Flashpoint: The New Fiduciary Regs: A Practical Review – Part II

Thank you for your patience in awaiting this second part to our review of the new Fiduciary rules issued by the Department of Labor. This installment will look at the potential for self-dealing if you are an advice fiduciary,

and how the Best Interest Contract Exemption (BICE) can help. As with Part I, our goal here is to provide you with concise, understandable information that is of interest to third-party administrators and financial advisors and the clients they service, rather than to the larger financial institutions. Therefore, we intend in this newsletter to provide you with the information that we think you really need to know, rather than with a full comprehensive review of the various rules and exemptions. This is why we are focusing on the BICE over the other exemptions. If you have questions about something not covered here, please give us a call or send an email and we can address your concern.

Self-Dealing Prohibited Transactions

Under Part I, we discussed how the regulations define an "investment fiduciary"—that is, someone who is a fiduciary because of providing investment advice for a fee or other compensation. The new rules are expected to increase significantly the breadth of advisors who are fiduciaries. If you are a fiduciary, you are subject to a special set of prohibited transaction rules that do not apply to the other types of parties-in-interest. These rules generally are referred to as the "self-dealing PTs," as they all relate to situations in which the fiduciary is benefitting itself rather than the client. In particular, a person or entity that is a fiduciary may not:

- Deal with the assets of the plan in its own interest or for its own account;
- Act in any transaction involving the plan on behalf of a party, or represent a party, whose interests are adverse to the plan or its participants and beneficiaries; or
- Receive any consideration for its own account from any party dealing with such plan in connection with a transaction involving the plan's assets.

Put simply, thou shalt not act contrary to the plan's interests. Most importantly, in the advice fiduciary context, thou shalt not recommend anything vis-à-vis the plan investments whereby you make more money if your advice is taken than you would if your advice is rejected. If you do, your own interests are assumed to motivate your advice, and that is a prohibited transaction.

In addition, thou shalt not take money from anyone else for something related to the plan. These are called "third party payments," and include such things as: gross dealer concessions; revenue sharing; 12b-1 fees; distribution, solicitation, or referral fees; volume-based fees; or fees for seminars and educational programs.

This part of the rule has been present since ERISA and is why fiduciary advisors generally are compensated on a level fee basis—either a flat fee or a percentage of plan assets. Historic guidance from the DOL has advised that the receipt by the fiduciary of third-party payments is not a problem if they are used to reduce the level fee, so that the total amount received by the fiduciary remains the same. This is one reason for the widespread use of level fees by fiduciary advisors.

The Rollover Conundrum

Historically, the self-dealing rules have also produced a significant headache for fiduciary advisors in relation to capturing rollover money. When a participant terminates employment, he or she has four options with regard to the plan account:

- Leave the money in the plan indefinitely (assuming that the account is worth at least $5,000; if it is less, the plan can force the money out directly to the participant or to a rollover IRA);
- Take the account out in cash and pay taxes;
- Roll over the money to a plan sponsored by the participant's new employer; or
- Roll over the money to an IRA.

If the participant wants a rollover, the fiduciary advisor commonly would like to get that participant as an individual client and help the participant manage the IRA investments. However, this is a problem. Advisors usually charge more for IRA advice than for plan advice. Commonly, the services provided to an individual client are more extensive, and there is no "economy of scale" in the IRA, as there is in the plan. If the advisor is a fiduciary to the plan, he or she then stands to make more money if he or she recommends an IRA rollover rather than keeping the money in the plan. Wuh whoa, Scooby Doo! That is self-dealing, even if the participant has been working with the advisor for years, even if the participant is informed of the compensation differential, and even if the participant approves the arrangement. To make it worse, if an advisor with no relationship to the plan recommends a rollover to the participant, he or
she is not self-dealing because he or she is not currently a fiduciary. This means that it is actually permissible for the non-fiduciary advisor to act other than in the participant's best interest in making the rollover recommendations.

Financial advisors commonly have had three approaches to the rollover conundrum:

- Give the advice anyway. This could have been due to a misconception or ignorance about the conundrum.
- Tell the participant that the advisor cannot give advice about rollovers because of the conflict of interest, but assure the participant that if he or she actually takes the funds out of the plan on his or her own, the advisor can then work with the participant. (In other words, once the funds are out of the plan, the advisor is no longer an ERISA fiduciary and can give advice without conflict.)
- Give investment education and not advice. Tell the participant his or her options, without making any specific recommendations.

None of these options is particularly satisfying for either the advisor or the participant, who just wants to get help from someone he or she knows and trusts.

Enter the BICE

The Best Interest Contract Exemption (BICE) is the DOL's effort to permit the investment fiduciary to receive compensation other than level fees under certain circumstances. It is clear from the Preamble to the exemption, as well as the exemption terms themselves, that the DOL is trying to structure an environment where the participant remains protected and the advisor acts in the participant's best interests. The DOL approaches this in two ways: on the one hand, forcing the fiduciary to behave within constraints, and on the other, giving a disappointed participant access to litigation as an enforcement mechanism.

First, we need to discuss some terms of art:

- A Retirement Plan Investor or Investor is a participant, beneficiary, or IRA holder;
- An Advisor is someone who is a plan fiduciary because he or she is giving investment advice vis-à-vis a plan or IRA and who is also related in some way to a financial institution and is registered or licensed to give such advice;
- A Financial Institution or FI is an entity that employs or otherwise retains the Advisor and is an RIA, a bank or similar institution, an insurance company, a broker-dealer, or an entity described as a financial institution in a DOL individual exemption;
- An Affiliate is generally a person or entity that controls, or is controlled by, the Advisor or the FI; is an officer, director, partner, employee, or relative of the Advisor or FI; or is a company of which the Advisor or FI is an officer, director, or partner.
- A Related Entity is an entity other than an Affiliate in which the Advisor or FI has an interest that could affect the exercise of their best judgment.

The full BICE has six extensive categories of requirements:

1. Contractual requirements;
2. Fiduciary acknowledgement;
3. Impartial Conduct Standards (ICS);
4. Policies and Procedures requirements;
5. Disclosure requirements; and
6. Record retention requirements.

Posted on our website at www.ferenczylaw.com is the BICE Supplement Document for New Fiduciary Regs – Part II (click here to access), a supplement that goes through the detailed requirements for the BICE. However, it is likely that most readers of this newsletter will be more interested in the abbreviated version of the BICE that applies to level fee advisors. People in the industry are whimsically calling this the "BICE Lite."

BICE Lite

The BICE Lite is a streamlined exemption for those Advisors who are Level Fee Advisors (LFA). An LFA is an Advisor whose only fee in connection with investment advisory or management services is level and disclosed in advance. A "level fee" is one that is a fixed percentage of the value of plan assets or a set fee that does not vary with the recommended investment. Because the usual financial arrangement in place today for those who are advice fiduciaries to a plan is a level fee, the BICE Lite should apply for most of those advisors. Under this exemption, only requirements 2 and 3 from the BICE list above apply. There are additional considerations that apply when the advice relates to a rollover. The Advisor also must document these considerations.

BICE Lite Requirements

Fiduciary acknowledgement. Prior to, or at the time of the transaction on which the advice is being provided, the FI must provide the Investor with a written statement acknowledging that it is a fiduciary. The essence of this requirement is that, if an Advisor is relying on the BICE or BICE Lite, the DOL will not allow him or her to deny later that he or she is a fiduciary. Impartial Conduct Standards. There are three elements to this promise by the Advisor to behave impartially:

- The investment advice must be in the best interest of the Investor. "Best Interest" means that the advice:
  – Meets ERISA's prudence requirements – that is, that the Advisor is acting with the same care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims. As the Advisor to the plan is an ERISA fiduciary, he or she should be meeting this requirement anyway;
  – Is based on the investment objectives, risk tolerance, financial circumstances, and needs of the Investor; and
  – Is without regard for the financial interests of the Advisor, FI, Affiliates, Related Entities, or any other party.
- The Advisor's compensation must be reasonable; and
- The Advisor may not make any statements that are misleading.

Making this promise is not enough; the Advisor must actually behave according to these standards. If the prohibited transaction involves a rollover from a plan in which the Advisor is a fiduciary to an IRA, and the transaction will result in additional compensation to the Advisor, the exemption requires that the Advisor document (and retain the documentation):

- That the Advisor considered:
- – Other alternatives, including leaving the money in the plan;
  – The fees and expenses associated with the plan and the IRA;
  – Whether the employer pays some or all of the expenses in the plan; and
  – Differences in the levels of service being provided in the plan vs. the IRA;
- Why the new arrangement is in the Investor's Best Interest; and
- If the transaction involves a switch from a commission-based account to a level fee arrangement, why the arrangement is in the Investor's Best Interest. Will This Solve the Rollover Conundrum? At least nominally, this exemption will permit investment fiduciaries to capture rollovers from retirement plans that they advise. An important issue affects not just the BICE Lite but also all potential fiduciary investment advice that is given by someone involved with the plan. As mentioned in the New Fiduciary Regs – Part I FlashPoint, many, many things can constitute fiduciary advice, such as recommending a financial advisor to a plan administrator. Whether the advice given is fiduciary in nature may depend on whether there is any compensation received for that advice. Similarly, whether a fiduciary relying on the BICE Lite has "level compensation" may depend on whether anything other than the set fee constitutes inadvertent compensation

Consider the following:

- A TPA offsets all revenue sharing payments from an FI against his or her fees, but the FI provides the TPA (and other TPAs who have recommended a minimum number of clients to it) with a trip to a resort to attend an educational meeting.
- A TPA recommends a client to a financial advisor. The advisor sends the TPA a gift certificate to a nice restaurant.
- A TPA recommends a client to a financial advisor, in the knowledge that the advisor will return this "kindness" by referring his clients to the TPA.

Because the "compensation" definition in the DOL guidance does not have any de minimis standard, even the stuffed animals and other "swag" at conferences could be sufficient payment to cause what would otherwise be a level fee to not be so.

Conclusion

As noted before, the regulation and exemption are new and unexplored. Since we sent you Part I of this series, several lawsuits have been filed to prevent the regulation from going into effect. The DOL has not yet begun to respond to the questions raised by the industry and its representatives are refusing to speak substantively about the regulations right now.

Remember that the regulations are not effective until April of next year, and full compliance with the BICE and BICE Lite requirements is effective as of January 1, 2018 (transition rules will apply between these dates). A lot can happen before then. Part III of this series will discuss what people are saying, what concerns are being expressed, what issues are being litigated, and our own thoughts on the regulations.

Pensions on Peachtree 2017 is coming!
April 24 – 25, 2017
Marriott Century Center, Atlanta, Georgia

The 2017 Pensions on Peachtree Conference, co-sponsored by FIS and Ferenczy Benefits Law Center, is being planned as we speak. If you would like to make suggestions for topics to include in our event, just give us a call or send us an email. We look forward to seeing you there!

FERENCZY
BENEFITS LAW CENTER
We are your ERISA solution™

Ilene Ferenczy • ilene@ferenczylaw.com | Alison Cohen • acohen@ferenczylaw.com
Adrienne Moore • amoore@ferenczylaw.com | Adriana Starr • astarr@ferenczylaw.com
Tia Thornton • tthornton@ferenczylaw.com | Leah Dean • ldean@ferenczylaw.com

2635 Century Parkway Suite 200, Atlanta, GA 30345
T 404.320.1100 | F 404.320.1105 | www.ferenczylaw.com