

Drinker Biddle

Unexpected Prohibited Transactions for Advisory Services to Plans and IRAs

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The Fiduciary Rule

Timeline for fiduciary rule and exemptions:

- June 9, 2017: Regulation expanding definition of non-discretionary fiduciary advice. But, discretionary investment management is a fiduciary service.
- June 9, 2017: “Transition” exemptions (e.g., BICE).
- July 1, 2019: Delayed final exemptions.
- March 15, 2018: Decision by 5th Circuit Court of Appeals.
- January 1, 2020: Projected date of new SEC and DOL guidance.

Who is A Fiduciary?

- The “new” fiduciary definition.
- The 5-part test.
- Proposals later this year.

The 5-Part Test

Old rule definition of fiduciary:

- Recommendations provided for compensation;
- On a regular basis;
- Pursuant to a mutual understanding that;
- The advice will serve as a primary basis for investment decisions; and that
- The adviser will provide individualized advice based on the particular needs of the retirement investor.

Note: RIAs and the 5-part test: Recommending rollovers and IRA transfers.

What Does the Delay Mean?

- Coordination of SEC, DOL and State Insurance Commissioners?
- Uniform definition of fiduciary adviser?
- Uniform standard of care?
- Uniform treatment of conflicts of interest?

But ERISA statutory prudent man rule, duty of loyalty, reasonable compensation limit, and prohibited transactions.

And Code statutory limit to reasonable compensation.

Prohibited Transactions

- Generally speaking, financial conflicts of interest are prohibited under both ERISA and the Internal Revenue Code.
- Some prohibited transactions only apply to fiduciaries, but others apply to all service providers.
- The Department of Labor can create exceptions (called “exemptions”) to transactions that are prohibited under the Code and ERISA.

Prohibited Transactions

Both ERISA and the Code prohibit **any service provider** from receiving more than reasonable:

- Code §4975(c)(1)(C) and §4975(d)(2): Services permitted “if no more than reasonable compensation is paid.”
- ERISA §406(a)(1)(C) and §408(b)(2): Services permitted “if no more than reasonable compensation is paid.”

The Code covers IRAs and tax-qualified plans. ERISA generally covers private sector tax-qualified plans.

The Importance of Services

It is a prohibited transaction under ERISA and the Code if advisers can receive more than “reasonable compensation” for services to plans or IRAs.

- Determination of reasonable compensation.
- The “reasonableness” of compensation: What are the services? What is the value of those services?

Note: Benchmarking and burden of proof.
Statutory provisions in ERISA and Code.

Prohibited Transactions

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

- that results in receipt of compensation by the “adviser”* from a party other than the plan (ERISA §406(b)(3) and Code §4975(c)(1)(F)).
- where the “adviser”* causes himself to receive a benefit (e.g., compensation) (ERISA §406(b)(1) and Code §4975(c)(1)(E)).

*“adviser” includes affiliates.

Compensation: The “but for” rule.

The BICE Prohibited Transaction Exemption

The Financial Institution and Adviser must comply with the Impartial Conduct Standards . . .

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

Note: The 5th Circuit opinion also vacated BICE.

Retirement Plans Sponsored Advisory Firm

- PTE 77-3 (open-end mutual funds):
 - Only permissible fee is advisory fee from fund.
 - No redemption fee unless paid only to fund.
 - No sales commission (or 12b-1).
 - Dealing no less favorable to plan vs. other investors.
 - Prudence requirement and expense ratios.

- PTE 79-13 (closed-end registered funds of affiliate) – substantially identical requirements as PTE 77-3

Issues for RIAs

RIA's Own Retirement Plans

- Discretion.
- Advisory fees.
- 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 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.

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

Payments to Affiliates and Related Parties

Prohibited Transaction Issues for RIAs

Asset Allocation and Asset Class Fees

Prohibited Transaction Issues for RIAs

Performance-Based Compensation

Prohibited Transaction Issues for RIAs

Solicitor's Referrals and Fees

Prohibited Transaction Issues for RIAs

In the preamble to BICE, the DOL said:

Similarly, the prohibited transaction rules could be implicated by a recommendation to switch from a low activity commission-based account to an account that charges a fixed percentage of assets under management on an ongoing basis.

➤ “Reverse churning.”

SEC 2018 Examination Priorities

The SEC is also focused on recommendations to change from commission accounts to fee accounts:

We will also focus on firms that have practices or business models that may create increased risks that investors will pay inadequately disclosed fees, expenses, or other charges. These practices or business models include:

- advisers that changed the manner in which fees are charged from a commission on executed trades to a percentage of client assets under management.

FINRA 2018 Examination Priorities

FINRA will review situations in which registered representatives recommend a switch from a brokerage account to an investment adviser account where that switch clearly disadvantages the customer, such as where the registered representative recommended that the customer purchase a securities product subject to a front-end sales charge in a brokerage account and then shortly thereafter recommended that account be transferred to a fee-based account.

DOL Investigations of Advisers

“[BD/RIA] has agreed to pay \$633,715.46 to 10 pension plans This agreement follows an investigation by the [DOL] that found the full-service brokerage company violated federal law when it recommended certain hedge funds of funds as investments These recommendations resulted in the hedge funds of funds paying [BD/RIA] revenue-sharing and other fees.”

Comment: Same concept applies to IRAs.

DOL Investigations of Advisers

“[RIA] has agreed to pay \$1,265,608.70 to 13 pension plans to resolve alleged violations of ERISA. An investigation . . . found that the . . . fiduciary investment adviser made investments in mutual funds on behalf of ERISA-covered defined benefit plan clients and received 12b-1 fees from those funds [RIA] failed to fully disclose the receipt of the 12b-1 fees, and to use those fees for the benefit of the plans either by directly crediting the amounts to the plans or by offsetting other fees the plans would be obligated to pay the company.”

***Perez v. Ramsay*, (No. 14-cv-6733, W.D. N.Y., Filed December 29, 2014)**

Ramsay provided investment advisory services to ERISA-covered plans and also owned a TPA that administered the plans:

- The DOL alleges that Ramsay caused himself and his companies to be paid fees and commissions which were not properly disclosed to or authorized by the plans;
- The DOL also alleges Ramsay used his fiduciary authority to cause the plans to invest in a higher fee fund when the *same* fund portfolio was available in a lower fee class.

Prohibited Transaction Issues for Clients

- Householding:
 - PTE 97-11.

- Family members of advisers.

IRAs and Retirement Plans of Family Members

- Fairly commonplace for advisers to manage IRAs for children, parents, etc.
- IRA owner or retirement plan fiduciary's decision to hire a relative (as a compensated adviser) is a PT.
- This is true even if the advisory relationship is a level fee arrangement – here, the PT is the decision to hire a relative, not the adviser's recommendations.

Prohibited Transactions for Plans and IRAs

*“ . . . A fiduciary may not use the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay an additional **fee to such fiduciary** (or to **a person in which such fiduciary has an interest which may affect the exercise of such fiduciary’s best judgment as a fiduciary**) to provide a service.*

Note: Applies to plans and IRAs.

Relatives [ERISA 3(15)]/Members of the Family [IRC 4975(e)(6)]

- Spouse.
- Ancestor.
- Lineal descendant.
- Spouse of a lineal descendant.
- But these **are not necessarily** the only relatives/family members in which a fiduciary may have an interest which **may** affect the fiduciary's judgment – we have seen the DOL allege PTs as to others as well.

Disclosures of Material Conflicts

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

Questions?



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