A NEW FIDUCIARY RULE FOR THE INVESTMENT ADVICE PLAYBOOK

How the DOL's Fiduciary Rule Has Fundamentally Changed Investment Advice for IRAs

By Fred Reish - Partner, Drinker Biddle & Reath LLP
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The Department of Labor’s (DOL) new fiduciary guidance, applicable on April 10, 2017,¹ has fundamentally changed the rules of investment recommendations to Individual Retirement Accounts (IRAs), which includes distributions and rollovers to IRAs as well. Therefore, it’s important that advisors understand the new requirements and, if necessary, change how they give advice and how they are compensated. This article discusses the most important considerations for advisors.

From a big picture perspective, the DOL’s guidance increases the regulation of:

- Investment advice to plans and participants.
- Investment advice to IRAs.
- Recommendations about distributions and withdrawals from plans and IRAs.

All of those recommendations will become fiduciary advice, which means the recommendations must be prudent and in the best interest of the investor. In addition, once an advisor becomes a fiduciary, the advisor is subject to the fiduciary prohibited transaction rules. Those rules prohibit an advisor from affecting the level of his compensation through the advice or recommendations. In addition, the advisor cannot receive payments from third parties who are dealing with the plan or IRA (e.g., 12b-1 fees from mutual funds or commissions from insurance products). However, the DOL has also issued prohibited transaction exemptions that will allow those payments—but only if their requirements are satisfied. These two exemptions will, in the future, be used by many advisors:

- **Prohibited Transaction Exemption (PTE) 84-24** applies to the sale of insurance products to plans, participants and IRAs (with the exception of variable annuities and indexed annuities, which are covered by the next exemption).
- **The Best Interest Contract Exemption (BICE)** covers all other investments and insurance products.

Because of the very broad scope of the rules, this article does not cover all of the issues and requirements and instead will focus on recommendations of mutual funds to IRAs.
THE FIDUCIARY DEFINITION

The DOL regulation says that a recommendation to an IRA owner to buy, sell or hold an investment is a fiduciary act, resulting in fiduciary status for the advisor. While that definition is broad, it is made even more encompassing by the definition of “recommendation.” According to the regulation, a recommendation is a “suggestion” that, when viewed objectively, an IRA owner engage in a particular course of action such as buying, selling or holding an investment. It’s theoretically possible that almost any mention of an investment, followed by an IRA owner acting on the investment (and the advisor receiving any form of compensation) would be considered a suggestion—and, therefore, fiduciary advice. As a result, a conservative position is to consider any conversation with an IRA investor that mentions specific investments to be fiduciary advice.

AVOIDING PROHIBITED TRANSACTIONS

If an advisor makes a fiduciary recommendation to an IRA owner, and the IRA owner approves and implements the advice, that implicates the fiduciary prohibited transaction rules found in section 406(b) of the Employee Retirement Income Security Act (ERISA) and section 4975(c) of the Internal Revenue Code).

The DOL has long taken the position that a discretionary investment manager is a fiduciary and is subject to those prohibited transaction rules. As a result, from the perspective of the DOL and Internal Revenue Service (IRS), discretionary investment management has always required level-fee advice that is free of financial conflicts of interest (i.e., avoids prohibited transactions).

While fiduciary advisors to IRAs are governed by the fiduciary prohibited transaction rules, they are not covered by ERISA’s prudent man rule or duty of loyalty standards. (However, some IRAs are subject to ERISA's fiduciary standard. That includes IRAs that are a part of SIMPLE or SEP programs, and where at least one common law employee is covered under the arrangements.) Instead, the only application of the fiduciary definition to IRAs is for the prohibited transaction rules. As a result, if a fiduciary advisor does not engage in a prohibited transaction while providing investment advice to an IRA owner, the fiduciary advisor is not subject to either the fiduciary or the best interest standards of care. Instead, the fiduciary advisor is subject to the applicable securities laws (e.g., the SEC fiduciary rule or FINRA's suitability standard). In order to avoid those prohibited transactions, though, the advisor must provide “pure” level-fee advice.

That begs the question, what is a “pure” level fee? For these purposes, that means that neither the advisor, his or her supervisory entity (e.g., the broker-dealer or Registered Investment Advisor, or RIA, firm) nor any affiliate receives any money or items of monetary value beyond the stated advisory fee. So, for example, if the broker-dealer, RIA firm or an affiliate had a proprietary mutual fund, a recommendation of that fund would cause additional money to be paid to the combined group (i.e., the mutual fund management fee).

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As another example, the prohibited transaction rules would preclude the receipt of a 12b-1 fee on top of the advisor’s stated fee. However, the law permits levelization of compensation through offsets. In that case, the advisor could offset the 12b-1 fee against his or her advisory fee. The result would be that the advisor’s compensation is level, in the sense that, regardless of the recommendations made, he or she does not receive any additional compensation.

The first method to satisfy these rules is for advisors to receive pure-level compensation. In that case, the advisor would not need to take advantage of the prohibited transaction exemptions—because there isn’t a prohibited transaction—and the advisor would not be subject to the prudent man rule, duty of loyalty or the best interest standard of care.

However, where an advisor (or his or her supervisor entity or an affiliate) receives compensation in addition to the stated fee, the advisor and the supervisory entity (e.g., the broker-dealer or RIA firm) will need the relief afforded by BICE, the Best Interest Contract Exemption. BICE is a complicated and lengthy exemption, with many conditions. This article discusses some of the most important requirements in the exemption. However, advisors, broker-dealers and RIA firms should work with their attorneys to develop compliant procedures, contracts and disclosures.

As the name suggests, one of the requirements of the Best Interest Contract Exemption is that the advisor and his or her supervisory entity have a contract with the IRA owner. The contract must contain a number of statements and disclosures. First and foremost, the contract must state that the advisor and the supervisory entity are fiduciaries and that they agree to adhere to the best interest standard of care (in essence, a combination of the prudent man rule and the duty of loyalty from ERISA). As a result, if the advisor does not provide prudent advice nor put the IRA owner’s interest ahead of his or her own, the IRA owner has a breach of contract claim against the fiduciary advisor and the supervisory entity. The contract can require arbitration for individual claims. However, the contract must allow class action litigation, where there is a commonality of claims by IRA owners.

Clearly, it’s more important than ever that advisors change their practices to comply with the new best interest standard.

Based on litigation involving ERISA plans, advisors will need to apply “generally accepted investment theories” and “prevailing investment industry practices.” The most commonly accepted investment theory is Modern Portfolio Theory. Another accepted theory is diversification to minimize the risk of large losses. Taking those theories into account, advisors should develop portfolios that are diversified by asset classes and investment styles and then populate those portfolios with investments that are well diversified (e.g., mutual funds). The asset allocation should be determined by the individual needs, circumstances and age of the investor (among other factors). In many ways, this latter requirement is similar to the suitability and know-your-customer standard applied to broker-dealers and their registered representatives.
However, these rules do not limit the ability of the IRA owner to decide how his or her IRA will be invested. If an IRA owner wants to invest in a way that would not be viewed as prudent (e.g., not diversified), the IRA owner is entitled to make that decision. However, to protect themselves, advisors should have written directions to that effect. In that case, the advisor’s fiduciary role will be limited to prudently advising within the scope of the IRA owner’s directions.

Another requirement for BICE is that an advisor’s compensation cannot incent the advisor to recommend one investment over another, which might result in a recommendation that is not in the best interest of the IRA owner. However, it is difficult to design a structure for transaction-based compensation that doesn’t have the potential to favor some investments over others, or more transactions instead of fewer. As a result, some broker-dealers are contemplating level fees for advisors in order to satisfy this BICE requirement. When the BICE requirements are satisfied, though, the supervisory entity (e.g., the broker-dealer) can receive additional compensation. For example, an advisor might receive level compensation for recommendations to an IRA owner, but the supervisory entity and its affiliates may receive additional compensation. That could allow, for example, a broker-dealer to receive revenue sharing and an affiliated investment manager to receive advisory fees from proprietary mutual funds.

Another requirement is that the compensation of the advisor and his or her supervisory entity be “reasonable.” While the concept of reasonable compensation is a well-accepted and measured concept under ERISA (e.g., through benchmarking reports in the 401(k) world), it is new for most of the advisory services in the IRA world. Basically stated, though, the requirement is that the fees be reasonable when compared to the services rendered, the complexity and nature of the investments, and other similar factors. For example, if an advisor provided financial planning in connection with large IRA accounts, the advisor should be able to earn more compensation than an advisor who does not. If an IRA owner wants to meet on a regular basis to review the account, that would be an additional service that justifies higher compensation. Unfortunately, there are few, if any, services in the IRA setting that would assist with the evaluation. However, that should change in the relatively near future, since benchmarking services will develop to serve the need.

As a final note on BICE, while it requires financial disclosures about advisor compensation and services, these requirements have been substantially relaxed from the proposal.

CONCLUSION

The DOL’s fiduciary regulation requires that individual advisors, broker-dealers and RIA firms reconsider their current practices in light of the new regulatory and exemption requirements. Decisions need to be made about whether to use a pure level-fee approach or the relief provided by BICE. Obviously, the pure level-fee approach will be easier from a compliance perspective. However, other considerations (such as revenue sharing and proprietary investments) may mandate the use of the exemption. The applicability date of April 10, 20171 is rapidly approaching. As a result, advisors should be working with their supervisory entities to develop practices and agreements.

1 The fiduciary rule applies on April 10, 2017. Parts of BICE initially apply on April 10, 2017, however, some of the requirements are deferred until January 1, 2018.
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