DTCC INITIATIVE SUPPORTING THE DEPARTMENT OF LABOR (DOL) FIDUCIARY RULE

CONCEPT PAPER

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1 Executive Overview

1.1 Background

On April 6, 2016 the U.S. Department of Labor (DOL) published a new rule addressing conflicts of interest in retirement advice. The new rule broadens the DOL fiduciary standard to cover retirement advisors. Generally, under the DOL new rule, any individual receiving compensation for providing certain advice that is specifically directed to a particular plan sponsor, plan participant or IRA owner will be deemed a ‘fiduciary.’

Persons deemed fiduciaries under the new rule will be required to provide impartial advice or recommendations in their client’s best interest. A fiduciary cannot accept any payment creating a conflict of interest, unless the fiduciary qualifies for an exemption intended to prove that the customer is adequately protected.

The new rule is applicable to transactions occurring on or after April 10, 2017.

Under the new rule a person will be deemed a fiduciary if they provide certain advice or recommendations (Covered Investment Advice) under certain circumstances. The following categories of advice or recommendations are subject to the final rule:  

- Recommendations as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including recommendations to receive a distribution of benefits or roll over assets from a plan or IRA (i.e., advice about how to invest assets)
- Recommendations as to the management of securities or other property, including recommendations as to the management of assets rolled over to or distributed from an IRA (e.g., advice about how to exercise voting rights)

A person would be considered a fiduciary under the new rule if they provide Covered Investment Advice and the person, either directly or indirectly (e.g. through or together with an affiliate) represents or acknowledges fiduciary status, provides the advice under an agreement, arrangement or understanding that the advice is individualized to the person being given the advice, or with respect to a particular investment, directs the advice to a specific recipient or set of recipients.

A Prohibited Transaction Exemption (PTE) is required if the fiduciary qualifies for conflict of interest and receives differential compensation (e.g., commissions).

The new rule modifies the PTE 84-24, by, among other things, removing Variable Annuities and Fixed Index Annuities in an IRA and retirement accounts from exemptions; adding ‘impartial conduct standard’ to the exemption; including that the advisor act in the IRA’s best interest and not make misleading statements regarding recommended investments, fees, material conflicts of interest and other matters relevant to investment decisions. Fixed Annuities will continue to be part of PTE 84-24.

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1 IRI Ops & Tech DOL Fiduciary Task Force Implementation Matrix Sub-Group
The DOL new rule established a new Best Interest Contract Exemption (BICE) that would give fiduciary advisors the ability to set their own compensation or earn variable compensation including commissions even if they otherwise qualify as a fiduciary under the new rule. The BICE has a transition period from April 10, 2017 to January 1, 2018. The BICE ‘artifacts’ are defined as Best Interest Contract (BIC) in which the advisor must promise to meet impartial contract standards and reasonable compensation; which outlines warranties including processes and procedures to comply with the BIC; and includes disclosure requirements including website and point of sale transaction disclosure reporting; special rules for propriety products, and grandfathering of existing business.

The final rule specifically states the requirements for the transition period of April 10, 2017 and January 1, 2018. The transition period outlines the grandfathering of accounts and negative consent coverage. Retirement accounts opened prior to April 10, 2017 and earning prohibited compensation may be grandfathered and serviced, with a BIC, as long as the compensation is not increased as a result of the advice. If subsequent additions are processed this would invalidate the grandfathering exemption.

1.2 Project Overview

The initiative will provide a centralized, automated and standardized solution to facilitate the satisfaction of disclosure requirements. These include direct and indirect expenses and an initial generic transaction disclosure for upfront fees and expenses. In addition the solution will support the exchange of data between the insurance carriers and distributors for reporting of ongoing fees and expenses for on demand disclosure, and website disclosures.

DTCC intends to create a Fee & Expense Disclosure Transmittal, ACORD 1241 (PPfA Lite) which includes fees and expenses at the product level, feature/rider level, and fund (subaccount) level. The insurance carriers (or vendors on behalf of the insurance carriers), will submit the data and the distributors will either receive a data file or access it via the DTCC Web Portal.

1.3 Client Benefits

Leveraging a central data source of comprehensive and standardized annuity information will greatly facilitate access to data critical to the management of and adherence to the Department of Labor’s fiduciary disclosure regulations. Key benefits include:

- greater transparency into annuity expenses, both direct and indirect, and commission schedules
- a streamlined data process with robust data validation, increased data conformity and accuracy based on a defined, standardized data dictionary
- a standard data format.
- reduced costs, risks and errors associated with manual processing; improved efficiency
• elimination of support and maintenance associated with proprietary feeds or product databases
• simplified web access
• timely updates to distribution partners

2 Business Assumptions

Several business assumptions were defined and validated by a DTCC DOL Work Task Force\(^2\).

The task force requires:

• the ability to populate a central source for data requirements
• access to fee and expense reporting and timely updates to distribution partners
• a centralized, standardized repository to access fee, expenses and commission schedules reporting at the product CUSIP level
• greater accuracy and confidence in the data validation process
• a transparent process to access required fee, expense, and commission data for the disclosures.

The requirement for data exchange is focused on the various disclosures to be provided to the investor. They include the two BICE disclosures and as well as the PTE 84-24 disclosure.

• An On Demand disclosure, to be provided either prior to or after the transaction, within 30 days of the client’s request. The on demand disclosure will include specific costs, fees, and compensation including third party payments. DTCC will support the exchange of this information in the ACORD 1241 message. Commission reporting will be supported in a new mainframe flat file.
• The Web page disclosure includes descriptions of all products and explanations of the third party arrangements with advisers. These may be expressed as dollar amounts or percentages; calculation formulas will be available in the new message.
• Data for the PTE 84-24 disclosure, which focuses on the fixed annuity product includes insurance commissions along with a statement of any charges, fees, discounts, penalties or adjustments which may be imposed, will be included in the new ACORD message and commission schedule file.

The disclosure data requirements will include direct expenses and other indirect compensation such as Third Party Payments. The direct expenses include, but are not limited to, Management Fees (Mortality and Expense; Annual Contract, Fund Management and Rider/Feature fees), Surrender Charge Rates & Schedules and Commission Schedules. The indirect compensation

\(^2\) Reference DTCC DOL Task Force members in Section 6.
may include various expenses such as revenue sharing, entertainment, and marketing allowances.

3 Business Requirements

3.1 Disclosure Data Population

DTCC will create a standard ACORD 1241 message to include the product level fees, expenses, and commission data supporting the disclosure requirements. The data will be provided by the insurance carrier or vendor and/or solution provider on behalf of the insurance carrier. In addition, DTCC will create a file to support the carriers’ communication of the Commission Schedules. Please see Appendix A which includes the draft Data dictionary, draft Schema and proposed Fee & Expense Transmittal Transaction Specification.

DTCC intends to leverage existing post-issue services by enhancing Positions and Valuations (POV), Commissions (COM), and Financial Activity Reporting (FAR) to support the DOL ongoing reporting requirements for the BICE. This document does not include these potential enhancements. They will be documented as part of the DTCC enhancement release process.

DTCC will develop the following requirements:

- a facility to support mainframe and web transmission of the newly created ACORD XML 1241 message.
- a facility to support the transmission of Commission Schedule Transmittal data via mainframe, fixed format file and web capabilities.

3.2 Disclosure Data Access

Fee, expense and commission data information in the repository will be accessed via a multi-faceted process. Please see Appendix B for the user interface screen mock ups for viewing of the data via the Access platform.

DTCC will leverage the I&RS Access platform via DTCC Web Portal to allow the user to inquire and access product data based on the role type of the firm.

3.3 Disclosure Data Delivery

The requestor of data from the repository has the ability to define, as part of the onboarding process how the data will be delivered by DTCC.

Initially, DTCC will offer two methods for delivery of the required data to recipients:
1. batch delivery based on a pre-determined output cycle
2. user interface accessibility via DTCC Web Portal.

Please see Appendix A and C for the draft data dictionary, record layouts, schema and transaction specifications.

In support of the user interface on the Access platform for viewing of the data, DTCC will give access to multiple roles to view and download information for fee and commission data based on Product CUSIP.
4 Proposed Data Flow for Fee, Expense & Commissions

Input (Carrier)   DTCC   Output (Distributor)

- Web Data Entry / Upload
- ACORD 1241 Fee & Expense Disclosure Transmittal Message
- DTCC Commission Schedule Transmittal File

General Validation

Schema Validation

Business Validation

Insurance Data Solutions

User Interface

CDTS Recipient Process

Data Output
5 Proposed Timeline

DTCC has been working with their clients and the industry to prepare for production development and launch. The group has finalized the business requirements and will begin to work on the functional and technical definition phase. Testing by the industry is scheduled for February 2017 and production is on target for April 2017.

As the work continues from concept to functional and technical design, the standard implementation will be developed and communicated to the industry.

The dates for this initiative are as follows:

- Business Concept Requirements – completed
- Functional & Technical Design – July 2016 – August 2016
- Build – September 2016 – November 2016
- QA and Performance Testing – December 2016 - January 2017
- UAT/PSE Testing – February 2017
- Production – April 2017
6 DTCC DOL Task Force Group Members (by Firm)

DTCC led two separate task force groups to assist in understanding the impact of the new rule. The firms participating in the Work Task Force group members are listed below. In addition, the Advisory Task Force members are identified below by (*) by the firm name.

<table>
<thead>
<tr>
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7 Naming Conventions & Definitions

**ACORD** – (Association for Cooperative Operations Research and Development) is a global, nonprofit organization serving the insurance and related industries. ACORD supports the development of electronic standards, standardized forms, and tools to support their use.

**Adviser** – is an employee, independent contractor, agent, or registered representative of a “Financial Institution” who satisfies applicable law and licensing with respect to the receipt of the compensation.

**Affiliate** – as defined in the rule means any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such person; any officer, director, partner, employee, or relative of such person; and any corporation or partnership.

**Best Interest Contract (BIC)** – a bilateral written agreement between an investor and the financial institution with respect to acknowledgment of fiduciary status, investment recommendations, impartial conduct standards, warranties, terms of the prohibited contract.

**Best Interest Contract Exemption (BICE)** – permits certain persons who provide investment advice to receive compensation that varies based on their investment advice based on a bilateral contract.

**Covered Investment Advice** – (a) recommendations as to the advisability of acquiring, holding, disposing, or exchanging securities or other property, including recommendations to receive a distribution of benefits or roll over assets from a plan or IRA (i.e., advice about how to invest assets) and (b) recommendations as to the management of securities or other property, including recommendations as to the management of assets rolled over to or distributed from an IRA (e.g., advice about how to exercise voting rights).
Department of Labor (DOL) Fiduciary Rule – defines who is a fiduciary investment adviser, while accompanying prohibited transaction class exemptions allowing firms to continue to receive a variety of common forms of compensation as long as they are willing to adhere to standards aimed at ensuring that their advice is impartial and in the best interest of their customers. A final regulation re-defining who is a fiduciary by reason of providing advice to a plan or IRA, broadening the scope of entities and persons who are deemed as EIRSA fiduciaries.

Direct Compensation – for purpose of the rule, any explicit fee or compensation for the advice received by the person (or by an affiliate) from any source, and other fee or compensation received from any source in connection with or as a result of the purchase or sale of a security. This includes, though not limited to, commissions, loads, finder’s fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, underwriting compensation, payments to brokerage firms in return for shelf space, recruitment compensation paid in connection with transfers of account to a new firm, gifts and gratuities and expense reimbursements.

Disclosures – obligations under the final BIC exemptions are divided into three categories: (1) contract disclosure, (ii) transaction disclosures; and (iii) web disclosures. The transaction disclosure supports a two-tiered approach to disclosure, where more general information is initially provided and then more detailed is provided upon request.

ERISA – (Employee Retirement Income Security Act of 1974) – enacted 9/2/74 is a federal law that establishes minimum standards for pension plans in private industry and provides for extensive rules on the federal income tax affects of transactions associated with employee benefit plans. ERISA protects the interests of employee benefit plan participants and their beneficiaries by requiring the disclosure of financial and other information concerning the plan to beneficiaries; establishing standards of conduct for plan to the federal courts; and providing for appropriate remedies and access to the federal courts.

Fiduciary – a person will be a fiduciary if, for a fee or other compensation, the person provides one of two categories of covered investment advice.

Financial Institution – is a registered investment adviser, bank, insurance company, or registered broker/dealer that employs an Adviser or otherwise retains the Adviser as an independent contractor, agent, or registered representative.

Fixed Annuity – is a type of annuity that will pay a guaranteed rate of interest for a set period of time. Both the principal and interest are guaranteed.

Fixed Index Annuity – is a type of annuity that grows at the greater of a) an annual, guaranteed minimum rate of return, or b) the return from a specified stock market index (such as an S&P 500), and reduced by certain expenses and formulas.

Grandfathering – DOL allows any ongoing commission payments that continue to be received for advice that was provided prior to the effective date of the new rules, meaning
brokers will not be required to give existing 12(b)-1 fees and other trailing commission payments.

**Impartial Conduct Standard** – advice provided is in the investor’s best interest, prudent and without regard to competing financial or other interests), compensation is not in excess of what is reasonable and no materially misleading statements about the transaction, fees and compensation or material conflicts.

**Product Profile for Annuities (PPfA)** – officially referred to as a Policy Product Transmittal #1201 in the ACORD TXLife Specification, and abbreviated PPfA) includes details necessary to prepare a well-formed annuity sales application as well as supporting details such as investment (fund) information, fees and expenses, and information on the selling agreements/commission necessary to fully support commission calculations at the point of sale.

**Prohibited Transactions Exemption (PTE) 84-24** – provides relief for certain transactions relating to the purchase, with plan assets, of fixed annuities.

**Related Entity** – is any entity other than an Affiliate in which an Adviser or Financial Institution has an interest that may affect the exercise of its best judgment as a fiduciary.

**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.

**Variable Annuity** – is a tax-deferred retirement vehicle that allows you to choose from a selection of investments, and then pays a level of income in retirement that is determined by the performance of the investment chosen.

### 8 Appendix

**Fee & Expense Transmittal Appendix**

Located in the Appendix A are the draft dictionary, schema and proposed Fee & Expense Transmittal Transaction specification.

**Screen Mock Ups for User Interface**

Located in the Appendix B are the draft screens that will be developed as part of the data access and view role with the solution.

**Proposed Commission Schedule Transmittal**

Located in the Appendix C are the draft record layouts for the support of the communication of the commission schedules.