

LEGAL UPDATE

New Fiduciary Rule Affects IRA Rollovers

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“Capturing” rollover assets is a classic example of cross-selling. In many instances, an advisor will have developed longstanding relationships with both a 401(k) plan sponsor and the plan’s participants. If the advisor can earn a higher level of compensation providing rollover IRA services than would otherwise be earned if the participant’s retirement assets remained in the plan, it would be tempting to encourage participants to roll over their account balances to IRAs as soon as they become eligible to take a distribution from the plan. The U.S. Government Accountability Office has issued several well-publicized reports concluding that, in fact, investment management services provided to IRAs are highly lucrative and significantly more valuable to advisors than fees generated by employer plans.

Prior DOL Guidance. Consistent with concerns about potential abuse, the DOL has issued detailed interpretive guidance on how ERISA’s prohibited transaction rules apply to advisors that engage in the practice of capturing rollover assets from their plan clients. The starting point for the DOL’s guidance is the general prohibition against fiduciary

self-dealing under Section 406(b) of ERISA and its mirror provision under the Internal Revenue Code. Under these rules, an advisor cannot make an investment recommendation to a participant that results in additional compensation for itself.

To curb potential abuses associated with “capturing” rollovers, the DOL issued Advisory Opinion 2005-23A. On its face, this interpretive guidance broadly suggested that any rollover-related advice from an advisor providing any fiduciary advice to the plan sponsor or the plan’s participants could result in a prohibited transaction. Although the DOL did not fully explain its reasoning, its position is that an advisor who serves the plan (or a participant) in a fiduciary role cannot discuss the advisability of rollover distributions with the plan’s participants and that any resulting rollover advice to the participants triggers a potential violation of ERISA’s prohibited transaction rules. The DOL rollover opinion indicates that advisors providing fiduciary advice, even if accidentally, will be treated as subject to the opinion’s restrictions. On the other hand, an advisor who does not serve as a plan

fiduciary can freely advise participants on rolling over their accounts to IRAs and how the rollover proceeds should be invested.

New Fiduciary Definition. The test for determining whether an advisor is an ERISA fiduciary is a functional one. Up to now, this has meant that if a person acts like a fiduciary or possesses fiduciary-like powers, the person will be treated as a fiduciary, even if the person has not been formally appointed to serve as the Plan's fiduciary. Rendering "*investment advice*" for ERISA purposes in exchange for any form of compensation is viewed as a fiduciary activity, which automatically causes the party rendering this advice to be viewed as a plan fiduciary.

But keep in mind that the term "*investment advice*," is a loaded term that under the proposed DOL regulations redefining fiduciary investment advice has been expanded to include a "recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over." The expanded definition also covers recommendations with respect to the management of rollover monies. This definition will create many new fiduciaries out of advisors who have never before had this status.

The DOL's fiduciary proposal would supersede Advisory Opinion 2005-23A. In contrast to the rollover opinion, the fiduciary proposal would turn any and all rollover advice into fiduciary advice. This would be the case even if the advice is rendered by an advisor who is otherwise not a fiduciary. Accordingly, a nonfiduciary advisor would automatically become a plan fiduciary under the new rule once it made any rollover recommendation to a plan participant. In the future, advisors providing rollover advice and receiving variable compensation or more compensation than the advisor would have received if plan assets had not been rolled over will need to qualify for an exemption or their rollover advice will violate prohibited transaction rules.

Exemptive Relief. Fortunately, the DOL has also proposed prohibited transaction exemptions that would give fiduciary advisors the ability to provide rollover advice and also earn higher rates of compensation on IRA assets that have been rolled over. These proposed exemptions include the new Best Interest Contract (BIC) Exemption and a revised version of PTE 84-24. Unfortunately, these exemptions have numerous, detailed requirements.

PTE 84-24 generally applies to sales of insurance products and mutual funds, but in the context of rollovers to IRAs, it will not be available with respect to mutual funds or annuities that are treated as securities, such as variable annuities. In contrast, the BIC Exemption covers a wide product range, including sales to IRAs of mutual funds and variable annuities.

The conditions for the protection afforded by the BIC Exemption include executing a written contract before any

recommendation is made. This contract must acknowledge fiduciary status, promise that the advisor's compensation will be reasonable and agree that the firm and advisor will act in the best interest of the plan participant who is considering the IRA rollover. Moreover, the best interest standard means that the advisor's recommendations must disregard the advisor's own financial interests, specifically the fact that the advisor might expect a better compensation arrangement from IRA-held assets compared to what he or she earns under an employer retirement plan. The written contract will also be required to identify conflicts of interest, and the advisor's firm will need to adopt written policies mitigating incentives created by differential compensation that encourages conflicted advice.

Complying with the BIC Exemption also has a disclosure component pursuant to which an advisor will be required in advance to provide a plan participant considering a rollover with a chart showing the total cost in dollars of each recommended asset for 1-, 5-, and 10-year periods. Asset by asset disclosure of fees and expenses paid by the IRA will also need to be made annually. And the firm will be required to maintain a Web page with information on compensation.

Unlike the BIC Exemption, PTE 84-24 does not require a written contract between an advisor and an IRA or the formal adoption of policies and procedures mitigating conflicts of interest. However, PTE 84-24 does require adherence to the best interest standard, so that advisors and their firms using PTE 84-24 will be limited to reasonable compensation and will need to figure out how to eliminate the effects of differential compensation paid to advisors. Although formal conflicts policies will not be required, firms will still need to address the issue of conflicts in practice.

FINRA Requirements. Advisors making recommendations to roll over plan assets to an IRA should also ensure that they comply with FINRA Notice 13-45 which means that their advice must be reasonably based on its suitability for the plan participant. This means that the advisor must consider the participant's investment profile as well as other information the participant may disclose.

The rollover decision needs to reflect how the plan from which assets would be distributed stacks up in comparison to the proposed IRA in terms of (i) investment options (ii) fees and expenses and (iii) services, such as advice planning tools. Furthermore, differences with respect to potential withdrawal penalties, protection from creditors and the applicability of required minimum distributions need to be considered.

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