Retrospective review requirements are similar, but the financial institution is responsible for finding its own errors and correcting them. PTE 84-24 directs the insurer to inform the producer of a discovered violation and asks the producer to correct it.
- Conflict mitigation—and the resultant limits on incentive compensation, educational conferences, bonuses, etc.—are essentially the same as in PTE 84-24.
- "Eligibility" requirements providing a 10-year ban for certain criminal convictions and settlements are also the same.

- **Who Can Be a Financial Institution under 2020-02?**

Only an insurance company, an RIA, a broker-dealer, or a bank/trust can serve as a co-fiduciary financial institution under PTE 2020-02. Intermediaries or other institutions cannot do so, though they may be able to assist financial institutions with some of the compliance requirements through contracts and agreements. To use PTE 2020-02, a financial security professional must have an appropriate relationship with one of these financial institutions.

Are Wholesalers and Intermediaries Assisting Producers Fiduciaries?

They may be, depending on the specific facts and circumstances. DOL included a partial exclusion from fiduciary status for recommendations made between financial professionals. While this exclusion may apply to some financial security professionals (those who only recommend, but do not manage, the client's money), it will not apply to all of them.
The concern is that if a producer—who is a fiduciary to the client—asks a wholesaler or an intermediary to help the producer decide which product to recommend to a specific client based on the client's individual circumstances, then that recommendation from the wholesaler or intermediary to the producer could be fiduciary advice under the Rule. This is because a discretionary fiduciary to a plan or IRA is included in the final definition of a Retirement Investor.

Instead of simply clarifying that recommendations between financial professionals are not fiduciary advice, the final Fiduciary Rule excludes from the definition of Retirement Investor only fiduciary advisors to plans and IRAs who do not have discretion[1] over investment decisions. This means that a recommendation to an advisor who manages money can be fiduciary advice, while a recommendation to an advisor who only recommends investments likely is not. As a result, the same recommendation to the same financial security professional regarding Client A might not be fiduciary advice, but it could be financial advice regarding Client B. Wholesalers, and intermediaries will need to review the circumstances under which they give individualized recommendations to ensure they do not unintentionally become fiduciaries under the complex new provision.

What Does the Rule Mean for Intermediaries?

The final Fiduciary Rule is not clear in its treatment of intermediaries like IMOs, FMOs, and BGAs. It is clear that they are not financial institutions for the purposes of PTE 2020-02. However, as discussed above, they may or may not be advice fiduciaries, depending on circumstances. DOL notes in its discussion of the Rule text that intermediaries may play roles in assisting producers and carriers with compliance obligations, including training, disclosure, compensation, and conflict mitigation. In summary, intermediaries will need to closely review what services they want to provide and whether those could make them fiduciaries. They also will need to review and discuss their current arrangements with insurance, securities, and financial professional partners in light of the new obligations placed on all of these entities under the Final Rule.

Conclusion:

The Fiduciary Rule again asserts DOL's claim of authority to regulate IRAs, annuities and life insurance sales associated with assets related to plans and IRAs. This assertion remains very controversial, especially since a similar regulation and effort failed in Federal courts only a few years ago. Litigation against this rule is quite likely. However, given the short implementation deadline of September 23, 2024, producers and their industry partners must begin working to comply now. Finseca has been active in fighting this Rule, and we will continue to take all appropriate steps to help our members continue to serve their clients and their families.

[1] Specifically, an ERISA Sec. 3(21)(A)(ii) fiduciary (providing non-discretionary fiduciary advice) is not a "Retirement Investor" while ERISA Sec. 3(21)(A)(i) and (iii) fiduciaries (those exercising or possessing authority to make investment decisions) are "Retirement Investors."