

COMPENSATION, GOVERNANCE & ERISA | June 8, 2016

The DOL's New Fiduciary Rule: Capturing the Apparent Conflict at "the Moment of Rollover"

The US Department of Labor's final fiduciary rule captures rollover, transfer and distribution recommendations to retirement investors.¹ In essence, under the rule, a financial organization or adviser is acting as a fiduciary when advising a retail client to take a rollover or distribution from an ERISA plan or individual retirement account, even if the rollover or distribution recommendation is not accompanied by an investment recommendation as to the rollover or distribution proceeds. When an ERISA plan is the source of funds for the rollover, the DOL's view is that ERISA's normal fiduciary and prohibited transaction rules apply. When the source of funds is an IRA, the DOL's position is that a prohibited transaction occurs due to the conflict that arises from the fee income that will be received by the financial organization if the rollover happens. In either case, reliance on an exemption will be necessary to avoid violating ERISA.

This publication focuses on the impact of the final rule on the business of accumulating assets through capturing rollovers and plan distributions.

The Broad Reach of the Final Rule

The broad reach of the final rule means that most financial advisers will be treated as "investment advice fiduciaries" when they make rollover or distribution recommendations.

In determining who is an investment advice fiduciary, the final rule focuses on the relationship between financial organizations and their retail clients and on the type of recommendations being made to these clients. To be covered by the rule, financial organizations and financial advisers must either (1) represent or acknowledge that they are acting as ERISA fiduciaries, (2) render advice pursuant to an agreement, arrangement or understanding that the advice is based on the particular needs of the retail client or (3) direct the advice to a specific retail client regarding the advisability of a particular investment or management decision with respect to the securities of the

¹ The final rule is available at: <https://www.dol.gov/ebsa/regs/conflictsofinterest.html>. For a complete overview of the final rule, you may wish to refer to our client publication: "The US Department of Labor's Final "Fiduciary" Rule Incorporates Concessions to Financial Service Industry but Still Poses Key Challenges," available at: <http://www.shearman.com/~media/Files/NewsInsights/Publications/2016/04/The-US-Department-of-Labor-Final-Fiduciary-Rule-Incorporates-Concessions-to-Financial-Service-Industry-CGE-041416.pdf>. For a discussion of the disclosure requirements of the new prohibited transaction exemptions, you may wish to refer to our client publication: "The DOL's New Fiduciary Rule: The Details on Disclosure," available at: <http://www.shearman.com/~media/Files/NewsInsights/Publications/2016/05/The-DOLs-New-Fiduciary-Rule-The-Details-on-Disclosure-CGE-05052016.pdf>. For a discussion of how the final rule differentiates between investment advice and education, you may wish to refer to our client memo: "The DOL's New Fiduciary Rule: The Thin Line Between Advice and Education," available at: <http://www.shearman.com/~media/Files/NewsInsights/Publications/2016/05/The-DOLsThe-Thin-LineEducation-and-Advice-CGE-051116.pdf>.

plan or IRA. Decisions for this purpose would include the type of account in which the retail investor's assets are to be held.²

For purposes of the final rule, a recommendation is a communication that, based on its content, context and presentation, would reasonably be viewed as a suggestion that the retail client engage in or refrain from taking a particular course of action. The final rule specifically refers to recommendations "with respect to rollovers, transfers or distributions from a plan or IRA, including whether, in what amount, in what form and to what destination such a rollover, transfer or distribution should be made." As a result, the final rule captures rollover and distribution recommendations, even when the resulting assets are not being contributed to an IRA or ERISA plan. The final rule supersedes an earlier DOL Advisory Opinion that held that it was not fiduciary advice to make a recommendation as to distribution options even if the advice is coupled with recommendations as to how to invest the distributed assets.³

Once financial organizations and advisers are treated as advice fiduciaries, ERISA's fiduciary standards and prohibited transaction prohibitions apply to the advice given to their retail clients. This means that financial organizations and financial advisers are precluded from receiving any direct or indirect compensation as a result of the retail client's decision to take the distribution or make the rollover following a rollover or distribution election based on their recommendation, including future fees from the management of the assets or other property subject to the rollover or distribution. All of which is a harsh result, as the obvious point of many rollover recommendations is to enable financial organizations to accumulate assets and to be compensated for managing these assets for the benefit of their clients after the rollover. The broad reach of the DOL's final rule effectively precludes financial organizations from making rollover or distribution recommendations without complying with an available DOL exemption.

The scope of the final rule may reach websites that allow retail clients to open rollover accounts and to roll distributions or consolidate IRA balances into these accounts. The final rule treats as a separate recommendation how securities or investment property are to be invested after being rolled over, transferred or distributed from the plan or IRA.

Use of the BIC Exemption

The Best Interest Contract Exemption provides relief under the final rule for rollover recommendations to retail clients. The BIC Exemption allows financial institutions and advisers to retail clients to receive direct or indirect compensation that would otherwise be prohibited by ERISA's fiduciary and prohibited transaction rules when they make rollover or distribution elections to their clients.

² The rule states that a recommendation as to the management of assets includes recommendations regarding the selection of account arrangements. The rule further states that a recommendation with respect to rollovers includes recommendations as to the destination to which such rollover should be made.

³ See DOL Advisory Opinion 2005-23A.

The obligations imposed by the BIC Exemption on IRA clients include entry into a written contract with the retail client in which the financial institution affirmatively acknowledges that it and the adviser are acting as a fiduciary; the investment advice is in the best interest of the retail client; the transaction will not cause the financial institution, adviser or their affiliates to receive compensation in excess of reasonable compensation; and statements made to the retail investor concerning its investment decisions will not be materially misleading.⁴

The BIC Exemption provides for streamlined conditions to cover initial rollover recommendations to so-called level fee accounts that charge a fee based on a fixed percentage of assets that does not vary based on the level of account activity or the investment products in which the account is invested.⁵ The BIC Exemption's streamlined approach for level fee accounts requires that the financial adviser provide the retail client with a written statement that the adviser is acting as a fiduciary with respect to the recommended transaction. In addition, the financial institution and the adviser must comply with the impartial conduct standards described in the BIC Exemption.

For rollovers from an ERISA plan to an IRA, the financial institution must document the specific reasons why the recommendation is in the best interest of the retail client, including considerations of the investor's alternatives to a rollover. This analysis must take into account the fees and expenses associated with both the plan and IRA, whether the employer pays for some or all of the plan's administrative expense and the different levels of services and investments available under each option. In the case of rollovers between IRAs, or to switch from a commission-based account to a level-fee arrangement, the level fee fiduciary must document the reasons that the arrangement is considered to be in the best interest of the retail client, including the services that will be provided for the fee.

Although the streamlined application of the BIC Exemption to level fee arrangements is a sensible approach, it still raises a number of operation and risk management questions for financial institutions. In connection with rollovers from an ERISA plan to an IRA, the rule requires financial institutions to consider information concerning the ERISA plan, including the fees charged by the ERISA plan and the plan's investment options. This information, however, may not be available to the financial institution or financial adviser, and the BIC exemption does not offer guidance as to when it is reasonable to rely on representations or available information on these matters or when it will be necessary to decline to make a recommendation until the information is available. In the context of rollovers from an IRA to a level-fee IRA, it is unclear how the DOL or retail clients will enforce noncompliance with the streamlined

⁴ Reasonable compensation has the meaning set forth in § 408(b)(2) of ERISA and § 4975(d)(2) of the Tax Code. In addition, the financial institution must adopt and comply with policies and procedures that are designed to ensure that it and its advisers adhere to these "impartial conduct standards." Further, the financial institution must disclose to the retail client any material conflicts of interest, along with any fees charged to the retail client's account and the types of compensation the financial institution, its affiliates and the adviser expect to receive in connection with their recommendations. Each of these requirements, as well as BIC Exemption's recordkeeping requirements, is detailed in our initial client publication discussing the final rule. See footnote 1, above.

⁵ The streamlined approach is not available if the financial institution, the adviser or their affiliates receive any compensation (such as commissions, 12b-1 fees or revenue sharing) beyond the level fee in connection with investment management or advisory services with respect to the plan or IRA.

BIC exemption, as there may not be an enforceable BIC contract in place between the parties. Similarly, it is unclear whether plan participants will have any rights or remedies when the advice from a financial adviser is not to take a rollover or distribution.

Conclusion

For the first time since the passage of ERISA, the DOL has subjected financial organization and financial advisers who make rollover recommendations to retain clients to ERISA's fiduciary standards and prohibited transaction rules with respect to those recommendations. The result will likely be a sea change in the way financial organizations approach asset accumulation from retail clients based on rollovers and plan distributions.

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