

DrinkerBiddle

Investigations of RIAs for Their Services to Plans

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DOL National Enforcement Project

[T]he PIC project . . . investigat[es] the receipt of improper or undisclosed compensation and supports the Department's . . . initiatives . . . that plan fiduciaries and participants receive comprehensive disclosure about service provider compensation and conflicts of interest.

PIC exams also focus on indirect compensation arrangements, conflicted and undisclosed arrangements and arrangements that are outside of market standards.

Note: 408(b)(2) disclosures.

Prohibited Transaction Rules

Both ERISA and the Code prohibit **fiduciary advice**:

- that results in receipt of compensation by the “adviser”* from a party other than the plan; or
- where the “adviser”* causes himself to receive a benefit (e.g., compensation).

*“adviser” includes affiliates.

Note: The Internal Revenue Code has similar provisions for IRAs.
Compensation: Cash and non-cash compensation.

Prohibited Transaction Exemptions

When fiduciary advice causes a prohibited transaction, the transaction may proceed if the conditions of an exemption are satisfied.

The burden of proof of compliance with the exemption is on the person claiming the exemption.

The Temporary Non-Enforcement Policy

DOL Field Assistance Bulletin (FAB) 2018-02: If investment advice fiduciaries are working diligently and in good faith to comply with the Impartial Conduct Standards . . .

- Best interest standard of care.
- No materially misleading statements.
- Only reasonable compensation.

Note: Non-discretionary investment advice only.

Compensation

The term “*fee or other compensation, direct or indirect*” means . . . any explicit fee or compensation for the advice received by the person (or by an affiliate) **from any source**, and any other fee or compensation received from any source in connection with or as a result of the purchase or sale of a security or the provision of investment advice services, including, though not limited to, . . . **gifts and gratuities, and expense reimbursements**. [Emphasis added.]

Note: Compensation includes both money and things of monetary value.

Compensation

*“A fee or compensation is paid “in connection with or as a result of” such transaction or service if the fee or compensation **would not have been paid but for** the transaction or service or if eligibility for or the amount of the fee or compensation is **based in whole or in part on the transaction or service.**”*
[Emphasis added.]

Issues for RIAs

RIA's Own Retirement Plans

- Discretion.
- Advisory fees.
- Services of affiliates.
- Proprietary product: Prohibited Transaction Class Exemption (PTCE) 77-3.
- Third party payments.
- Plans of affiliates.

Prohibited Transaction Issues for RIAs

Discretionary Investment Management

- Frost Advisory Opinion (97-15A).
- Discretion and undisclosed (or inadequately disclosed) fees (and the SEC's SCSDI).

Prohibited Transaction Issues for RIAs

Proprietary Investments and Services

- Fiduciary services to both plan and participants.
- PTCE 77-4.
- Collective Investment Trusts.

Prohibited Transaction Issues for RIAs

Payments from Custodians (and other third parties)

- NTF funds (DOL investigations).
- Other revenue sharing.
- Share classes and SEC SCSDI.
- Non-discretionary advice and discretionary management.

Prohibited Transaction Issues for RIAs

Asset Allocation and Asset Class Fees

Real Life Issues from DOL Investigations of RIAs

- An RIA and a third party administrator (TPA) were owned by a common parent. The TPA administered the RIA's plan for a fee.
- An RIA charged an advisory fee to its own 401(k) plan.
- An affiliate of an RIA received 12b-1 fees and other revenue based on investment recommendations that the RIA made to a 401(k) plan.
- An affiliate of an IRA was a sub-adviser to Collective Investment Funds (CIFs). The RIA, acting as a fiduciary adviser to plans, recommended the CIFs to retirement plans.

DOL Investigation of RIA

Documents and Information Requested:

All documents identifying the amount of fees or other compensation, including gifts, gratuities, commissions, investment management fees, sales charges, redemption fees, 12b-1 distribution fees, placement fees, insurance premium commissions or other things of value [RIA] received, directly or indirectly, . . .

continued . . .

DOL Investigation of RIA

Continued . . .

. . . In connection with any transaction involving ERISA-covered employee benefit plan clients, including documents sufficient to identify the name of the entity from which the fees were received, the amount of the fees, all contracts or agreements for the receipt of fees and the name of each associated plan to which the fees relate.

SEC Proposed RIA Interpretation

This [fiduciary] obligation to provide advice that is suitable and in the best interest applies not just to potential investments, but to all advice the investment adviser provides to clients, . . .

*. . . including advice about an investment strategy or engaging a sub-adviser and **advice about whether to roll over a retirement account so that the investment adviser manages that account.***

The SEC Prioritizes Rollover Recommendations

In 2015, the SEC issued a National Exam Program Risk Alert entitled the “Retirement-Targeted Industry Reviews and Examinations Initiative (‘ReTIRE’).”

*OCIE, through the National Examination Program (NEP), will conduct examinations of SEC-registered investment advisers and broker-dealers (collectively, registrants) **under the ReTIRE Initiative** that will focus on certain higher-risk areas of registrants’ sales, investment, and oversight processes, **with particular emphasis on select areas where retail investors saving for retirement may be harmed.***

continued . . .

The SEC Prioritizes Rollover Recommendations

Continued . . .

- **Reasonable Basis for Recommendations.** Registrants have important obligations under the federal securities laws and SRO rules (with respect to broker-dealers) **when making recommendations or providing investment advice.** To the extent applicable and required, the staff will assess the actions of registrants and their representatives for consistency with these obligations when: **(i) selecting the type of account;**⁵ . . .

continued . . .

⁵See FINRA, Rollovers to Individual Retirement Accounts, Regulatory Notice 13-45 (December 2013).

The SEC Prioritizes Rollover Recommendations

Continued . . .

- **Conflicts of Interest** . . . The staff will review registrants' sales and **account selection practices in light of the fees charged, the services provided to investors, and the expenses of such services to evaluate**, . . . whether: (i) . . . and (ii) **material conflicts of interest**, such as compensation structures that may incentivize representatives to make certain recommendations, **are disclosed or otherwise addressed**.

SEC ReTIRE Initiative

The areas of concern from Phase One of the Initiative include:

- Recommendations for investors and retirees to go into incorrect share classes;
- Misleading marketing materials with respect to investment offerings and rollovers;
- Lack of documentation to support the reasonableness of recommendations (including rollovers);
- Vague or omitted disclosures related to fees, conflicts, and services of affiliates; . . .

SEC Examination of RIA

Provide any written disclosures and any scripts used during the past six months regarding:

- a. Distribution options (i.e., maintaining assets in a former employer's plan, transferring assets to a new employer's plan, rolling assets over to an IRA, or taking a lump sum distribution), the tax implications of those options, and other considerations . . .*

continued . . .

SEC Examination of RIA

Continued . . .

- b. Conflicts of interest or financial interests that Registrants or its representatives have in recommending any specific product or account type;*
- c. the various types of account options available to clients (i.e., IRA Rollover), including the account-level fees and expenses and services provided; . . .*

FINRA Focus on Rollover Recommendations

The FINRA 2018 Regulatory and Examination Priorities Letter highlights rollovers by saying:

Employer-sponsored retirement plans play a critical role in many individuals' retirement planning and for this reason will be an important area of focus for FINRA. In this regard, FINRA will focus on the suitability of firms' and registered representatives' recommendations made to plan participants, including Individual Retirement Account rollover recommendations involving securities transactions.⁵

Note: The footnote is to FINRA Regulatory Notice 13-45.

SEC Share Class Selection Disclosure Initiative

*While many of the respondent investment advisers disclosed that they (as dually registered broker-dealers), their affiliated broker-dealer (or its registered representatives), or the investment adviser's supervised persons **"may" receive 12b-1 fees** from the sale of mutual fund shares and that **such fees "may" create a conflict of interest, . . .***

continued . . .

Share Class Selection Disclosure Initiative, U.S. Securities and Exchange Commission, May 1, 2018.

SEC Share Class Selection Disclosure Initiative

Continued . . .

*. . . the firms **failed to disclose that they had a conflict of interest because many mutual funds offered a variety of share classes**, including some that paid 12b-1 fees and others that did not for eligible clients, and **failed to disclose that they were, in fact, receiving 12b-1 fees** due to the mutual fund shares they bought for or recommended to their clients.*

SEC SCSD Initiative FAQs

*Does an adviser have to disclose both conflicts – i.e., conflicts associated with **(1) making investment decisions in light of the receipt of 12b-1 fees and (2) selecting the more expensive 12b-1 fee paying share class when a lower-cost share class was available for the same fund?***

*As reflected in the cases cited in the Announcement, **both of these disclosures are necessary.** An adviser is eligible for the SCSD Initiative if it failed to disclose either or both of those conflicts.*

Best Execution

*The Commission has brought several settled enforcement proceedings against investment advisers for **failing to seek best execution** when the advisers caused clients to purchase a more expensive share class when a less expensive share class was available.*

SEC Examination of RIAs as SCSDI Follow-up

The SEC requested following information on a SCS Practices follow-up examination:

- “12b-1 fees” means ongoing annual marketing and distribution fees paid by a mutual fund per Rule 12b-1
- “Revenue Sharing Payments” are payments made by a clearing firm as a result of investments by Advisory Clients in certain mutual funds and/or money market funds

Note: Consequences.

Disclosures of Material Conflicts

RIAs should review their ADV disclosures in light of the heightened awareness of conflicts of interest.

- “May” receive fees from investments and providers.
- Query: Need to describe impact on investor?
- Rollover recommendations.

Senior Investors and Retirement Accounts and Products

*In examinations of investment advisers, OCIE will continue to **review the services and products offered to seniors and those saving for retirement**. These examinations will focus on, among other things, compliance programs of investment advisers, the appropriateness of certain investment recommendations to seniors, and the supervision by firms of their employees and independent representatives.*

2019 Examination Priorities, U.S. Securities and Exchange Commission.

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