GROOM LAW GROUP

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Fiduciary Rule – "Hire Me"

On April 6, 2016, the U.S. Department of Labor ("DOL") made available its much-anticipated final regulation on the definition of "fiduciary" under section 3(21)(a)(ii) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The new rule will have a profound impact on the retirement system and how services are provided throughout the industry. The package of materials released by DOL includes the following:

- A final regulation re-defining who is a "fiduciary" by reason of providing investment advice to a plan or an IRA (the "Final Regulation");

- Final versions of the Best Interest Contract Exemption (the "BIC Exemption"), related supplemental exemptions, and the new prohibited transaction class exemption for principal transactions in certain investments (the "Principal Transactions Exemption"); and

- Final amendments to several existing prohibited transaction class exemptions, including prohibited transaction class exemption ("PTE") 84-24, currently the primary source of prohibited transaction exemptive relief for the sale of insurance and annuity products to plans and IRAs.

The Final Regulation, changes to existing class exemptions, and certain elements of the BIC Exemption will be effective 60 days from the date of their publication in the Federal Register (*i.e.*, June 7, 2016). Despite this relatively early effective date, the terms of the rules generally delay their applicability until April 10, 2017. In the case of the BIC Exemption, special transition relief further delays the applicability of most conditions until January 1, 2018.

This client alert provides an overview of the "hire me" issue. For an analytical summary of the Final Regulation, BIC Exemption, the Principal Transactions Exemption, and changes to other existing exemptions, please see our client alerts covering those subjects.

I. Fee Based Advice Models and the "Hire Me" Conundrum

Most financial advisers and firms serving the retail segment of the financial services marketplace had been closely following DOL's proposed BIC Exemption. Some appear to have concluded – even before seeing the final version – that compliance with the BIC Exemption should be avoided at all costs, as it would not only be extremely challenging but could also subject individual advisers and firms to costly litigation risk, including potential class action litigation risk, arising out of alleged violations of the "best interest" promise that lies at the heart of the exemption. While a number of the BIC Exemption's most onerous provisions were eliminated, there may still be a number of reasons for wanting to avoid it.

Since the BIC Exemption was proposed last year, many firms have been searching for strategies that could permit them to avoid complying with the BIC Exemption while still providing a high level of service to their retail clients. One much discussed strategy is a

fiduciary advice model that is free of financial conflicts; this model is inspired by DOL guidance to the effect that a fiduciary adviser would not have a conflict of interest under the prohibited transaction provisions of ERISA and the Internal Revenue Code of 1986, as amended, if any 12b-1, shareholder services or sub-transfer agent fees attributable to a client's investments in mutual funds are used to benefit the client, either as a dollar-for-dollar offset against the fees the client would be obligated to pay to the adviser for its services or as amounts credited directly to the account. *See, e.g.*, Advisory Opinions 97-15A and 97-16A (May 22, 1997).

Under such a "level fee" program, whereby the individual adviser and the firm would both be compensated at exactly the same rate irrespective of the investment products recommended to the client, the adviser and the firm would be fiduciaries, but, while making recommendations *within the program*, would be free of fiduciary conflicts that would require relief under the BIC Exemption or other DOL exemptions. A related model is based on the DOL "SunAmerica" advisory opinion, and, in this model, the adviser's fiduciary conflict is addressed (arguably eliminated) by implementing the advice of an unrelated (and unbiased) financial expert (who is paid a level fee).

Another strategy is to couple investment advisory services with one or more existing prohibited transaction exemptions, such as the "investment advice" exemption in ERISA section 408(b)(14)/(g) (level fees or computer model), PTE 86-128 for purely commission-based compensation (*e.g.*, Exchange-Traded Funds or "A" shares), or PTE 77-4 for proprietary fund sales.

However, it might be premature to conclude that such levelized fee or alternative exemption strategies are a cure-all for "avoiding the BIC" while doing business – including rollover business – in the retail space. The potential Achilles' heel of these strategies is that before the adviser and the firm can begin providing fiduciary advice under either approach, ***they first need to sell the advisory service itself***. Moreover, in the vast majority of cases the advice program offered for sale can only be implemented for individuals who first roll over 401(k) plan or IRA account monies to a new IRA that is compatible with the advice program providers' platform.

The problem is that under the Final Regulation, a person renders investment advice as a fiduciary not merely when recommending the purchase, sale or holding of securities or other investment property, but in other contexts as well, including recommending (i) a rollover distribution or (ii) the engagement of a person who, for a fee or other compensation, would provide advice (whether on a discretionary or non-discretionary basis).

This brings us to the "hire me" conundrum. If, under the Final Regulation, a person is acting as a fiduciary when recommending a fee based investment advice or management program (including its own or its affiliate's), that person's financial interest in earning fee based compensation upon being engaged *results in a conflict that would itself require exemptive relief*. In turn, the most likely – and possibly only – source of exemptive relief appears to be the BIC Exemption; ironically the very result that the levelized fee model was intended to avoid in the first instance.

II. What Does the Final Regulation Say?

As it turns out, the Final Regulation clearly provides that one does not become a fiduciary merely by marketing oneself or an affiliate as a potential advice fiduciary, *unless that recommendation is coupled with an investment recommendation*. Thus, a fee-based adviser can freely "recommend" his or her services. ***However, this may be a pyrrhic victory because the vast majority of such "hire me" recommendations are likely to be made in conjunction with an investment recommendation.***

In particular, the Final Regulation makes it clear that a recommendation to roll over plan or IRA assets is *always* an investment recommendation. Moreover, the Final Regulation (or its preamble) indicates that any of the following are also investment recommendations:

- Recommending that someone *not* roll over but keep his/her assets where they are,
- Recommending investment policies or strategies,
- Recommending that someone move from a commission-based account to a fee-based account,[1] and
- Recommending – as part of the sales presentation – that an investor use a particular investment or fund.

The following scenarios are less clear, but could also involve an investment recommendation:

- Recommending *between* a new commission-based account and a new fee-based account, and
- Recommending between two advisory options (with different levels of service and fees).

In other words, just about the only situations in which a suggestion to "hire me" is – perhaps – not a fiduciary recommendation are (1) taking cold calls from customers who have already made the rollover decision or (2) advising a plan fiduciary to terminate its existing advisory relationship and replace it with another.

To the extent that a level fee adviser wishes to market his or her services in connection with a rollover (or in any of the other contexts noted above), he or she will need to rely on the BIC Exemption or some other exemption. ***However, in this situation, the BIC Exemption may be the only available exemption.*** The BIC Exemption does contain a streamlined "level fee" option, which enables advisers and financial institutions that receive only a level fee in connection with the advice they provide to rely on the exemption *without entering into a contract* so long as special attention is paid and documentation kept to show that certain specific recommendations, including a recommendation to rollover assets from a plan to an IRA, are in

[1] Many financial institutions have proposed simply directing customers into fee-based accounts. The preamble to the Final Regulation makes it clear that DOL believes doing so in inappropriate cases may constitute a prohibited transaction.

the customer's best interest. While no bilateral contract is required, a written acknowledgement of fiduciary status with respect to the rollover recommendation must be furnished to the advice recipient along with an affirmative statement to abide by DOL's "Impartial Conduct Standards" (essentially, a unilateral contract for purposes of affording the participant rolling over with enforcement rights under ERISA). Moreover, since the level fee condition extends to all affiliates, the streamlined BIC Exemption may not provide relief for recommending a rollover into an arrangement if the program's fees are levelized only at the firm level and not across the entire organization.

In this respect, advisers hoping to avoid the BIC Exemption in the rollover context by relying on the "level fee" or "computer model" ("robo-adviser") exemptions in ERISA section 408(b)(14)/408(g) may be out of luck.[2] While section 408(b)(14) covers any "transaction" in connection with the provision of investment advice to a participant or IRA, we suspect that the rollover recommendation will be viewed by DOL as a separate and distinct transaction not "in connection with" the subsequent level fee or "robo" advice. Using a non-exemption strategy such as "SunAmerica" likewise may be blocked. The BIC Exemption likely will be needed to "bridge the gap." (And once you are forced to use the BIC Exemption to sell your service, is there a strong reason to use a different approach when actually providing that service?). Luckily, even in the case of a rollover recommendation that does not satisfy the streamlined exemption, no contract is required if the recommendation involves taking a distribution from an ERISA plan. However, absent 100% level fees, recommending a rollover from one IRA to another will likely require a written contract and compliance with the full BIC Exemption.

[2] Financial institutions may be investigating the section 408(b)(14)/408(g) option with the expectation of earning additional compensation for affiliates.