DOL 101: The fiduciary rule's impact on annuity carriers

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Part 2 of this series of articles about the DOL fiduciary rule's impact focuses on annuity carriers.

The **Department of Labor's fiduciary rule** is the most significant industry game-changing development we have seen since the tax reform to annuities in the early 1980s. As an annuity compliance expert with a leading consulting company, the biggest question I receive these days is: "How do I comply?" Even though I'd like to have a panacea response, my answer is often the same: "It depends."

Every company, distributor and producer is in a unique position under this rule, and compliance answers will vary based on the licenses a producer carries, the types of annuity products manufactured and the role served by the distribution firm.

This is part 2 of a series of articles taking a deep dive into what the annuity world is likely to look like once the rule takes effect next April. (If you missed **part 1 — it addressed the rule's impact on insurance-only producers**). Part 2 takes a look from the perspective of the annuity carrier.

DOL dividing lines

Carriers come in all shapes and sizes, but the DOL rule really only sought to delineate them

based on one single criterion: the type of annuity product manufactured and sold. Carriers that only offer so-called fixed-rate annuity contracts, may seek relief under revised Prohibited

Transaction Exemption (PTE) 84-24 in order to pay differential compensation to agents, while those manufacturing indexed or variable annuities in the qualified market will have to comply with the new Best Interest Contract Exemption (BICE).

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While the DOL clearly intended to draw this line of demarcation, it may not have anticipated a separate, more blurry line created by its rule — that is, those carriers that have distribution partners that are permitted to sign the BICE contract as an eligible financial institution under the rule and those that do not.

For some background, this second, blurry line did not really exist under the **DOL's proposed rule back in April 2015**. That's because the proposed rule differentiated between "variable annuity contracts and other annuity contracts that are securities under federal securities laws" and so-called "non-security annuities" which would include all fixed annuities. However, in the final rule, indexed annuities were transferred from PTE 84-24 to the BICE. As a result, a once clear dividing line separating annuity product types now more closely resembles a gerrymandered map.

Now, the traditional definition of fixed annuity (which, since 2010, has been fairly well-defined in the industry after SEC Rule 151a was vacated by the courts and the Harkin Amendment was adopted) has been bifurcated between the DOL's newly termed fixed rate annuity contracts and indexed annuities.

The result is a myriad of rule implementation questions — each specific to the type of annuity products the carrier manufactures.

Different products, different implementation standards

Steps for implementation of the DOL rule vary by carrier and products offered. This article identifies three distinct courses — one for the carrier offering fixed rate annuity contracts, one for the carrier manufacturing **variable annuities** and one for the carrier manufacturing indexed annuities.

First up: Carriers selling fixed rate annuity contracts

Though compliance life for carriers solely offering fixed rate annuity contracts within PTE 84-24's framework will likely be more palatable than those under the BICE framework, the rule will still require several new implementation steps. PTE 84-24 specifically requires the same impartial conduct standards as BICE, including disclosure of all material conflicts of interest

impartial conduct standards as BICE, including disclosure of all material conflicts of interest and receipt of only reasonable compensation. Though fixed rate annuity contract

manufacturers will not have to worry about BICE's contractual requirement, they will still likely need to draft new disclosures for compensation and other point-of-sale documents as well as ensure producers are trained on new fiduciary obligations.

Some fixed rate annuity contract carriers may ultimately determine that they don't have any obligations under the rule because the onus is really on the producer to comply with the new fiduciary standard. While that reading may not technically be inaccurate, it is probably impractical. The reality is that a vast majority of carriers would probably prefer point-of-sale disclosures to be drafted by in-house legal and compliance teams — not individual producers. Most believe carriers will inevitably need to assist distribution with PTE 84-24 requirements.

Second: Carriers selling variable annuities

For carriers that largely operate in the variable annuity space, BICE preparations have been ongoing since last April. Most were resigned to the fact that the BICE would likely be the new normal, and, as a result, they have been working closely with broker-dealer, bank, wirehouse and RIA distribution partners that will be willing to sign as the financial institution on the BICE contract.

Many variable annuity carriers are also actively listening to their distribution's requests for potential product and compensation changes necessitated by the rule, including levelized commissions, shorter surrender charge schedules, less complex fee structures, and product differentiators and compensation based on neutral factors. In addition, variable annuity product manufacturers are working in concert with their financial institution partners to ensure accurate carrier information is relayed for the drafting of the point-of-sale BICE contract, point-of-sale disclosures and the required "web disclosure," which must be updated quarterly.

Third: Carriers selling indexed annuities

While the above two product manufacturers have some unanswered questions under the rule ("Define reasonable compensation?" or "What does a best interest contract really look like?"), the indexed annuity carriers are unquestionably the ones facing the toughest questions at this time.

It all comes back to the blurry line discussion. The above carriers at least have some guidance for or from their distribution. For many indexed annuity carriers that rely on independent distribution from insurance-only (non-securities licensed) producers for a portion of their business, the rule provides less clarity.

Those indexed carriers that offer products predominately through broker-dealer, bank and RIA channels with little distribution coming from independent marketing organizations (IMOs)

or insurance-only producers will likely be following a similar analysis to the variable carriers above. But those indexed carriers that rely heavily on IMO distribution and insurance-only sales are likely asking themselves the following:

If there's no broker-dealer, RIA or bank in the picture for the insurance-only producer, will the carrier be willing to sign the BICE contract?

Indexed annuity carriers' big decision

The BICE requires a financial institution to sign an actual, physical contract with the retirement investor at the time of sale. The DOL defines a financial institution as a broker-dealer, a bank, an RIA or an insurance carrier. When no other financial institution is available to sign the contract for an insurance-only agent, the carrier is the only possible option, at least as written today.

The DOL acknowledged as much in the BICE preamble:

"The Department notes that if the product manufacturer is the only entity that satisfies the "Financial Institution" definition with respect to a particular transaction, the product manufacturer must acknowledge fiduciary status and exercise the required supervisory authority with respect to the exemption, including entering into the contract…."

What the DOL may not have intended, though, was the precarious decision an indexed annuity carrier must make with respect to signing such a contract.

The contract requires a whole host of representations and warranties, including adherence to impartial conduct standards, acknowledging fiduciary status, warranting adoption of policies and procedures designed to ensure producers adhere to BICE compliance, and much more. While detailed, the contract may make some sense for a broker-dealer or RIA that is experienced with monitoring and supervising brokers and advisors.

On the other hand, many **indexed annuity** carriers only know state suitability rules. They have never supervised transactions or taken on fiduciary liability for producers. They are not in the same position as the broker-dealer or RIA where they get to see an advisor's full product suite and the carrier certainly isn't required by the SEC or FINRA to maintain a robust set of supervisory policies and procedures. How would a carrier be able to do this? How does the carrier sign a contract acknowledging fiduciary status and a best interest standard of care for an independent agent that sells for 10 other carriers?

Some carriers have asked these questions and already hinted there is no way they would be willing to sign the BICE contract. These carriers are likely willing to seek more distribution in the broker-dealer/RIA/bank channels and focus on PTE 84-24 products and unaffected nonqualified contracts for independent distribution.

But others *are* exploring what it would mean to sign this contract. And many are finding that the initial questions of risk are answered only by a subset of more questions as the potential impact is measured and analyzed.

The initial concern is liability. How do you mitigate it? How do you quantify it? Is the risk the same regardless of whether you sign or don't sign? Are you going to be a named plaintiff either way in future lawsuits? How big of a deal is the contractual claim within the BIC? Can a "BIC in a Box" be created and easily reproduced?

Carriers are also asking questions about what the contract would even look like. Is it possible to write a limited contract that discloses supervision for only that one single transaction? Or does the rule require some sort of ongoing monitoring?

What about disclosure of **compensation**? Most have determined that the sales trips, perks and production bonuses are probably going away. But how do you compensate IMOs? How far do you go down the rabbit hole with the web disclosure? Do you need to indicate how much the index provider gets paid? The annuity design group? The TPA that administers the business?

And will the BIC itself need to be filed with the states? Some believe it will if it's incorporated into the insurance or annuity contract or application, which is one option the DOL provides in the BICE preamble. How long will that take to get approved?

One thing is clear: indexed annuity carriers have a lot of questions to get comfortable with before signing the BICE contract.

What will the post-DOL rule world look like for carriers?

The fixed rate annuity contract carriers and variable annuity carriers (avoiding signature on the BICE contract) will have significant implementation steps — some of which have been raised in this article and many of which are yet to be determined as additional DOL guidance is provided and subsequent cases are litigated.

As for indexed annuity carriers, some will likely sign the BICE contract and some will not. Those that do may rely heavily on their IMO partners to assist with the monitoring process. This may also involve shifting some of the added liability to IMOs, while also potentially indicating the IMO will be paid less. IMOs may be in a difficult position to bargain when faced with the decision of some compensation for insurance-only sales vs. no compensation for insurance-only sales.

But why take the risk? Why would the carrier even be thinking of signing as financial institution under BICE?

Easy. The risk of any potential added liability in the post-DOL rule world is outweighed by the

risk of lost sales and earnings. Not necessarily short-term lost earnings — most indexed annuity carriers can absorb that. But any sustained decline in sales will potentially lead to rating agency downgrades, greater reputational risk, potential layoffs and a disgruntled producer force that may never sell your products (qualified or nonqualified) again.

Additionally, there's a potential market opportunity for those carriers that sign the BICE contract. They may be able to bring on many new insurance-only agents and could create allegiances for years to come.

Bottom Line: carriers have a long haul ahead with DOL rule implementation, regardless of product type offered. A disruption is probably inevitable, at least to some degree. Those carriers that are willing to pivot and adapt to the changing environment will be in the best situation to succeed in the post-DOL rule world.

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