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Prohibited Transactions: IRA and RIA Qualified Money: Interesting Angles on the DOL's Fiduciary Rule #23

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This is twenty-third article about interesting observations concerning the fiduciary rule and exemptions.

When the definition of fiduciary advice is expanded on April 10, 2017, the investment and insurance recommendations of a much larger group of advisers will be classified as fiduciary advice and will, as a result, increase the focus on financial conflicts of interest (which ERISA and the Internal Revenue Code refer to as "prohibited transactions," or PTs). My suspicion is that, for most ERISA retirement plans, there will not be a great impact on advisers—because, to a large degree, advisers to retirement plans already are acknowledged fiduciaries. (To be fair, though, there will be some impact . . . particularly on smaller plans, where some insurance companies and broker-dealers have, in the past, taken the position that their advisers are not fiduciaries. Nonetheless, based on my recent experience in working with broker-dealers, the adjustments are being made without a great deal of difficulty.)

On the other hand, the impact on advisers' practices with IRAs will be significant. That is particularly true of investment and insurance services provided by broker-dealers. But, it is also true, to a lesser degree, of the services provided by RIAs. (Note: This article does not discuss recommendations to participants to take distributions and roll over to IRAs or recommendations to IRA owners to transfer their IRAs. Significant changes will be required for both RIAs and broker-dealers for those recommendations.)

One of the biggest changes—because of the fiduciary prohibited transaction rules—is that advisers will no longer be able to make recommendations that can affect the level of their compensation. An obvious example is that an adviser could not recommend a proprietary mutual fund (managed by an affiliate) without committing a prohibited transaction. That's because a recommendation cannot increase the compensation of the adviser, his supervisory entity (*e.g.*, a broker-dealer), or any affiliated or related party. Another example is that a financial adviser with a broker-dealer could not recommend that an IRA invest in mutual funds which pay different levels of 12b-1 fees to the broker-dealer and, indirectly, to the adviser. In effect, the adviser would be setting his own compensation (as well as the compensation of the supervisory entity). Similar issues exist for referral fees, revenue sharing, and so on. In all of those cases, the broker-dealer will need to either move to a level fee environment or to satisfy one of the prohibited transaction exemptions (most likely BICE—the Best Interest Contract Exemption).

Similar issues exist for RIAs. For example, we have seen cases where RIAs recommend proprietary products (*e.g.*, affiliated mutual funds). That is a prohibited transaction. Another example of an RIA prohibited transaction is where the adviser recommends an allocation to fixed income and an allocation to equities, but then charges a higher fee for managing the equities. By virtue of recommending the allocations, the adviser has determined the level of its compensation . . . and, therefore, has committed a prohibited transaction.

The moral of this story is that broker-dealers and RIAs need to closely review their investment practices for qualified money. ("Qualified" money is the new terminology for money in IRAs or plans. It is an easy reference to the types of accounts that are subject to the new rules.) Since virtually all investment and insurance advice to IRAs and plans (including recommendations about distributions, withdrawals and transfers) will become fiduciary advice on April 10, 2017, two steps should be taken. First, if they don't already exist, processes need to be put in place so that any advice satisfies the prudent person requirement. Generally speaking, that process should result in portfolio investing. Second, all payments for the advice (including indirect and non-cash compensation, whether to the adviser, the supervisory entity or any affiliates or related parties) needs to be examined. Once these rules are applicable, the compensation arrangements will need to satisfy the prohibited transaction rules in section 406(b)(1) and (3) of ERISA and the corresponding provisions in section 4975 of the Internal Revenue Code. Or, in the alternative, the condition of a prohibited transaction exemption must be satisfied.

And, all of that needs to be done by April 10, 2017.

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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