Core Catalysts

2016 Regulatory Update: Employee Retirement Income Security Act of 1974 (ERISA)

Changes influencing financial services and insurance firms

Introduction

This whitepaper covers certain changes to the Employee Retirement Income Security Act of 1974, known as ERISA. In light of the many changes, this paper will cover the "The Conflict of Interest Rule", which emphasizes "fiduciary duty" and mandates that brokers and advisers of retirement plans act in their clients' best interests.

Why is the regulation changing?[1]

For over four decades, ERISA law has remained unchanged while employer retirement offerings have evolved considerably – from employer-sponsored pension plans to individual retirement accounts (IRAs) to 401(k) plans. As new financial instruments have come to market, many pension fund managers have been supplanted by brokers.

Included in ERISA was a 5-part regulatory test whereby advisers were mandated to meet ***all 5 criteria*** in order to be classified as a "fiduciary", and because the language was framed narrowly, many advisers were precluded. The term "fiduciary" is defined by the U.S. Department of Labor as:

"…those persons or entities who exercise discretionary control or authority over plan management or plan assets, have discretionary authority or responsibility for the administration of a plan, or provide investment advice to a plan for compensation or have any authority or responsibility to do so are subject to fiduciary responsibilities. Plan fiduciaries include, for example, plan trustees, plan administrators, and members of a plan's investment committee."

"…a person is a fiduciary to a plan or IRA to the extent that the person engages in specified plan activities, including rendering "investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan"

Background:

Why is the regulation in place?[2]

The following is a list of certain key protections provided in the law:

- **Plan participant and dependent protections** - *i.e. employees and beneficiaries supported by the retirement investments*
- **Employment stability protections** – *including industries and commerce activities for those respective industries in the United States*
- **Protections that support additional vesting options for long-term employees**
- **Disclosure requirements that provide information to plan participant** – *including features, funding, and annual reporting requirements specified in 29 U.S. Code § 1023.*

- **Tax revenue requirement to protect United States tax revenue dollars** - safeguards for the operational and administrative aspects of the plans, since they receive preferential tax treatment
- **Asset protection in case of employer bankruptcy** – *requirements for retirement plan assets to be separate from business assets in case of insolvency*
- **Provisions for grievance and appeals process by plan participants** – *additional abilities to receive the benefits form their plans*
- **Provisions that allows participants to sue for benefits or breaches of fiduciary duty**

For a comprehensive list, see Title 29 USC, Chapter 18, Subchapter I, Subtitle B

What is the regulation code for ERISA?

The regulation is structured as follows:

Title 29 USC, Chapter 18, Subchapter I, Subtitle B
Part 1 - reporting and disclosure (§§ 1021 to 1031)
Part 2 - participation and vesting (§§ 1051 to 1061)
Part 3 - funding (§§ 1081 to 1085b)
Part 4 - fiduciary responsibility (§§ 1101 to 1114) ***---***Primary topic***
Part 5 - administration and enforcement (§§ 1131 to 1151)
Part 6 - continuation coverage and additional standards for group health plans (§§ 1161 to 1169)
Part 7 - group health plan requirements (§§ 1181 to 1191c)

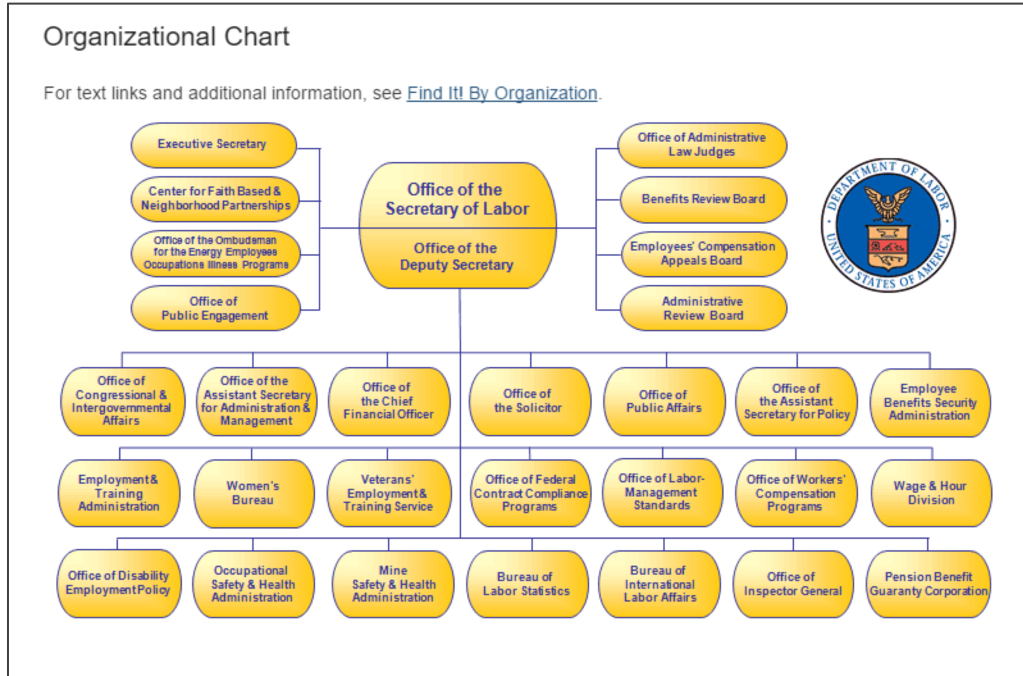
ERISA is also often referred to in conjunction with Internal Revenue Service code

What other amendments are covered in the regulation?

In addition to the regulatory code mentioned above, ERISA has had key amendments including the Consolidated Omnibus Budget Reconciliation Act (COBRA), the Health Insurance Portability and Accountability Act (HIPAA), the Newborns' and Mothers' Health Protection Act, the Mental Health Parity Act, and the Women's Health and Cancer Rights Act.

Who enforces the requirements of ERISA?

Enforcement is split between the U.S. Department of Labor (DOL) and U.S. Department of Treasury (DOT). The DOL comprises many offices. The Employee Benefits Security Administration (EBSA) is the office assigned to manage parts of ERISA as well as the Pension Benefit Guarantee Corporation. Under the DOT, the Internal Revenue Service (IRS) manages part of ERISA (IRS).



Source: U.S. Department of Labor

Who are non-government entities that administer and are responsible or impacted from the requirements of ERISA?[3]

The following non-government entities are involved in ERISA

- Plan administrators, broker/dealers, investment advisers
- Employers (a.k.a. Employee Organizations)
- Plan Participants (a.k.a. Employees, clients)
- An employer's plan administrator will perform required duties under ERISA unless the employer is acting as administrator; often, the insurance company acts as administrator

What changes will result from the regulation?[4]

A prominent rule, called "The Conflict of Interest" Rule has been created. The rule's primary focus is on "fiduciary duty". The rule mandates an adviser acts in the plan participant's best interests, and to do so, the firm must ensure the policies require a contract between plan participant and the fiduciary be executed. Enforcement of the rule and its respective contract is anticipated to help reduce the ability for incentives to perversely influence an adviser's benefit plan recommendations (including investment advice) to a plan participant (thus, offering "best interest" advice). Without this rule, an adviser could give advice that corresponds to sales incentive plans resulting in personal gain even if the result was negative financial outcome for a client. Pundits state that the rule will allow plan participants access to contractual evidence, which can be used in legal action with a fiduciary if there is a breach in contract.

Certain exceptions to the rule include the Best Interest Contract Exception (BICE) whereby a contract is not required. Other exceptions include the Class Exemption for Principal Transactions in Certain Assets that allow advisers to sell investments out of their own inventory. Certain Prohibited Transaction Exemptions are also provided, which allow some prohibited transactions to be grandfathered into the rule. Each exception has its own requirement.

For example, within BICE, fiduciaries may receive fees if they are classified as "Level Fee Fiduciaries". In this compensation structure fees are disclosed upfront in the contract, and provided as a set fee or as fixed percentage of the value of the asset. Fees that **are not** allowed include brokerage or insurance commissions, 12b-1 fees, revenue sharing payments, or revenues from third-party payments. Additionally, through BICE, a contract is not required; however, according to vol. 81, no. 68 Federal Register 21007, a *Financial Institution** is still required to perform certain duties listed below:

- *Acknowledge fiduciary status with respect to investment advice to the Retirement Investor;*
- *Adhere to Impartial Conduct Standards requiring them to:*
    - *Give advice that is in the Retirement Investor's Best Interest (i.e., prudent advice that is based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to financial or other interests of the Adviser, Financial Institution, or their Affiliates, Related Entities or other parties);*
    - *Charge no more than reasonable compensation; and payments meet the requirements of an exemption.*
    - *Make no misleading statements about investment transactions, compensation, and conflicts of interest;*
- *Implement policies and procedures reasonably and prudently designed to prevent violations of the Impartial Conduct Standards;*
- *Refrain from giving or using incentives for Advisers to act contrary to the customer's best interest; and*
- *Fairly disclose the fees, compensation, and Material Conflicts of Interest, associated with their recommendations.*

**** The definition for "Financial Institution" can be found on page 21083 of the Federal Register***

What are the impacts to insurance?

Insurance brokerage firms and annuity marketing organizations would need to comply with BICE in order to sell variable and equity-indexed annuities that are related to retirement accounts.

When are certain changes required?

The Effective date is June 7, 2016; however, the applicability date is **April 10, 2017**.

As stated in the Federal Register vol. 81, no. 68 FR 20946 (April 8, 2016), the Department of Labor states the applicability date of April 10, 2017 is "*adequate time for plans and their affected financial services and other service providers to adjust to the basic change from non-fiduciary to fiduciary status.*"

There will be a *"phased"* implementation for the Best Interest Contract Exemption and the Principal Transaction Exemption rules. The Department of Labor has provided an effective date of **January 1, 2018** for firms to sort out compliance needs required to comply with the rules including requirements for disclosure, documentation and implementation of policy and procedures, and contract changes therein.

Looking Forward:

How can advisers and broker-dealers comply and protect themselves?[5]

Below are a few methods of compliance that may be executed within the financial institution:

1.) **Documentation of the policies and procedures** used to carry out fiduciary responsibilities in order to:
   - Document how the financial institution is requiring its financial advisers to maintain "basic standards of impartial conduct". This includes providing prudent advice, reasonable compensation, and avoiding misleading statements.
   - Document how the financial institution is mitigating conflicts of interest. This may include coverage through fidelity bonds.
   - Document how the financial institution will communicate any occurrences of conflicts of interest
   - Requirement that plans must have at least one fiduciary

2.) **Creation of a compensation model that supports "Level Fee Fiduciaries"**
   The compensation structure would disclose fees upfront in the contract. Fees would be set or as fixed percentage of the value of the asset.

3.) **Creation of an enforceable contract with investor that** *"set forth the standards of fiduciary conduct and fair dealing in an enforceable contract with the investor. The contract creates a mechanism for IRA investors to enforce their rights and ensures that they will have a remedy for advice that does not honor their best interest"*

4.) **Maintenance of controls for duties and roles**
   According to Department of Labor's ERISA FAQs, *"fiduciary status is based on functions performed for the plan, not just the person's title."* Controls include:
   - Limiting the level of advice a broker-dealer can provide to participants, including rollovers (6)
   - Training for appropriate sales communications – i.e. what constitutes a "recommendation"
     - *"Paragraph (b)(1) provides that ''recommendation'' means a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action. The determination of whether a ''recommendation'' has been made is an objective rather than subjective inquiry"*
     - *"In addition, the more individually tailored the communication is to a specific advice recipient or recipients about, for example, a security, investment property, or investment strategy, the more likely the communication will be viewed as a recommendation"*

5.) Hire a covered service provider (CSP) to handle fiduciary functions

A Covered Service Provider is defined in vol. 77, no. 23 Federal Register 5632 (February 3, 2012) as *"a service provider that enters into a contract or arrangement with the covered plan and reasonably expects $1,000 or more in compensation, direct or indirect, to be received in connection with providing one or more of the services described…"* [in this Federal Register]…*"pursuant to the contract or arrangement, regardless of whether such services will be performed, or such compensation received, by the covered service provider, an affiliate, or a subcontractor."*

Engaging a CSP would require some level of third-party oversight to verify functions are being performed by the CSP in accordance to the rule.

6.) "Eliminate the conflict" altogether

Forego retirement investment portion of business and focusing solely on non-ERISA regulated insurance products.

About Core Catalysts

Core Catalysts is a management consulting firm based in Kansas City, and we serve clients across the U.S. in various industries. Core Catalysts provides services such as process improvement, product/service commercialization, revenue enhancement, financial modeling, program/project management, software selection, enterprise risk management and business performance improvement through a team that is composed of results oriented individuals.

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