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What Does the 5th Circuit Decision Mean for Rollover Recommendations? Interesting Angles on the DOL's Fiduciary Rule #84

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This is 84th article about interesting observations concerning the Department of Labor's (DOL) fiduciary rule and exemptions. These articles also cover the DOL's FAQs interpreting the regulation and exemptions and related developments in the securities laws.

The 5th Circuit Court of Appeals has "vacated" the DOL's fiduciary rule and exemptions. What does that mean for recommendations to participants that they take plan distributions and rollover to IRAs?

It means a lot . . . in some cases.

But before discussing that, it's important to note that the decision isn't applicable yet. At the earliest, it will take effect on May 7. However, if the DOL contests that decision and the courts "stay"–or block—it as the hearings and appeals take place, it may not apply for a year or more . . . or it may be overturned. So, the only thing we know is that we don't know whether advisors are governed by the new fiduciary rule–the one the court vacated–or if the "old" pre-June 9, 2017 rules apply. Unfortunately, when it comes to recommendations of plan distributions and rollovers, those two sets of rules are different in significant ways.

Let's look at the post-June 8, or "new," rules–the ones that the 5th Circuit considered. Under those rules, a recommendation to take a plan distribution and rollover is a fiduciary act and must be based on a prudent analysis of the participant's needs and a comparison of the plan and the IRA. Also, it's a prohibited transaction if the advisor makes more money if the recommendation is accepted by the participant, that is, if the money is rolled to an IRA with the advisor. Fortunately, there is an exemption–the transition Best Interest Contract Exemption, BICE. Unfortunately, it's hard to comply with BICE.

But, what if the new rules (including BICE) are thrown out? Under the old rules, a recommendation to a participant to take a distribution and rollover was not, in most cases, a fiduciary recommendation. As a result, it was not subject to the prudent man and loyalty requirements, and it was not a prohibited transaction. (Note, though, both FINRA and the SEC view that advice as a securities recommendation subject to their jurisdiction. See, *e.g*., Regulatory Notice 13-45.)

However, it the advisor was a fiduciary to the plan, a recommendation to rollover would be a fiduciary act. See DOL Advisory Opinion 2005-23A. Of course, that implicates the fiduciary standard of care–prudence and loyalty. It also is a prohibited transaction if the fiduciary recommendation causes the advisor (or the advisor's firm) to earn more from the IRA than it did from the plan. For example, if the advisor is a fiduciary to the plan and the compensation from the plan is 25 basis points a year, but the compensation from the IRA will be 100 basis points per year, that's a prohibited transaction. Unfortunately, there isn't an old rule exemption . . . meaning there's no way around the prohibition.

To make matters worse, many broker-dealers have allowed their advisors to be fiduciaries to the plans they work with . . . so the number of fiduciary advisors to plans is much greater than it was before June 9 of last year. And some of those advisors had counted on rollovers as part of the bargain for their services to the plans.

To further compound matters, I suspect that the attention given to fiduciary services in recent years means that more advisors are fiduciaries whether they declare that status or not. That's because the old rule had a functional definition that will be satisfied in many cases. Two provisions in the old rule are that the advice must be given regularly and there has to be a mutual understanding that the advice will be a primary basis for the plan sponsor to make investment decisions. Since most advisors now meet with plan sponsors at least once a year, the "regularly" requirement appears to be satisfied. And, it's possible that a disinterested reasonable third party would view the materials and statements by the advisor are a primary basis for investment decisions. In that case, the second prong may also be satisfied. (Some people think that the mutuality is about an explicit understanding between an advisor and a plan sponsor. The DOL, though, would probably take the position that the test should be what a reasonable third party would think of the interactions.)

What does this mean? What should advisors and their firms do?

Until this plays out, advisors and their firms need to satisfy two conflicting rules. Of course, that's impossible.

If the new rules are followed, rollover recommendations must be prudent and loyal. The benefit of that burden, though, is that BICE would be available. That's not a bad result under the transition rules for BICE.

But, if the old rules are followed, many advisors will not be fiduciaries . . . and therefore won't need an exemption. However, for those advisors who are fiduciaries to plans, recommendations to rollover will be fiduciary acts and likely prohibited transactions–without relief. Perhaps they could use education, rather than make recommendations.

Unfortunately, though, until the legal "dust" settles, in the sense of a resolution of the litigation, we won't know which rules apply.

More practically, I suspect that many advisors and their firms will continue under the new rules until the situation clears up. That could be as early as late April, or it could be delayed until the Supreme Court rules–if the case gets that far, perhaps more than a year from now.

If that wasn't complicated enough, it's likely that the DOL will come out with a new proposed rule and exemptions in the second half of this year. If I had to guess, I would say that these revised rules will still say that a recommendation to take a distribution and roll over was still a fiduciary act. The interesting part would be what the new exemption will require.

Bottom line . . . get legal advice; this is risky.

The views expressed in this article are the views of Fred Reish, and do not necessarily reflect the views of Drinker Biddle & Reath.

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