

Investment Advice for Participants: Capturing Rollovers

By Fred Reish, Bruce Ashton and Jason Roberts

This is the third in a series of bulletins regarding the Department of Labor's (DOL) regulation on investment advice for participants (the "Fiduciary Adviser Rule"). The first bulletin provided an overview of the regulation (<http://www.reish.com/publications/pdf/investadvfinaldol.pdf>) and the second looked at its application to "pure" level fee investment advisers (<http://www.reish.com/publications/pdf/investadvprohtrans.pdf>).

In this bulletin, we examine comments made by the DOL in the Preamble to the regulation regarding recommendations by fiduciaries and service providers concerning distributions and rollovers from qualified plans to IRAs. We are currently advising RIA and broker-dealer clients on how to structure their rollover programs in light of this guidance, and it is important for both advisers and general plan fiduciaries to understand the DOL's views in this increasingly important part of the retirement plan market.

Given an increase in DOL enforcement activities, DOL/SEC information sharing and Congressional initiatives aimed at fee disclosure and conflicts of interest, we believe that plan distributions and IRA rollovers will likely be scrutinized and a focus of future examinations. This bulletin provides a discussion of past DOL guidance regarding IRA rollover activities, how that guidance is affected by the Preamble language and our observations and recommended action items.

Background

In 2005, the DOL released Advisory Opinion 2005-23A which addressed whether the recommendation that a participant take a distribution from his 401(k) plan and roll the funds to an IRA was subject to the fiduciary standards and prohibited transaction rules of ERISA. This activity is sometimes referred to as "capturing rollovers" and "cross-selling," which are becoming increasingly important to advisers and investment providers as the baby boomers near retirement.

The DOL said that the person making the recommendation would not be treated as a fiduciary to the plan, even where he offered investment advice with respect to the investment of funds in the IRA. However, to the surprise of many, the DOL went on to say that if the adviser was *already* a fiduciary to the plan, then making a recommendation to take a distribution, advising on how to invest the funds in the IRA or even *answering questions* about these matters would be subject to

Fred Reish to Receive ASPPA 401(k) Leadership Award

The American Society of Pension Professionals & Actuaries (ASPPA) announced that Fred Reish is the recipient of the 2009 ASPPA 401(k) Leadership Award. ASPPA will present The ASPPA 401(k) Leadership Award to Reish on Monday, March 23, at the ASPPA 401(k) Summit.

The ASPPA 401(k) Leadership Award acknowledges a specific accomplishment or contribution by an individual or group of professionals working in the 401(k) industry each year. Sponsored by Morningstar, Inc., a leading provider of independent investment research, this award recognizes leadership, innovation, and significant influence in the retirement industry. Each year, ASPPA selects an honoree for having a direct and positive influence on the ability of Americans to build successful retirement futures, especially through employer plans during the past year.

both ERISA's fiduciary responsibility rules and the restrictions of the prohibited transaction rules because this amounted to the exercise of discretion over the management of the plan.

Discussion in the Preamble

The discussion in the Preamble about capturing rollovers arose in the context of disclosures that are required to be made to participants under the exemption. The DOL pointed out that:

"Some commenters suggested that the required disclosure ... contain information pertaining to compensation and fees in connection with rollovers or other distributions or the investment of assets in connection with a rollover or other distribution."

The DOL agreed, stating that "[g]iven the potential for abuse in this area, the Department agrees that such information should be furnished to participants and beneficiaries." It pointed out that:

"the final rule contains a specific provision that serves to require the disclosure of all fees or other compensation that a fiduciary adviser or any affiliate might receive in

connection with any rollover or other distribution of plan assets or the investment of distributed assets in any security or other property pursuant to the investment advice.”

However, the DOL did not stop there. It went on to reiterate its position stated in Advisory Opinion 2005-23A in the context of what it referred to as “cross-selling, *i.e.*, using existing clients, plan participants and beneficiaries in this case, to *market additional services or products...*” [Emphasis added] First, it noted that advising a participant to take a distribution would not ordinarily be a fiduciary act, but if the person giving the advice is already a fiduciary, the opposite is true. Thus, if a person is serving as a fiduciary adviser under the 408(b)(14) exemption, giving such advice would be a fiduciary act. The DOL said:

“... the Department notes that, while advising a participant or beneficiary to take an otherwise permissible plan distribution would not normally constitute ‘investment advice’ within the meaning of [the DOL regulation defining that term under ERISA], *the Department has taken a different position with respect to such activities when the person making such recommendations is already a plan fiduciary, as would be the case with a fiduciary adviser.*” [Emphasis added]

The DOL then stated its view of the rules that apply to the person making the recommendation, including the prohibition against a fiduciary using plan assets for his own benefit in violation of ERISA Section 406(b)(1):

“When a person is already acting in a fiduciary capacity with respect to the plan, the Department has indicated that recommendations relating to the taking of a distribution or the investment of amounts withdrawn from the plan would constitute the exercise of discretionary authority respecting management of the plan and, *therefore must be undertaken prudently and solely in the interest of the participant or beneficiary, consistent with section 404(a)(1).* The Department further notes that if, for example, a fiduciary exercises control over plan assets to cause a participant or beneficiary to take a distribution and then to invest the proceeds in an IRA account managed by the fiduciary, *the fiduciary may be using plan assets in his or her own*

interest, in violation of [the prohibited transaction rule in] ERISA section 406(b)(1).” [Emphasis added]

It is especially important to take note of the DOL’s next comment—that the exemption for providing investment advice to participants and IRA beneficiaries does *not* apply to the prohibition against a fiduciary using plan assets for his own benefit. The DOL notes:

“The prohibited transaction relief offered by the statutory and class exemption [under Section 408(b)(14)], which apply to transactions related to the provision of investment advice to plan participants or beneficiaries, *would not cover such a violation.* Moreover, the Department is unable to conclude that the mere disclosure of fees or other compensation received in connection with such a distribution and investment, by itself, would be sufficient to avoid a violation of section 406(b)(1).” [Emphasis added]

Finally, the DOL pointed out that the issue of “cross-selling” creates an added responsibility for the general fiduciaries of the plan, *i.e.*, those who authorize the selection of a fiduciary adviser to give investment advice to the participants. The DOL states:

“Because a fiduciary adviser, in making recommendations related to the taking of a distribution or the investment of amounts so withdrawn from the plan, may violate ERISA section 404(a)(1) and/or 406(b)(1), *authorizing plan fiduciaries, in carrying out their duties under section 404(a)(1) in selecting and periodically reviewing the adviser, may need to understand the extent to which such recommendations will be made.*” [Emphasis added]

Summary of the DOL Position

Breaking these comments down into their components, here is what the DOL is saying in the Preamble to the Fiduciary Adviser Regulation about the issue of capturing rollovers:

1. Remember that fiduciary advisers are fiduciaries when they offer participant investment advice.
2. The recommendation to a participant to take an otherwise permissible distribution and roll it to an IRA is not investment advice under ERISA.
3. However, if the person making the recommendation is a fiduciary to a plan, including a fiduciary adviser, the DOL considers the recommendation itself to be a fiduciary act (because it is the exercise of discretion over the management of the plan) subject to the prudence and other requirements of ERISA governing the conduct of fiduciaries.
4. If the fiduciary adviser receives compensation for the advice to the participant or on the investment of the rollover assets, that could be viewed as a prohibited transaction because the adviser is using plan assets in his own interest.
5. This prohibited transaction is not covered by the fiduciary adviser exemption.
6. Under the regulation, the fiduciary adviser must provide disclosure to the participants of the extent to which it or any affiliate will receive compensation in connection with rollovers.

Pre-Conference Session at 401(k) Summit

Fred Reish, Bruce Ashton and Jason Roberts will present a pre-conference session, entitled “Disclosure Obligations in Times of Uncertainty,” at the upcoming 401(k) Summit. The session will be aimed at financial services professionals and will address current legal requirements—the fiduciary rules, proposed 408(b)(2) regulation, the recently introduced Defined Contribution Fee Disclosure Act and any other major proposals between now and then—plus strategies for managing risk and “best practices.” The session will be held at 8:00am on Sunday, March 22, in the Madeleine room, sections C and D. It is open to all registrants at the Summit.

7. As stated at the end of the Preamble language on this issue, plan sponsors have an obligation to understand the extent to which a fiduciary adviser intends to engage in “cross-selling” before selecting that person or his firm as a fiduciary adviser for the plan. This obligation exists because the plan sponsor has an obligation to prevent the fiduciary adviser from engaging in a breach of fiduciary duty or a prohibited transaction. “Understand” effectively means that the plan sponsor must consider the prudence of selecting the fiduciary adviser in the first place.

Observations

Even under the DOL’s stringent view of things, it is important to keep in mind that there is no prohibition against recommending that a participant take an otherwise permissible distribution, even if the person making the recommendation is a fiduciary to the plan. What is required is that the adviser consider what is in the best interest of the participant in making the recommendation so that he fulfills the obligations of a prudent fiduciary.

The more difficult—though perhaps not insurmountable—issue is the prohibited transaction rule applicable to the recommendation. That is, the recommendation cannot result in the fiduciary adviser using plan assets (*i.e.*, the assets being rolled over) for his own benefit—which would presumably occur if the fiduciary adviser receives compensation (*e.g.*, a commission or fee) for giving advice on the investment of the IRA assets. This does not necessarily mean that every arrangement for the capture of rollovers by a fiduciary adviser will cause a prohibited transaction, and it may be possible to structure the arrangement to avoid the issues the DOL raises in the Preamble and in Advisory Opinion 2005-23A.

A second observation is that it is possible to conclude that the DOL’s comments regarding the capture of rollovers is more limited than might first be assumed. We base this on the context in which the DOL made its comments in the Preamble, that is, on the practice it labeled “cross-selling.” The DOL defines this as “using existing clients, plan participants and beneficiaries in this case, to market additional services or products.” In other words, it may be that the DOL is limiting its conclusion to a situation in which the fiduciary adviser “markets” its rollover services versus the situation in which the participant elects to take a distribution and then requests advice on an unsolicited basis.

The DOL’s position is somewhat confusing. In the Preamble, it discusses the issue in the context of “cross-selling.” In the Advisory Opinion, it asks whether making “a *recommendation* that a participant roll over his or her account balance to an individual retirement account” constitutes investment advice; but in the answer, it says that where someone is a fiduciary to the plan, “*responding to participant questions* concerning the advisability of taking a distribution or the investment of amounts withdrawn from a plan” is a fiduciary act that is subject to the prudence and prohibited transaction rules of ERISA. Cross-selling, making recommendations and responding to questions are clearly different things, so the guidance itself has internal conflicts that make it difficult to distinguish between what is a safe practice and what is not.

PLANSPONSOR’s 15 Legends of the Retirement Industry

This is our fourth installation of the 15 “Legends.” In our future newsletters and bulletins, we will be featuring the other Legends that were selected by PLANSPONSOR. These “Legends” are individuals who have, in the past decade and a half, made a lasting contribution to the nation’s retirement security. For more information, go to <http://www.reish.com/publications/pdf/legends.pdf>.

Ann Combs, head of Vanguard’s Institutional Strategic Consulting Group, was honored as one of the 15 individuals selected as “Legends of the Retirement Industry.” She was the former Assistant Secretary of Labor and head of Employee Benefits Security Administration of the U.S. Department of Labor. PLANSPONSOR recognizes her leadership in assistance to the implementation of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), the SunAmerica decision, the expansion of voluntary compliance programs, the resolution of the Enron turmoil and market-timing scandal, the introduction of 409A for nonqualified deferred compensation programs, and the signing of the Pension Protection Act of 2006. Under her guidance, EBSA offered an insightful and practical guidance as to how plans sponsors and the retirement community could better perform their fiduciary responsibilities.

There are a number of areas in which we question the DOL’s analysis from a statutory interpretation standpoint, but the bottom line is that the DOL has painted with a broad brush... possibly in response to situations around the country in which advisors have recommended that participants take early distributions and then invest the funds in high risk investments that pay high fees to the advisors. The conclusion we have reached is that advisors should not be recommending to participants that they take an early distribution from their 401(k) plan—*i.e.*, a distribution while they are still working—and roll the funds to an IRA advised by that advisor. At the same time, we think that programs can be designed to address the concerns raised by the DOL where the participant is already going to be taking a distribution as a result of termination of employment or retirement.

Action Items

Notwithstanding our reservations about Advisory Opinion 2005-23A and the language in the Preamble, the DOL’s position creates an element of risk for firms in seeking to capture rollover business. We have advised a number of broker-dealers and investment advisory firms on the practices and procedures they should put in place to manage that risk. As a matter of risk management, we generally recommend that firms undertake a review of their policies and procedures and create disclosure documents that seek to mitigate the risk that an advisor may be deemed to be “marketing” IRA rollovers or otherwise engaging in a prohibited transaction. (Note that these action items apply to firms and their

advisers who provide fiduciary investment advice at both the plan and participant levels.)

Here are some specific action steps that firms should consider:

- For broker-dealers that do not permit their registered representatives to act as fiduciaries, procedures should be developed to clearly define the scope of permissible services (*e.g.*, to ensure that information provided to participants is considered “education” and not “advice”), so that they are not deemed to be fiduciaries subject to the corresponding rules concerning prohibited transactions.
- To the extent a registered representative or investment advisor representative is performing a fiduciary function, procedures should be developed to address the “marketing” or recommendations concerning rollovers. Moreover, such procedures should require documentation evidencing the participant’s independent election to take a distribution and his unsolicited decision to seek advice from the advisor regarding the investment of the proceeds.
- In light of the duty of plan sponsors to understand the extent to which the advisor will seek to capture rollovers, firms should adopt uniform disclosures to the plan sponsor regarding their activities. In representing plan sponsors, we advise that if they permit “cross-selling” and other IRA rollover services, they require the advisor to agree that such advice will be consistent with generally accepted investment principles, such as modern portfolio theory and strategic asset allocation, and prevailing investment industry standards because those are the standards under ERISA to which the general plan fiduciaries will be held. Therefore, the advisor’s disclosures should include a description of the type of advice that will be given to participants regarding the distributed assets along with these types of representations.
- The procedures should require the advisor to document his review of the firm’s policies concerning IRA rollovers with plan sponsors and participants. Firms that do not permit advisors to recommend or become the broker of record on participant distributions should clearly communicate such policies to their advisors and the advisor’s plan sponsor clients.
- RIAs should review Part II of their Form ADV to make sure that it is consistent with their rollover capture program. They should also establish procedures to ensure that IRA beneficiaries are being provided with Part II at the appropriate time.
- To the extent the participant selects an advisor to the plan to be his broker or investment advisor with respect to his IRA or elects to invest the proceeds of a distribution with an affiliate of the advisor, disclosure documents should be developed that detail all fees to be received by the advisor and/or any affiliated parties, any potential conflicts of interest, and procedures designed to avoid such conflicts, including supervisory review of IRA rollover transactions to determine whether an election to take a distribution and invest the proceeds is in the best interest of the participant.
- We recommend implementing a system to record the participants’ receipt of such disclosures and a representation from the participant that he understands that he could invest funds through an advisor that has no material affiliation with the plan.
- Given the uncertainty surrounding fiduciary versus non-fiduciary activities among advisors, we also recommend implementing training for advisors who service ERISA plans and participants. Firm policies are only effective to the extent advisors understand them and how they are to be applied. The same is true for compliance personnel, as those responsible for conducting supervisory activities must understand the underlying issues that the procedures seek to address.

Conclusion

In the Preamble to the Fiduciary Adviser Rule, the DOL has again reiterated a view that those who serve as fiduciaries to plans have additional hurdles to overcome in seeking to capture rollovers. Given the heightened scrutiny of fees and conflicts in the retirement plan market, we believe that addressing these issues now and developing a firm-wide response is essential from a risk management perspective.

Any tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

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