Debevoise & Plimpton

Insurance Industry Corporate Governance Newsletter

Introduction

As we outlined in our November 6 Debevoise In-Depth, the Department of Labor (DOL) recently unveiled its long-awaited proposal to revise the definition of an investment advice fiduciary under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the corresponding prohibited transaction provisions of the Internal Revenue Code.

In this edition of our Insurance Industry Corporate Governance Newsletter, we explore how this proposed rulemaking, which includes proposed amendments to two existing prohibited transaction exemptions, could impact insurance companies and agents in their sales of annuities to retirement investors. Understanding these proposals, and their potential impact on business practices going forward, will be very important to directors and officers of insurance companies engaged in the sale of retirement products and providing investment advice.

A Broader Concept of Investment Advice

Similar to previous unsuccessful efforts by the DOL to revamp these rules, the proposed rule would cause any investment recommendation to a retirement investor to be fiduciary investment advice if the person making the recommendation receives compensation in connection with the related investment decision. This would include one-time recommendations to roll over assets from a qualified employer plan or individual retirement account (IRA) into an annuity product, regardless of the frequency of any ongoing advice. Indeed, the DOL has been trying for over a decade to bring rollover recommendations under the umbrella of fiduciary advice, the presumption apparently being that retirement investors would generally be better off leaving their retirement assets in the employer plan, in terms of fees and available investment alternatives.

The scope of the proposed rule would likely cause many, if not all, ordinary course annuity sale transactions that are funded from an employer plan or an IRA to be made in a fiduciary capacity by the insurance company and the agent. If annuity sales are made in a fiduciary capacity and the fiduciary receives commissions in connection with the recommendation, the payment of those commissions would result in a prohibited transaction under ERISA and the corresponding excise tax provisions of the Internal Revenue Code, unless the insurance company and agent comply with an available prohibited transaction exemption.

The Exemptions and the DOL's Proposed Amendments to those Exemptions

There are two existing prohibited transaction exemptions available to insurance companies and their agents that would permit the receipt of commissions received in connection with the provision of fiduciary investment advice, both of which the DOL is proposing to amend.

- **Prohibited Transaction Exemption (PTE) 2020-02.** This exemption was finalized in 2020 as an effort to have insurers and others making rollover recommendations acknowledge fiduciary status in that context and adhere to a standard of conduct designed to mitigate potential conflicts of interest associated with the offering of commission-based products.[1] The exemption applies to the receipt of commissions by the investment advice fiduciary, as well as certain principal transactions with that fiduciary.

  PTE 2020-02 requires compliance with a "best interest" standard when making fiduciary investment recommendations. That standard includes (i) adhering to ERISA's prudent person standard of care and (ii) making recommendations that do not place the interests of the insurance company or agent ahead of the interests of the retirement investor. The latter portion of this standard mirrors the standard applicable to broker-dealers and others subject to the Securities and Exchange Commission's Regulation Best Interest, although Regulation Best Interest does not impose fiduciary status on those that it regulates.

  In addition to complying with this best interest standard, to avail themselves of the exemption available under PTE 2020-02 insurance companies and their agents would be required to acknowledge their fiduciary status in writing (and thus be precluded from ever arguing that they were not actually providing fiduciary investment advice), adopt policies and procedures designed to ensure compliance with the terms of the exemption, and document that compliance on an annual basis. Detailed disclosure regarding the reasons for a recommendation, the insurance company and agent's conflicts of interest, and the fees that are received from the sale must also be provided to the retirement investor.

- **Prohibited Transaction Exemption 84-24.** This is a commonly used exemption for commission-based annuity sales, and in its current form provides relief for both the payment of the commissions and the related sale of the annuity itself (which the DOL considers two separate transactions). Under the proposal, PTE 84-24 would be modified and narrowed as it relates to commissions received by fiduciaries. First, commission-based payments would only be exempt if the insurance company and the agent provide recommendations in accordance with a "best interest" standard, as well as complying with policy and procedure and documentation requirements that are substantially identical to those that apply under PTE 2020-02, as noted above.

  Second, PTE 84-24 is only available for transaction effected by **independent agents** offering products from **two or more insurers**. This excludes captive agents and those selling solely for one insurance company. These captive agents, along with the insurance companies for whom they sell annuities, would need to rely instead only on PTE 2020-02. The primary

[1] The original exemption included an attempt by the DOL to expand the scope of what constitutes fiduciary investment advice by redefining the concept of "ongoing" advice to include advice expected to be provided following a rollover recommendation. District court decisions have since held that subsequent advice could not be applied to assign fiduciary status to a rollover recommendation, which led to the current effort to amend the definition of what actions will make a person an investment advice fiduciary.

difference between the two exemptions relates to the insurance company's acknowledgement of fiduciary status (which is not required under PTE 84-24 when recommendations are made by independent agents) and the insurance company's duty to monitor and control the behavior of the agents (which is somewhat less strict in respect of independent agents under PTE 84-24).

- **Clarification of the Application of PTE 2002-02 to Annuity Sales**. As we have noted previously, there also appears to be a potential glitch in the scope of PTE 2020-02, which does not expressly provide relief to the sale of the annuity itself that PTE 84-24 provides. When it finalized PTE 2020-02, the DOL stated in the preamble to that exemption that annuity sales could be covered under the exemption, because an annuity sale was not a principal transaction for purposes of the exemption. We understand that certain industry participants who have already elected to comply with PTE 2020-02 (and thus have accepted fiduciary status in connection with their annuity sales) have also relied on the DOL's statements in the preamble. The preamble to PTE 2020-02, as proposed to be amended, does not include a similar statement about the sale of annuities not being principal transactions, and cautions that the exemption only applies to the limited universe of principal transactions expressly covered in the exemption itself. Given the fact that PTE 84-24, as proposed to be amended, would not exempt sales effected by a captive agent, the DOL should expressly clarify whether it intends PTE 2020-02 to apply to such sales.

Private Right of Action

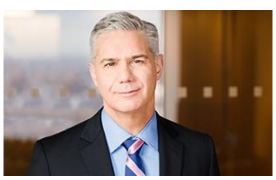
As opposed to the so-called "Best Interest Contract Exemption" that was an integral part of the DOL's prior effort to expand the activities that constitute fiduciary investment advice, neither PTE 2020-02 nor PTE 84-24 includes a new private right of action for IRA investors in the event an investment advice fiduciary receives compensation without complying with the terms of the exemption. This private right of action for IRA investors that was created by the DOL's 2016 rulemaking was one of the key reasons that rule was vacated by a federal appeals court – Congress clearly decided to limit private rights of action to participants in ERISA-covered plans and left enforcement of the Internal Revenue Code's prohibited transaction rules to the Internal Revenue Service alone.

Of course, under the recently proposed amendment to the DOL's investment advice regulations, fiduciary recommendations that relate to assets held in an employer-sponsored plan, and rollover recommendations in particular, would be subject to ERISA, and under the statute itself, a retirement investor does have a private right of action for breaches of ERISA's fiduciary responsibility provisions. Thus, while it is not creating a new right of action, the DOL is expanding the circumstances in which ERISA-covered retirement investors can bring an action under the statute. And, as with the Best Interest Contract Exemption, this private right of action could be brought on a collective basis via a class action lawsuit.

What's Next for this Rulemaking?

- The DOL has proposed an expedited timeline for the rule's notice and comment process. Comments were due January 2, 2024, a period of just over sixty days after the proposed rule was first made available and spanning two major U.S. holidays. The DOL has expressly declined a request from certain trade groups to extend that comment period, and the DOL held two days of public hearings, on December 12 and 13, before all comments were received and made available. This expedited timeline is almost certainly based on a desire to finalize the rule prior to the point in time that it could be repealed by a new Congress and a new administration under the Congressional Review Act, should President Biden lose his reelection bid.

- The final rule will be effective sixty days after it is published in the Federal Register. Given the timing issues under the Congressional Review Act, this could mean a final rule is published as early as May, and would then become effective by late summer 2024, with no transition period currently proposed. Insurance companies and agents who are not currently complying with PTE 2020-02 and who do not have affiliates required to comply with the SEC's Regulation Best Interest may have significant work to do in order to bring their sales practices into compliance with the relevant exemption. In this regard, it is worth restating that a condition to each of the exemptions is fiduciary acknowledgement by the insurance company and/or the agent making the recommendation. While it is possible for annuity sales practices to be non-fiduciary in nature, and thus avoid the need to comply with an exemption, the DOL is very skeptical that such a conclusion is an appropriate view of market practice, and will not permit insurance companies to rely on written disclaimers where it believes that agents are otherwise making recommendations as apparent fiduciaries.
- The only certainty around the rule at this point is that there will be litigation attempting to block it after it is finalized. While the likelihood of success of that litigation is impossible to predict, we do believe that the current proposal is substantively not very different at its core than the earlier DOL attempts that have been rejected by federal courts. While it has been crafted purposely to avoid certain of the criticisms leveled at the prior rule by the federal appeals court that vacated it, the DOL is again attempting to turn a single investment recommendation into a fiduciary act, and is again attempting to apply a standard of conduct to IRA investors that Congress expressly limited to ERISA-subject retirement plans. We expect these elements of the proposed rule will be areas of focus in whatever litigation ensues.



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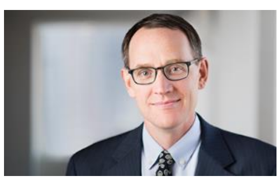

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