ADVANTAGE COMPENDIUM

Opinion on Dept of Labor Fiduciary Standards 2016 Revisions April 2016

How The New DOL Fiduciary Standard Revisions Affect Agents

I'll begin with my ending:

1) My opinion is ***the DOL revised Fiduciary Standard rules WILL NOT go into effect***. Several lawsuits will be filed with the final result being the court staying implementation of the revisions until the DOL has redone their analysis of the economic impact of the proposed revisions, especially as it relates to annuity marketing companies and fixed index annuity carriers. Since this would effectively force the DOL to restart the process in a less supportive political environment – regardless of which party wins the presidency – it won't happen and this revision will die.

2) ***The DOL Fiduciary Standard rules have NO EFFECT IN 2016***. The "applicability" date for sales under the new rules is 10 April 2017. If you are selling annuities, nothing has changed from the way you were operating yesterday. If you're an agent the best approach when seeing news and editorials about the DOL revisions is to ignore them. Until the courts rule it's all simply noise that will get into your head and distract you from doing your job if you let it.

3) ***This does not affect sales of non-qualified annuities*** – today or tomorrow.

The Effect on Agents:

Fixed Rate, DIA and Immediate Annuities (PTE 84-24)
You may receive a reasonable commission on a fixed rate annuity, immediate annuity or deferred income annuity if:

1a) You admit you are a fiduciary.

1b) You show, in writing, the commission – plus any cash or non-cash incentives - you are receiving in the first and any subsequent years, and show any overrides that marketing companies you are contracted through are receiving on the purchase, preferably as a dollar amount, but a percentage may be used.

1c) You disclose Material Conflicts of Interest and show policy fees and surrender charges.

1d) The annuity buyer signs off on a disclosure detailing these items.

2). The transaction is on terms at least as favorable to the Plan or IRA as an arm's length transaction with an unrelated party would be.

3) You retain records for 6 years demonstrating compliance with the exemption.

Index Annuities BIC (Best Interest Contract) Exemption

You may receive a reasonable commission on an annuity or cash value insurance contract if:

1a) You admit you are a fiduciary and agree to put the client's best interest first.

1b) You show, in writing, the commission – plus any cash or non-cash incentives - you are receiving, and show any overrides that marketing companies you are contracted through are receiving on the purchase, preferably as a dollar amount but a percentage may be used.

1c) You disclose Material Conflicts of Interest and any other fees.

1d) You state whether you will be monitoring the performance of the annuity, suggesting changes if needed, and, if monitoring, state how often.

1e) The annuity buyer signs off on a disclosure detailing these items.

2). You adhere to Impartial Conduct Standards and agree to put the client's best interest first. This is defined as recommending the annuity that reflects 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 Retirement Investor, without regard to the commission.

3) You retain records for 6 years demonstrating compliance with the exemption.

4) The annuity buyer agrees, you can agree to limit claims in future lawsuits against you to actual and not punitive damages.

5) None of these provisions apply or are enforced on trailing commissions you are receiving from an annuity purchase made prior to 10 April 2017. However, if new commissions are generated from new premiums the fiduciary provisions apply (example: a flexible premium annuity is purchased in March 2017 and the buyer adds premium in May 2017. The new "sale" would fall under all of the new fiduciary rules – if the agent recommended adding to the annuity).

Differences Between BIC and PTE 84-24

Two words: potential liability. To avoid liability when selling a fixed annuity that falls under PTE 84-24 (basically every type of fixed annuity except index annuities) the agent simply needs to show that no special deals were made and the annuity buyer was treated the same as everyone else buying the same annuity. An agent should not have to defend why he sold a 7 year multiple year guaranteed annuity (MYGA) that had a rate of 2.5% and paid a 4% commission instead of the 7 year MYGA with rate of 3% that had a 3.5% commission.

By contrast, since a fixed index annuity falls under the Best Interest Contract Exemption the agent must put the client's best interest first and this means showing that an independent third party would have made the same recommendation.

Example: If the agent sold an annuity with a 10 year surrender period and a 7% commission and a similar one with a 7 year surrender period was available with a 5% commission, or if the agent had two similar FIAs available, but selected the FIA from the carrier with lower financial ratings that also happened to pay a higher commission than the higher rated insurer, that the agent would need to demonstrate that the difference in commission had zero impact on the agent's recommendation.

There are many other differences between BIC and PTE 84-24 from how "grandfathering" existing arrangements is treated to insurer supervision and disclosures, but the biggest one for non-captive agents is the potential liability if it is alleged you didn't act like a fiduciary.

Applicability Dates

10 April 2017. On this date the agent must act as a fiduciary for qualified annuity purchases.

1 January 2018. Any remaining changes in the DOL revision not yet in effect go into effect.

Serving 3 Masters

Under the DOL revisions the typical fixed annuity agent will be operating under three different regulatory and liability environments, possibly when working with the same annuity buyer:

Fixed Rate/Fixed Index (nonqualified) – Agent is governed by state insurance laws and liability pertaining to laws of agency and any Suitability Requirement the Insurance Department imposes on annuity sales.

Fixed Rate (qualified) – Agent is governed by state insurance laws and liability pertaining to laws of agency and any Suitability Requirement the Insurance Department imposes on annuity sales. In addition, agent is acting as a fiduciary and to receive a commission must act under the tenets of Prohibited Transaction Exemption 84-24 that requires the agent to ensure the terms of the annuity are at least as favorable to the Plan or IRA as an arm's length transaction with an unrelated party would be.

Fixed Index (qualified) – Agent is governed by state insurance laws and liability pertaining to laws of agency and any Suitability Requirement the Insurance Department imposes on annuity sales. In addition, agent is acting as a fiduciary and to receive a commission must act under the tenets of the Best Interest Contract which, in addition to several other points, requires the agent to recommend an annuity that reflects 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.

Can you even picture a scene where the agent is meeting with the customer about purchasing a fixed index annuity and the agent has shown a spreadsheet of the 20 possible annuities that might be in the best interests of the customer (also disclosing the commission), and then customer says he has other IRA funds and he might like a MYGA. The agent then brings out one brochure and says this one is offered on terms at least as favorable to you as to others (also disclosing the commission). And now the customer says he has nonqualified funds for an FIA and the agent again brings out only one choice and refuses to disclose the commission? Neither can I.

The reality is disclosure forms, standards for recommendations, and even compensation will all move towards complying with the most restrictive supervisory/liability option. In short, longer and more complicated disclosures, more sales and annuity transfers/exchanges declined because they may not fit a narrow interpretation of "best interest", lower commissions for agents and much lower overrides for marketing companies.

What Is Reasonable Compensation and What is "Best Interest"

Saying that the agent's recommendation was in the annuity buyer's best interest is based on if it is the same decision that a prudent person would make....seems a little vague, doesn't it. Agents acting as fiduciaries can receive "reasonable compensation", but what is reasonable?

On the later the DOL has provided a little guidance. For example, they have said on a fixed rate or fixed income annuity that just because the annuity pays a higher commission than a mutual fund that might have reached the same goal, that it doesn't make the higher commission unreasonable. However, the DOL has been very clear that the way they see all of the terms being defined is by plaintiff lawyers suing agents and carriers and watching how the courts decide.

Why The Lawsuits Will Prevail

I'm not a lawyer, but I also wasn't a lawyer when I said that SEC Rule 151A would be struck down by the courts a year before American Equity Inv. Life Ins. Co. v. SEC was brought before the U.S. Court of Appeals for the D.C. Circuit that vacated rule 151A because it was "arbitrary and capricious in failing to properly consider the effect of the rule on efficiency, competition, and capital formation".

That lawsuit was about interpretations of the Securities Act which does not apply here, but other provisions do. Title II of the Unfunded Mandates Reform Act of 1995 requires each Federal agency to prepare a written statement assessing the effects of any Federal mandate in a proposed or final agency rule that may result in an expenditure of $100 million or in any one year by the private sectors. The annual cost of the DOL revision to consumers is in the billions.

The DOL did do an economic analysis. It estimated costs for small, medium and large broker/dealers, for registered investment advisors and, in some fashion, for insurers. The DOL even says that TIAA and Northwestern Mutual submitted estimate of the cost of compliance. However, the DOL minimizes the effect of the DOL revision on index annuity carriers by saying they aren't big firms, and, anyway, only twelve of the FIA providers don't also sell variable annuities too and if they sell variable annuities they have to spend the money anyway. The DOL failed to accurately depict the cost to FIA insurers of the DOL mandate and completely ignored the effect on the marketing organizations that bring in $30 billion of fixed annuity sales and employ thousands of consumers across the country.

Summary

The DOL Fiduciary Revision is a poorly designed rule designed to fix a problem that they cannot convincing show even exists. Their economic analysis is flawed and severely underestimates the cost and damage the rule will cause index annuity insurers, marketing companies and agents. On this basis alone, a lawsuit will prevail that stops the revision and sends it back to the DOL where it will die.

Addendum –Background Of The DOL Rule & Editorial Comments

Background

For several decades the financial world operated under a dual standard – a fiduciary one where the professional had control of the consumer's money and a suitability one where the professional recommended investments that were suitable for the consumer, but did not directly control the assets. The two systems worked rather well. Fixed annuities were not a part of either standard since they operated under the laws of agency. However, Dodd-Frank changed this a bit by placing fixed index annuity sales under suitability rules. As a practical matter the majority of states applied these suitability rules to all fixed annuity sales.

In 2009 Phyllis Borzi was named by the President to head up the private-sector benefit plan area. Borzi decided that a fiduciary-only standard was needed to protect consumers from being harmed – without showing any proof then or subsequently that U.S. consumers were being harmed more by a suitability approach than a fiduciary one. In spite of this, Borzi began pushing for the DOL fiduciary-only standard in 2010. Due to heavy resistance, the proposal looked unlikely to prevail...until Borzi made several visits to the President in the fall of 2014 and early 2015. Subsequently, the President announced his support for the DOL fiduciary-only standard and the attitude changed from "never happen" to "sure thing".

<u>The Economic Advisor Cocktail Napkin "Study"</u>

The basis for White House support was a paper that is called a "study" by proponents, but is, in reality, a four and a half page memo from the President's Council of Economic Advisers that says a non-fiduciary standard costs consumers $17 billion a year. They came up with this imaginary number by looking at one preliminary working paper involving 792 university employees [Chalmers & Reuter, 2012]. This paper did show that the brokered group earned 0.9% less a year than the do-it-yourself group, but it omits an inconvenient truth. This retirement plan gave participants two options; they could meet and work with a broker, or they could pick their own investments and "here is an armload of reading material and a list of links to investment webinars, good luck". The participants that chose to use a broker were younger and less experienced. **When asked why they chose the broker option 70% said the ability to meet with and talk to a broker was important to them.** This brokered group recognized they needed professional help and chose to pay for it.

From this one look of 791 people where some university employees chose to pay a professional for his help, we got the DOL saying that conflicted advice is costing working and middle class families $17 billion a year. This is like saying John Doe paid $60 to get his taxes done by a CPA, but the CPA took advantage of him because John Doe would have had $60 more if he'd done his own taxes, and since there are 200 million people filing returns that obviously tax preparers are costing families $12 billion a year. This ignores that John Doe may not be able or want to do his own taxes.

<u>Over 3000 Comments & 100 Meetings– The Bulk Saying What A Bad Rule It Is</u>

In the end, even though Borzi admitted to Congress that the DOL could never find any research that demonstrated abuse in having a dual standard[1] and that the majority of the comments were against the proposal, the final rule was still issued.

DOL Says Fixed Index Annuities Are Identical To Variable Annuities, Options And REITs

I don't know which of the early DOL meetings had a gadfly or industry competitor telling the DOL that FIAs posed the same risk as VAs, but he did quite a sales job. Despite several meetings and a great detail of evidence demonstrating that the only real difference between fixed rate annuities and fixed index annuities is that FIAs typically resulted in more interest over time, the DOL ruled that a fixed annuity with interest guarantees and no risk of stock market loss had the same risk as a variable annuity, option or non-traded REIT where 100% of your money could conceivably be lost.

You can get an idea of who was catching their ear by the language. Those covered by PTE 84-24 are "traditional annuities" and "deferred income annuities" are specifically included. The DOL says that lifetime income guarantees are important, but does not mention guaranteed lifetime withdrawal benefits except by negative implication by stating that deferred income annuities get the exemption because they have "terms that are more understandable to consumers".

The DOL excludes FIAs by saying the exemption excludes annuities "in which contract values vary...based on...the investment experience of an index or investment model". However, a good lawyer could convince a judge that FIA contract values never vary "based on the investment experience of an index" because (1) the annuity does not invest in the index, (2) the annuity value can never negatively vary, or (3) all fixed declared rates vary based on index or investment model since they will change in the future based on the returns of the general account model and, in this, FIAs are identical. The DOL also says fixed rate annuities get the exemption based on predictability of payments, but future fixed rate account values over and above the minimum guarantees suffer the same uncertainties as FIAs.

It attempts to justify the exclusion by citing opinions from securities regulators, some from over a decade ago – no insurance regulators are cited – and the few commenters that said FIAs should not have the exclusion (there are many sentences that begin "One commenter" and then slam FIAs" while minimizing the majority of positive comments about FIAs by saying "According to *some* commenters" FIAs are good). It then says FIAs are too complex and that investors can "overestimate the scope of their protection from downside risk". Of course, it provides zero instances where annuitybuyers have been damaged and fails to say what "scope" the DOL is talking about. Finally, it repeatedly says that surrender charges can cause an "investor" to get back less than their principal - *So there!* But ignores the reality that surrender charges can cause the same loss with fixed rate annuities (and immediate annuities cannot usually be cashed in at all).

It is apparent the entire DOL revisions ignores the academic approach where one discovers the truth by looking at the facts, and instead uses the politician's angle where you decide what you want the outcome to be beforehand and then mention only those facts that support your preconceived result. Frankly, the overwhelming feeling I got from reading the thousand plus pages of the DOL revision was one of disgust.

John Chalmers & Jonathan Reuter. 2012. *What is the impact of financial advisors on retirement portfolio choices and outcomes?* NBER Working Paper 18158 http://www.nber.org/papers/w18158

1. Testimony of Phyllis C. Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration Before the House Committee on Education and the Workforce, Subcommittee on Health, Employment, Labor, and Pensions. 26 July 2011 http://www.dol.gov/ebsa/pdf/ty072611.pdf