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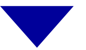

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What is the DOL Fiduciary Rule?

The 2017 Department of Labor (DOL) rule ***changes the way*** the financial industry delivers ***retirement investment advice***. The essence of the plan is: When an advisor provides advice, it must be in the ***best interests*** of the client and not for the benefit of the advisor and his compensation.

Advisors must mitigate their ***conflicts of interest*** that may influence their advice. Examples of a conflict of interest include:

- Moving a client from a fee-only product (handled by fee only advisors) to one with commissions paid to the advisor. Or, conversely, from a commissioned account to a fee-based product where the advisor charges fees.

- Placing a client in a certain product where higher commissions are paid.

- Soliciting a client to roll money out of an existing retirement account into one managed by the advisor where limited product choices exist.

- Putting a full 30 percent of a client's nest egg into a particular variable annuity where you received a commission and not another annuity where you could not receive compensation.

The new rule expands the ***fiduciary standard of care SPECIFICALLY for retirement plan investment advice*** under ERISA (Employee Retirement Income Security Act) to include qualified retirement plans, IRAs and IRA Rollovers. The rule also applies to Health Savings Accounts (HSAs), Medical Savings Accounts (MSAs) and Coverdell Education Savings Accounts (Education IRAs).

The rule demands ***impartial conduct standards*** that require advisors to earn ***reasonable compensation***. This is not to say the lowest compensation, just reasonable. In essence, the compensation must not be excessive based on the going market or prevailing best practices for services rendered.

The most significant requirement under the fiduciary rule, is that advisors (including agents for certain types of products and clients) can no longer earn commissions and other forms of compensation,

unless they agree to do so pursuant to a ***Best Interest Contract (BIC)*** with the client.

To repeat: The DOL rule doesn't ban ***commissions or revenue sharing***, but it requires advisers who are compensated that way to have ***clients sign a best interest contract*** exemption, or BICE. As a test of the advisor's intentions, investors with such a contract in place, will be able to arbitrate a solution when damaged. Nothing, however, prohibits the investor who feels damaged or feels their interests have not come first to sue their advisers in court.

The thrust of the new rules will be to force agents and advisors offering investment advice to retirement investors to document to their clients, the DOL or whoever brings them to task, that they have acted in the best interest of their client. Not only will this involve a substantial increase in paperwork, but as a fiduciary, you will need to explain and fully understand a full compliment of marketplace products, to explain why investing your client's money in the product(s) you chose was a better choice.

What is a BIC agreement?

A BIC agreement is a ***disclosure form*** signed by the client and a ***financial institution*** (insurance company, broker-dealer, registered investment advisors, bank or insurance marketing organization that has applied as a financial institution with the DOL) that commits the provider of the advice to a fiduciary standard of care. In other words, the BIC agreement is generally not directly between the advisor and client, but between the client and the financial institution.

The rule stipulates that the BIC does not have to be signed until the client actually opens an account. The BIC verbiage can also be incorporated directly into the paperwork of a client advisory agreement or account opening document rather than a standalone document.

What is a fiduciary standard of care?

If you fall under the fiduciary rule, you must act in the ***best interests*** of the client and practice a fiduciary standard of care, i.e., *act with the 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 the enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances and needs of the plan or IRA.*

At what point do I become a fiduciary?

When you make a ***recommendation*** to a retirement account investor, you become a fiduciary. A ***recommendation, under the rule, means*** a communication that would be reasonably viewed as a suggestion that a client ***take a particular course of action***, e.g., providing a selective list of products tailored to a client's needs or advising a client to rollover some of his 401k into an annuity.

Merely making a note of investment options without regard to individual needs, general communications, investment education, general financial or retirement materials, interactive worksheets to help people evaluate options are NOT considered a recommendation.

It is anticipated that the DOL will further clarify what is and is not a recommendation.

How can I avoid being a fiduciary?

Even if you fall outside the DOL fiduciary definition, avoiding fiduciary status for many financial product transactions is becoming harder since legal decisions in courts are trending toward the assumption that ***most financial advisors (insurance agents included) can be classed as fiduciaries***. Consider the following rulings:

- A court determined an agent to be a fiduciary simply because he held himself out to have ***special knowledge*** and the client knew nothing about the technical aspects of insurance.

- An agent was classified a fiduciary when he was asked for the ***best available*** package. In essence, the client put the agent on notice that he was relying on agent's expertise to obtain desired coverage.

- An agent, who is used exclusively by a client over a period of years, where the client has come to be dependent on the agent's advice, could be found to be a fiduciary if his coverage failed.

- An agent could be in fiduciary hot water if he recommends a poor indexed annuity with a Best Rating of "B" that pays a high commission, instead of recommending an identical "A"-Rated annuity paying a smaller commission.

Isn't this the same as *suitability* standard rules?

No. The BIC contract goes ***beyond the suitability standards*** the industry adopted years ago. Under the old suitability rules, an agent must have a reasonable basis to believe that a recommended annuity is suitable for the customer based on the information obtained through the reasonable diligence, to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

Being a fiduciary requires financial advisers working with retirement investors to act in the ***best interests*** of their clients, ***before their own***, when providing investment guidance. ***Being a fiduciary means*** an advisor has ***unlimited responsibility*** to show and prove your advice was sound. If it was determined your advice was unsound, you could potentially be liable for losses, i.e., you can be sued for the loss.

Being a fiduciary, under the DOL rule, unlike suitability standards, requires advisors to focus on ***conflicts of interest*** between the agent and his client, e.g., repositioning a client's money so you are able to benefit from products you recommend. That did not exist under suitability rules.

Do the rules also apply to insurance-only agents and products, i.e., agents that do not have a securities license or registered as investment advisors?

It depends. Every producer is unique and his compliance depends on the licenses he carries and the product(s) recommended. In general ...

- If you sell non-qualified annuities, to private individuals (outside 401k or IRA retirement plans) using after-tax dollars, you are probably exempt from fiduciary rules.

- If you sell annuities of any kind AND act in a fiduciary manner (your client has depended on your advice exclusively for a long

period of time), you might not come under the fiduciary rule, but you should have some kind of BIC agreement.

- If you sell variable or indexed annuities to 401k or IRA / IRA Rollover clients, you will not avoid the fiduciary rule. You will need a BIC contract.

- If you sell fixed annuities, without dispensing investment advice to your retirement clients, you may be eligible for a less stringent exemption and not need to comply with the full BIC obligations.

What do you mean when you say I am *probably exempt* from the fiduciary rule?

The rules are complex and depend on the unique situation and recommendation. As we mentioned above, the laws are trending toward assuming agents are fiduciaries, whether a BIC agreement exists or not. In other words, an agent can unwittingly assume the role of a fiduciary, and thus a higher level of responsibility, by his actions or the circumstances of a financial transaction. In the role of advising clients on investment products for their retirement plan or IRA, you are definitely considered a fiduciary with all the responsibilities it assumes.

After the new rules start, will ALL my product recommendations be put under a fiduciary microscope?

No. Advice outside the scope of a retirement account, purchased with non-qualified dollars, i.e., investments made with after-tax dollars, are not subject to the new rules.

Even under the new rules, the fiduciary code recognizes that no one can identify the absolute ***best*** insurance product for a retirement investor, especially considering the myriad of options available. Specifically, the DOL rule states that ***prudent advice*** is required. ***Prudent advice*** is advice that is based on investment objectives, risk tolerance, financial circumstances and the needs of the retirement investor, without regard to the financial or other interests of the advisor. So, the advice given, and the circumstances and clients involved will dictate your degree of fiduciary responsibility.

Given this, it makes sense that agents, even those selling insurance only products, should reshape their business and client interactions to

best meet fiduciary compliance, even when you are not determined to be a fiduciary.

Bottom line? Practice agent due care to do the best job possible and always put your client's interest before your own commissions. Also, if you are an insurance-only agent***, avoid giving investment advice*** since that is one of the triggers for fiduciary rule compliance.

How can I avoid giving investment advice?

One of the basic principles of the new fiduciary law is that anyone giving ***investment recommendations*** to a retirement plan / IRA client for a fee or commission is considered a fiduciary advisor. Further, insurance-only agents are prohibited by law from giving ***investment advice.*** To avoid violating the latter, it is recommended that agents, who are not registered investment advisors or securities licensed, **REFRAIN FROM . . .**

- Discussing risks specific to the consumer's individual securities portfolio.

- Providing advice regarding the consumer's specific securities or securities investment performance, or comparing the consumer's specific securities or securities investment performance with other financial products, including annuity contracts or life insurance policies.

- Recommending the liquidation of specific securities, or identifying specific securities that could be used to fund an annuity or life insurance product.

- Recommending specific allocations, in dollars or percentages, between insurance and securities products.

- Offering research, analysis or recommendations to a consumer regarding specific securities.

- Completing securities forms, except for: 1) providing general information to the consumer related to the consumer's existing or new annuity or life insurance product; 2) assisting with forms that are required by the insurance company to complete an insurance transaction; and 3) assisting with forms that are required by Iowa insurance regulations.

- Using the following term or terms: investment adviser, securities agent, or investment adviser representative under California securities laws; and similar titles that tend to indicate to customers that the individual is licensed to provide investment advice, that the individual is licensed to sell securities, or otherwise holding the individual out as providing investment advice to others, when the individual is not so licensed.

<u>What kind of advice CAN I give clients without violating investment adviser rules?</u>

In general the insurance-only agent may discuss with the consumer...

- The consumer's financial situation and needs. This may include a discussion of the consumer's financial experience, financial objectives, including whether the consumer needs to earn a guaranteed rate of interest, needs concerning guaranteed minimum increases in guaranteed values, or wishes to have available a minimum lifetime income stream.

- The client's risk tolerance, including need for principal protection or protection from market risk; need to balance and diversify risk, including need for product or issuer diversification that may support an insurance position within a consumer's financial plan; tax status, including whether the assets used to purchase the annuity or life insurance are or need to be tax deferred; existing assets, including annuity, investment, and life insurance holdings; financial resources generally available for the funding of the annuity or life insurance; liquidity needs and liquid net worth, including whether there are funds other than those being used to purchase the annuity or life insurance that will be available during the surrender period of the annuity or life insurance for emergency or urgent needs, and where those funds are located; financial time horizon; and intended use of the annuity or life policy.

- The stock market in general terms including market risks and recent or historic economic activities that are generally known to the public and regularly discussed in public media.

- General financial discussions to give the agent reasonable grounds for believing that the recommendation to purchase, borrow against, exchange, or replace an annuity or life insurance is suitable for the consumer.

- Issues regarding annuity suitability, replacement, and exchange or transfer forms as required by California insurance regulations.

- The fact that invested funds need protection from market risk; that the tax status of the funds and that tax deferral needs to be utilized or maintained; that the funds may be needed to provide a lifetime income stream; that the funds need to earn a guaranteed interest rate; or that there are other funds available during the surrender period of the annuity or life insurance for emergency or urgent needs and where those funds are located.

- General discussions about balancing risk, diversification, etc., that support an insurance position within a consumer's financial plan.

- Advice as part of a financial plan. When doing so, an insurance-only person should clearly identify himself or herself as an individual who holds a California insurance license and explain that such license authorizes the person to discuss how annuities or life insurance products may fit into the consumer's financial plan and that he or she is authorized to sell annuity or life insurance products and not sell, recommend or provide advice about securities.

How do I comply with the fiduciary rules?

While procedures and systems are still be formulated, it would appear that ***most compliance*** and the drafting of BIC agreements ***will come through approved financial institutions*** (banks, carriers, brokerage houses, registered investment advisors or insurance marketing organizations registered with DOL as financial institutions). These institutions will be expected to create policies and procedures that the DOL will review and retain jurisdiction over. If the firm does not create the proper environment by establishing mechanisms to police its own conflict of interest, a financial institution can lose its ***prohibited transaction exemption*** which instantly renders all of its activity a prohibited breach.

Do not interpret this to mean you do not have individual responsibilities and individual liability. If you are giving investment advice to an employer retirement plan or IRA client and you are receiving a fee or commission from your recommendations, you ***will***

fall under the fiduciary rule and you ***will*** be financial responsible to vet your recommendations if something goes wrong.

To protect yourself as much as possible, ***your compliance with the rules should include the following:***

- Mitigate receiving payments / commissions that create conflicts of interest.

- Avoid participating in quotas, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that are intended or would reasonable be expected to cause advisers to make recommendations that are not in the best interests of the retirement investor. These will be banned under the new rules.

- Acknowledge (embrace) your fiduciary status.

- Adhere to basic standards of impartial conduct, including giving prudent advice that is in the best interest of the customer.

- Avoid misleading statements and procedures. This will specifically effect sales disclosures and illustrations, particularly variable and equity-indexed annuities. The illustrations may be the same, but the scrutiny they are subjected to will be much higher.

- Disclose conflicts of interest and the cost of advice (fees / commissions).

If I charge fees instead of commissions, am I exempt under the rule?

First, if you have less than $100 million in client funds to manage and five or more clients, to offer investment advice for a fee, you will have to ***register as an investment advisor*** with the State of California Department of Corporations. This is an arduous process and requires securities licensing, minimum net worth requirements and substantial paperwork. Advisors who are making a long term commitment may indeed invest in the effort to become an RIA.

Existing Registered Investment Advisors (RIAs), who already are held to a fiduciary or "best interest" standard, will have small

operational changes to make to serve retirement plans and IRAs. They'll need additional documentation under the DOL to show how clients' interests are being put first.

That could be challenging with 401(k) rollovers, for instance, if the fees the client will owe the RIA for managing the IRA will be greater than the existing plan's fees. The DOL rule also incorporates a contract some have dubbed "BICE lite," which fiduciary advisers may need to have signed by clients to transition retirement assets. The cost of these changes could be a challenge for small RIAs, who will likely react by looking to merge with larger firms, a trend that's been occurring in recent years anyway because of extra compliance costs due to other regulation.

When does the DOL fiduciary rule take effect?

The key provisions of the rule will take effect ***April 10, 2017***, with a transition period through ***January 1, 2018***. At that time, the last of the detailed disclosure and other policies and procedures must be put in place. Basically, advisors who give fiduciary investment advice to retirement investors will be subject to the fiduciary obligation on April 10, 2017. The enforcement for failing to implement requirements, however, will be delayed until January 1, 2018 (the transition period).

Is there any grandfathering?

Yes. The rule grandfathers any ***ongoing commission payments*** that continue to be received for advice that was provided prior to the effective date. Further, any client ***contributions (investments) made or committed prior to the effective date*** of the rule will be permitted to continue without being subjected to BIC agreements. ***New money investments*** that would trigger a new commission or compensation to the advisor will require a new BIC agreement.

Eventually, existing clients will need to be transitioned into the BIC world. Essentially, they will giving the option to leave if they do not want to sign an agreement.

Of course, all new clients, after the rule takes effect, will be subject to the BIC contract.

Who enforces the fiduciary rules?

For any fiduciary advice pertaining to ERISA plans, the Department of Labor (DOL) itself can continue to enforce as it has in the past, in addition to the fact that harmed participants have the right to sue in court. In fact, ERISA-related lawsuits have had a significant impact on the employer retirement plan space in recent years.

For fiduciary advice pertaining to IRA accounts, the Department of Labor itself cannot enforce the prohibited transaction rules directly; technically, the DOL can write guidelines to define a "fiduciary" under both ERISA, and IRC Section 4975 of the Internal Revenue Code (which governs IRA accounts) under the Reorganization Plan No. 4 of 1978. Enforcement could thus fall under the purview of the IRS. And the IRS can potentially apply significant penalties – from 15% to as much as 100% of the value of the account under IRC Sections 4975(a) and (b).

If the IRS is not been active in enforcing against fiduciary prohibited transactions, the Department of Labor has required those providing fiduciary investment advice recommendations to IRAs to sign the BIC… which creates the potential for the advisor (or at least, the Financial Institution) to be sued for failing to adhere to the BIC as a fiduciary, even if the IRS won't enforce directly.

In other words, if advisors fail to follow their fiduciary obligations with respect to IRA accounts and rollovers, the DOL itself cannot enforce a proceeding against the advisor for failing to adhere to fiduciary duty, but the DOL *also* ensured that ***consumers have legal recourse*** for the client's attorney to sue instead.

In fact, extending this requirement, *the BIC explicitly requires that a financial institution* ***cannot require consumers to fully surrender their rights to compensation for damages or require them to fully waive their rights to pursue action in court***. Instead, while the rules *do* allow the BIC to require that *individual disputes* may go to the industry-standard mandatory arbitration, *consumers must retain the* ***right to pursue a class action lawsuit*** *in court*. Which means if a Financial Institution systematically fails to adhere to appropriate fiduciary policies and procedures and implement them accordingly, *the Institution faces a high likelihood of a class action lawsuit in the future*, for which the required disclosures will provide a roadmap to the plaintiff's attorney to pursue!

In addition, the Department of Labor still retains the right to evaluate a Financial Institution's policies and procedures themselves, and has already vowed that it will be "closely monitoring" Financial Institutions as they roll out their new policies and procedures in the coming year. If the policies and procedures themselves are not up to snuff, the Department of Labor can potentially declare that the Financial Institution has failed to meet the BICE requirements – which would render the firm ineligible for the necessary Prohibited Transaction Exemption, causing *all* of its advisors and conflicted compensation to be in violation of DOL rules, a potentially catastrophic outcome that Financial Institutions will desperately wish to avoid!

How do the insurance companies view the fiduciary rule?

- Some are developing specified annuity products that will ONLY be available to fee-based agents, i.e., there is no commission paid. As a result, the carrier can offer better rates or a more lenient withdrawal schedule. To make any money from recommending this product, you would have to become a registered investment advisor and charge a fee for your investment advice.

- Some carriers may not allow insurance-only agents access to products to sell in the qualified market, i.e., you could not sell an annuity to a 401k or IRA rollover client.

- Many carriers are analyzing whether they are willing to sign BIC agreements at all, since it is hard to monitor the fiduciary actions of tens of thousands of agents. Especially when some are selling product from multiple carriers. Instead, they may defer the liability to broker-dealers, insurance marketing organizations or even require that agents selling their annuities in the qualified market to become registered investment advisors.

- The selling of exempt fixed rate annuity contracts sold outside retirement plans is likely to continue somewhat unchanged, although we are trending as a fiduciary world and it would be wise for agents to consider serving the client's interest first at all times.

- State Farm Insurance says it will not be accepting liability under the Best Interest Contract (BIC) on the sale of annuities or

mutual funds by the more than 12,000 of its agents throughout the U.S. who have licenses to sell securities.

- Court challenges from industry groups to try to derail the DOL fiduciary rule are likely. An injunction could push the implementation date further down the road into the next administration, which would allow those new agency officials to decide the remaining details of the rule's implementation.

- Republican lawmakers have already passed congressional resolutions to kill the DOL regulation, but President Barack Obama has pledged to stop those with a veto, and opponents don't have enough votes in Congress to override that veto.

What does a BIC agreement look like?

The final version will vary based on the financial institution and products they sell. However, DOL has made clear what they want to see in a BIC disclosure:

Contractual Disclosures

Certain contractual disclosures must be in the written contract. If the disclosures do not appear in a contract with a Retirement Investor, the exemption is not satisfied with respect to transactions involving that Retirement Investor.

The Financial Institution and the Adviser must ***identify in the written contract any material conflicts of interest.*** This disclosure may be a general description of the types of material conflicts of interest applicable to the Financial Institution and Adviser, provided the disclosure also informs the Retirement Investor that a more specific description that is kept current is available on the Financial Institution's Web site (web address provided) and by mail, upon request of the Retirement Investor.

The written contract must inform the Retirement Investor of ***the right to obtain complete information about all of the fees*** currently associated with the Assets in which it is invested, including all of the fees payable to the Adviser, Financial Institution, and any Affiliates and Related Entities in connection with such investments. The fee information must be complete, and it must include both the direct and the indirect fees paid by the plan or IRA.

The written contract also must disclose to the Retirement Investor whether the Financial Institution offers proprietary products or receives third party payments with respect to the purchase, sale or holding of any Asset. Third party payments, for purposes of this exemption, are defined as sales charges (when not paid directly by the plan, participant or beneficiary account, or IRA),and other payments paid to the Adviser, Financial Institution or any Affiliate or Related Entity by a third party as a result of the purchase, sale or holding of an Asset by a plan, participant or beneficiary account, or IRA. A ***proprietary product*** is defined for purposes of this exemption as a product that is managed by the Financial Institution or any of its Affiliates.

The contract must provide the address of a ***Web page*** that discloses the compensation arrangements entered into by the Adviser and the Financial Institution. The Web page must show the direct and indirect material compensation payable to the Adviser, Financial Institution and any Affiliate for services provided in connection with each Asset (or, if uniform across a class of Assets, the class of Assets) that a plan, participant or beneficiary account, or an IRA, is able to purchase, hold, or sell through the Adviser or Financial Institution, and that a plan, participant or beneficiary account, or an IRA has purchased, held, or sold within the last 365 days, the source of the compensation, and how the compensation varies within and among Asset classes. The Web page must be easily accessible and updated at reasonable intervals, not less than quarterly. The compensation may be expressed as a monetary amount, formula or percentage of the assets involved in the purchase, sale or holding.

Individual Transactional Disclosure

There must be ***point of sale disclosure*** to the Retirement Investor, prior to the execution of the investment transaction, regarding the all-in cost and anticipated future costs of recommended Assets. The disclosure is designed to make as clear and salient as possible the ***total cost that the plan***, participant or beneficiary account, or IRA will incur when following the Adviser's recommendation, and to provide cost information that can be compared across different Assets that are recommended for investment. In addition, the projection of the costs over various holding periods would inform the Retirement Investor of the cumulative impact of the costs over time and of potential costs when the investment is sold.

Individual Annual Disclosure

Individual disclosure is also required in the form of an ***annual disclosure.*** Specifically, the proposal requires the Adviser or Financial Institution to provide each retirement investor with an annual written disclosure within 45 days of the end of the applicable year. The annual disclosure must include: (i) A list identifying each Asset purchased or sold during the applicable period and the price at which the Asset was purchased or sold; (ii) a statement of the total dollar amount of all fees and expenses paid by the plan, participant or beneficiary account, or IRA, both directly and indirectly, with respect to each Asset purchased, held or sold during the applicable period; and (iii) a statement of the total dollar amount of all compensation received by the Adviser and Financial Institution, directly or indirectly, from any party, as a result of each Asset sold, purchased or held by the plan, participant or beneficiary account, or IRA, during the applicable period. This disclosure is intended to show the Retirement Investor the impact of the cost of the Adviser's advice on the investments by the plan, participant or beneficiary account, or IRA.

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