April 8, 2016

Fiduciary Rule – Prohibited Transaction Exemption 84-24

On April 6, 2016, the U.S. Department of Labor ("DOL") made available its much-anticipated final regulation on the definition of "fiduciary" under section 3(21)(a)(ii) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The new rule will have a profound impact on the retirement system and how services are provided throughout the industry. The package of materials released by DOL includes the following:

- A final regulation re-defining who is a "fiduciary" by reason of providing investment advice to a plan or an IRA (the "Final Regulation");

- Final versions of the Best Interest Contract Exemption (the "BIC Exemption"), related supplemental exemptions, and the new prohibited transaction class exemption for principal transactions in certain investments (the "Principal Transactions Exemption"); and

- Final amendments to several existing prohibited transaction class exemptions, including prohibited transaction class exemption ("PTE") 84-24, currently the primary source of prohibited transaction exemptive relief for the sale of insurance and annuity products to plans and IRAs.

The Final Regulation, changes to existing class exemptions, and certain elements of the BIC Exemption will be effective 60 days from the date of their publication in the Federal Register (*i.e.*, June 7, 2016). Despite this relatively early effective date, the terms of the rules generally delay their applicability until April 10, 2017. In the case of the BIC Exemption, special transition relief further delays the applicability of most conditions until January 1, 2018.

This client alert provides an overview of the finalized changes to PTE 84-24. For an analytical summary of the Final Regulation, BIC Exemption, the Principal Transactions Exemption, and changes to other existing exemptions, please see our client alerts covering those subjects.

I. Executive Summary

PTE 84-24 has been substantially trimmed. It no longer provides exemptive relief for transactions involving Fixed-Indexed Annuities or Variable Rate Annuities. Now, it only provides relief for Fixed Rate Annuity Contracts sold to plans and IRAs and for sales of mutual funds by principal underwriters to plans. The amendments to PTE 84-24 clarify that exemptive relief is available for sales of Fixed Rate Annuity Contracts in connection with rollover recommendations. Finally, fiduciaries seeking shelter under PTE 84-24 from the prohibited transaction prohibitions of ERISA sections 406(a)(1)(A)-(D) and 406(b), must comply with the "Impartial Conduct Standards" that DOL also

introduced in the BIC Exemption. PTE 84-24's narrowed scope effectively leaves the BIC Exemption as the sole source of exemptive relief for sales of annuity products other than fixed.

II. Pre-Amendment PTE 84-24

PTE 84-24, in its present form (the "Pre-Amendment Exemption"), provides relief from ERISA sections 406(a)(1)(A)–(D) and 406(b), and the parallel Internal Revenue Code provisions, for the following transactions with respect to plans and IRAs—

- The receipt of commissions by an agent, broker, or pension consultant in connection with the purchase of an insurance or annuity contract;
- The receipt of commissions by a principal underwriter in connection with the purchase of mutual fund shares;
- The effecting by an insurance agent or broker, pension consultant, or investment company principal underwriter of a transaction for the purchase, with plan assets, of an insurance or annuity contract or securities issued by an investment company; and
- The purchase of an insurance or annuity contract.

Several conditions apply to the relief granted by the Pre-Amendment Exemption. The transaction must be on terms at least as favorable as an arm's length transaction with an unrelated party would be, no more than "reasonable compensation," within the meaning of ERISA section 408(b)(2), may be paid, and the transaction must be effected in the "ordinary course" of the business of the insurance agent or broker, pension consultant, insurance company, or investment company principal underwriter. Generally, an independent fiduciary, such as a plan's named fiduciary, must also approve the transaction after receiving disclosures concerning fees and whether the agent, broker, or consultant is limited by contract from recommending certain investments.

As of the applicability date of April 10, 2017, the changes described below will apply to PTE 84-24 (to the "Amended Exemption").

III. Key Changes to PTE 84-24

A. Covered Insurance and Annuity Products

PTE 84-24 is amended to significantly limit the scope of relief available to cover sales of annuity products. Only sales of Fixed Rate Annuity Contracts are covered. The Amended Exemption defines a Fixed Rate Annuity Contract as an immediate or deferred annuity providing benefits that do not vary based on the investment experience of a separate account maintained by the insurer and that either (1) satisfies applicable state nonforfeiture laws at the time of issue or, (2) in the case of a group fixed annuity, guarantees the return of principal net of reasonable compensation and provides a

guaranteed declared minimum interest rate in accordance with the applicable state nonforfeiture laws for individual deferred annuities.

Moreover, the Amended Exemption explicitly no longer covers sales to IRAs or plans of either Fixed-Indexed or Variable Annuity Contracts. An appendix to the Amended Exemption provides a comparison chart of the features of Fixed Rate Annuities, Fixed-Indexed Annuities, and Variable Annuities, as DOL sees them.

For Fixed-Indexed and Variable Annuity sales, the BIC Exemption is available. In the preamble to the Amended Exemption, DOL explains that it ultimately determined that the conditions of the Pre-Amendment Exemption were insufficiently protective to safeguard the interests of plans and IRAs in investing in Fixed-Indexed and Variable Annuity products in light of the complexity, risks, and enhanced conflicts associated with those products. In DOL's view, the BIC Exemption's conditions, which include a contractual commitment to adhere to the Impartial Conduct Standards when transacting with IRA owners, adoption and adherence to anti-conflict policies and procedures, and required disclosures, are better suited to address the conflicts of interest that accompany those products.

We also note that the Amended Exemption now includes a distinction between annuity contracts and other, non-annuity insurance contracts. The Amended Exemption continues to be available for such other forms of insurance (*e.g.,* various types of life insurance), to the extent that recommendations to purchase that insurance constitute investment advice. The Final Regulation provides that fiduciary advice does not include recommendations to purchase "health insurance policies, disability insurance policies, term life insurance policies, and other property to the extent the policies or property do not contain an investment component."

In summary, the Amended Exemption provides relief only for --

- The receipt of "Insurance Commissions" (as newly defined) in connection with the purchase of a Fixed Rate Annuity Contract with assets of a plan or IRA;

- The receipt of "Mutual Fund Commissions" (newly defined) in connection with the purchase of mutual fund shares with assets of a plan;

- The effecting of a transaction for the purchase of Fixed Rate Annuity Contracts or other insurance contracts with assets of a plan or IRA, or of mutual fund shares with assets of a plan (e.g., the provision of services in connection with these purchases); and

- The purchase from an insurer of Fixed Rate Annuity Contracts and other insurance contracts with assets of a plan or IRA.

B. Rollover Transactions

Some commentators requested clarification that PTE 84-24 would cover the sale of annuity products in connection with rollover transactions. The Amended Exemption

includes new language indicating that rollover-related sales of Fixed Rate Annuity Contracts are covered.

C. Reasonable Compensation

DOL has changed the definition of reasonable compensation for purposes of the Amended Exemption to require that the "combined total of all fees and compensation received . . . for their services does not exceed reasonable compensation within the meaning of ERISA section 408(b)(2) and Code section 4975(d)(2)." DOL explains that this change was made in order to harmonize the definitions of reasonable compensation across the Amended Exemption and the BIC Exemption.

In the preamble to the Amended Exemption, DOL clarified that the determination of whether compensation is reasonable depends on the facts and circumstances, and factors to consider include, among other things, (1) the market pricing of service(s) provided and the underlying, asset(s), (2) the scope of monitoring, and (3) the complexity of the product. Further, DOL stated that providers are not required to recommend the investment with the lowest cost, without regard to other relevant factors. In the preamble to the Amended Exemption, DOL notes that "spread" (*e.g.,* the difference between the fixed return credited to the contractholder and the insurer's general account investment experience) should not be treated as compensation for this purpose.

D. Insurance Commissions and Benefits for Statutory Employees

DOL narrowed the scope of permissible commissions paid to fiduciary advisers for insurance sales. A "commission" is now a defined term, meaning "a sales commission paid by the insurance company to the insurance agent or broker or pension consultant for the service of effecting the purchase of a Fixed Rate Annuity Contract or insurance contract, including renewal fees and trailers, but not revenue sharing payments, administrative fees, or marketing payments."

On the positive side, DOL did extend relief for other types of adviser compensation. Some insurance agents may be eligible to qualify for employee benefits such as health care and retirement benefits if they meet certain production thresholds for sales of the sponsoring company's products. Some commenters requested clarification that the receipt of these benefits would be covered by PTE 84-24.

The Amended Exemption clarifies that it provides relief for an insurance agent's receipt of employee benefits in connection with the sale of annuities and insurance contracts. DOL further clarified that an agent's receipt of health or pension benefits would not violate the Impartial Conduct Standards "in and of itself," so long as the payment of the benefits is not structured in a way to undermine the insurance agent's ability to comply with the standards.

E. Disclosure Requirements

As noted above, the Pre-Amendment Exemption required the provision of certain disclosures ("Transaction Disclosures") prior to the execution of a transaction. Additional disclosures were required if an additional purchase was made and three years

had passed since the prior disclosure or if there were material changes to the information in the initial disclosure.

Under the Amended Exemption, an advice fiduciary must still provide a Transaction Disclosure in writing and in an easy to read and understand format prior to the execution of a transaction. With respect to recommendations to purchase annuities and insurance contracts, the Transaction Disclosure must include:

- A disclosure of the insurance commission for the first year and for each of the succeeding renewal years that will be paid by the insurance company to the provider of advice (and, if applicable, a separate identification of any amount of the commission that will be paid to any other person as a gross dealer concession, override, or similar payment);

- A statement of any charges, fees, discounts, penalties, or adjustments which may be imposed in connection with the purchase, holding, exchange, termination, or sale of the contract; and

- If the provider of advice is an affiliate of the insurance company or the products it can recommend are limited by its relationship with an insurance company, a description of the nature of the affiliation, limitation, or relationship.

With respect to recommendations to purchase annuities and insurance products, as well as mutual fund securities, the commission must be expressed, to the extent feasible, as an absolute dollar figure, and if not feasible, as a percentage of gross annual premium payments, asset accumulation value, or contract value.

Also, the Amended Exemption updated the frequency of new Transaction Disclosures that must be provided in connection with additional purchases — the disclosures must now be provided every year, instead of every three years.

F. Impartial Conduct Standards

The Impartial Conduct Standards (*e.g.,* duty to act in the best interest of the plan or IRA and the duty to avoid misleading statements) have been retained in the Amended Exemption in largely the same form as proposed. As with the BIC Exemption, the Impartial Conduct Standards of the Amended Exemption have been modified slightly to include a reference to ERISA's "prudent expert" standard of care. The Amended Exemption provides that –

> . . . a fiduciary acts in the "Best Interest" of the Plan or IRA when the fiduciary 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, based on the investment objectives, risk tolerance, financial circumstances and needs of the Plan or IRA, without regard to the financial or other interests of the fiduciary, any affiliate or other party.

G. Mutual Funds

Historically, the Pre-Amendment Exemption allowed an investment company's principal underwriter (or an affiliate) to receive commissions in connection with a plan's or IRA's purchase of mutual fund shares. Consistent with the proposed amendment, the Amended Exemption excludes relief for such mutual fund sale to IRAs.

The Amended Exemption also retains the proposed amendment's narrow definition of covered "mutual fund commissions." Mutual fund commissions are now defined as a commission or sales load paid either by the plan or the investment company for the service of effecting or executing the purchase of investment company securities. Importantly, mutual fund commissions do not include a 12b-1 fee, revenue sharing payment, administrative fee, or a marketing fee. Thus, the Amended Exemption will not cover many forms of common compensation in the industry. The preamble to the Amended Exemption expressly refers principal underwriters advising IRAs towards use of the BIC Exemption.