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REEXAMINING THE IMPACT OF THE FIDUCIARY RULE

In April 2016, the United States Department of Labor ("DOL") issued final regulations to expand the definition of "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code of 1986, as amended (the "Code"). Under the rule (the "Fiduciary Rule"), persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of certain benefit plans or arrangements will be treated as fiduciaries in a wider array of advice relationships. The Fiduciary Rule has been criticized by various industry groups with concerns about implementation and has been the subject of recent litigation. Consequently, the future of the Fiduciary Rule is uncertain. Individual Retirement Account ("IRA") advisors and financial institutions should re-think how the Fiduciary Rule may apply on a going forward basis and should reconsider procedures already taken to comply with this rule.

BACKGROUND: APPLICABLE STANDARDS PRIOR TO THE FIDUCIARY RULE

Without regard to the Fiduciary Rule, financial advisors registered as broker-dealers or insurance agents are regulated under the Investment Advisers Act of 1940 (the "Advisers Act") as "investment advisers" ("IAs"). Under the Advisers Act, an IA is required to know a client's financial preferences and recommend a "suitable" investment or vehicle for that client. The recommendation does not need to be the best available option for the client – IAs were held to the much more lenient suitability standard.

An IA is distinguished from a "registered investment adviser" (an "RIA"). The Advisers Act holds an RIA to a stricter fiduciary standard than an IA. As a fiduciary, an RIA must act in the best interests of the client and owes the client a duty of undivided loyalty and good faith. An RIA must not engage in any action that conflicts with the interests of the client (or must disclose such conflicts of interest to the client and obtain the client's waiver of such conflicts), must avoid misleading the client, must not use the client's assets for the RIA's own benefit or the benefit of another client (unless the RIA obtains the client's consent), and must provide the client with a full and fair disclosure of all material facts (i.e., facts that a reasonable investor would consider important). Failure to meet this standard may constitute fraud on the client.

In addition, ERISA imposes obligations on an individual that is considered a "fiduciary." Generally, an advisor (including an RIA) will be considered a "fiduciary" under ERISA if he or she provides advice on a plan. Prior to the enactment of the Fiduciary Rule, the issue of whether or not an advisor provides "advice" as a fiduciary was considered under a five point test. Pursuant to this test, an advisor is considered to be an ERISA fiduciary if the advisor is recommending securities or investments (1) on a "regular basis," (2) pursuant to a mutual agreement, arrangement or understanding (written or otherwise), (3) with an understanding the advice serves as a primary basis for investment decisions, (4) that is individualized to the needs of the specific client, (5) for compensation.

THE FIDUCIARY RULE

Under the Fiduciary Rule, the ERISA "fiduciary" definition is expanded to cover any representative who provides certain types of investment advice for a fee or other compensation. As a result, a financial advisor may be required to comply with ERISA fiduciary standards and to avoid certain ERISA prohibited transactions (or satisfy a prohibited transaction exemption). For example, an IRA advisor who offers advice on rollovers to IRAs or whether or not to recharacterize a Roth IRA conversion may be treated as an ERISA fiduciary with respect to those IRA assets. The Fiduciary Rule is intended to provide investors with increased protection when seeking investment advice on retirement plans and IRAs and to provide certainty to those investors regarding the standard that applies to a particular financial advisor.

The Fiduciary Rule provides certain related prohibited transactions exemptions. Two of these exemptions are intended to provide flexibility for certain financial advisors that have become subject to the ERISA fiduciary requirements as a result of the Fiduciary Rule; the "best interests contract exemption" and the "principal transactions exemption." Under these exemptions, a financial advisor may engage in a transaction that would otherwise be a prohibited transaction under ERISA and the Code.

- The best interests contract exemption (the "BICE") allows a financial advisor to receive compensation as a result of offering certain investment advice that would otherwise be considered self-dealing (e.g., recommending an IRA rollover that the advisor will then manage in exchange for a fee). However, a financial advisor may not use the BICE to engage in a "principal transaction" – such advisor must use the principal transactions exception (discussed below).

  Complying with the BICE depends on the financial advisor's fee structure. An advisor is either a "level fee" advisor or is not a "level fee" advisor. An advisor is a "level fee" advisor if the advisor's compensation is disclosed in advance to the investor and the fee is either a set retainer or is calculated as a percentage of assets under management. If the advisor receives any commission or engages in revenue sharing, the advisor is not a "level fee" advisor. We note that until July 1, 2019, when the Fiduciary Rule becomes effective, the fee distinction is irrelevant – any advisor subject to the Fiduciary Rule may meet the conditions of the BICE by complying with the impartial conduct standards (discussed below).

If the advisor is a "level fee" advisor, complying with the BICE is fairly easy – the advisor provides the investor with a written statement of the advisor's fiduciary obligation (and that of his or her financial institution) and complies with "impartial conduct standards" (and ensures that his or her financial institution also complies with such standards). To comply with the impartial conduct standards, an advisor and his or her financial institution must act in the investor's best interests, accept no more than reasonable compensation and avoid misleading statements. In addition, if the level fee advisor recommends a rollover to an IRA from either an ERISA plan or another IRA, the advisor must document the basis for the advisor's advice.

If, on the other hand, an advisor is not a "level fee" advisor, the advisor's advice is considered conflicted. The advisor can comply with the BICE only if the investor signs a contract with the advisor that allows the advisor to provide such advice. This contract does not need to be signed at the initial meeting with the investor – it can be signed later in the process (e.g., when the investor opens the account to engage in the transaction at issue). The contract must state, among other things, that the advisor and/or the financial institution has adopted policies to mitigate the impact of conflicts and ensure that the advisor complies with the impartial conduct standards, will not use compensation incentives that would encourage an advisor to not act in the best interests of the client, whether proprietary products are offered, and must inform the client of the services provided and the fee. The contract must also include a link to the financial institution's website, which must contain additional disclosures (e.g., a typical fee schedule, a model contract, description of institution's policies and procedures relating to conflict-mitigation, etc.). If the advisor recommends any proprietary products, certain other compliance is required, including an evaluation of whether any limits on its product offerings are consistent with its fiduciary obligations to a client.

If a financial advisor has a business structure that tends to generate frequent conflicts of interest with respect to retirement-related advice, the BICE will be helpful to provide advice to investors while remaining in compliance with the Fiduciary Rule. It is important to note, however, that the BICE is not a free pass for advisors – the advisor is still bound as a fiduciary to the investor and must act in the investor's best interests when providing advice.

- The principal transactions exemption ("PTE") permits certain persons who provide investment advice with respect to an employee benefit plan or IRA to engage in certain principal transactions involving debt securities and other investments. In a principal transaction, the financial advisor (and his or her financial institution) engages in the transaction on his or her own behalf. In this type of transaction, the advisor is typically compensated by charging a "mark-up" or a "mark-down" on the market price of the security. Absent an exemption, under the Fiduciary Rule, an investment advisor would be unable to recommend a principal transaction to a client. The DOL was concerned about the potential for advisor bias in this type of transaction but the DOL determined that the PTE was necessary because principal transactions are often useful to investors.

  Similar to the BICE requirements explained above, the PTE requires an advisor to provide the investor with a written statement of the advisor's fiduciary obligation (and that of his or her financial institution) and complies with "impartial conduct standards" (and ensures that his or her financial institution also complies with such standards). In addition, an advisor and his or her financial institution must implement policies designed to prevent violations of the impartial conduct standards and make certain additional contractual and annual disclosures. The advisor must make certain disclosures in a contract with an investor either prior to or at the time of the recommended transaction. The advisor also must provide an annual disclosure that lists each principal transaction during the year (along with details about each such transaction).

  However, the PTE only applies to advisors whose fiduciary authority regarding the investor's assets in the transaction is limited to providing investment advice.

For example, the PTE does not apply to an advisor or a financial institution that is the employer of employees covered under the plan involved in the transaction or to an advisor who has full investment discretion for a plan or IRA assets.

NEW DEVELOPMENTS AND STEPS TO CONSIDER AS AN IRA ADVISOR

The status of the Fiduciary Rule is currently in limbo. In an April 2017 release, the DOL delayed imposing the full conditions of these exemptions during a “transition period” that was originally scheduled to end on January 1, 2018. In November 2017, the DOL issued an 18-month extension of this transition period. As a result, the transition period is now scheduled to expire on July 1, 2019, at which time full compliance with the Fiduciary Rule will be required. As mentioned above, the Fiduciary Rule will not be fully implemented until 2019 and various lawsuits have challenged the legality of the rule in United States Courts of Appeals. Significantly, the Fifth Circuit Court of Appeals recently concluded that the DOL exceeded its regulatory authority by implementing the Fiduciary Rule. The Fifth Circuit entered a mandate to vacate the rule effective May 7, 2018. As a result, the future of the Fiduciary Rule is currently unclear. The DOL could still appeal the Fiduciary Rule for U.S. Supreme Court review. Even if the DOL chooses not to appeal, a consumer advocacy group could also request a rehearing. The Fiduciary Rule remains in effect at least until May 7, 2018, and advisors must continue to comply with the Fiduciary Rule until that date. After May 7, the future of the Fiduciary Rule is currently unknown.

Given the current status of the Fiduciary Rule, we recommend that advisors and financial institutions consider the following actions:

Consider retaining policies and procedures adopted for the Fiduciary Rule:

Financial advisors and financial institutions should continue to comply with the Fiduciary Rule until it becomes clear that the rule is no longer effective. Moreover, if the rule is repealed, consider the extent to which it makes sense to retain policies and procedures that were adopted to comply with the Fiduciary Rule (e.g., disclosures, agreements etc.). Without the Fiduciary Rule, it is possible that a different regulating agency may enact a similar set of rules with the goal of protecting investors. Separately, it may make sense to retain certain disclosures and/or procedures in order to manage risk or clarify services for clients.

Reconsider whether or not you may be a fiduciary under the "old" ERISA five point test:

If the Fiduciary Rule is repealed, the ERISA five point test will govern whether or not an advisor is a fiduciary. Even if you have analyzed the ERISA five point test in the past and concluded that it does not apply to your activities, it may be worthwhile to reconsider how to apply the five point test. The Fiduciary Rule triggered discussion about acting in a client's best interests and how to avoid conflicts. Advisors and financial institutions should consider whether these discussions might result in an expanded application of the Fiduciary Rule. However, we do not have any reason to believe that one-off advice regarding an IRA rollover, by itself, would cause an advisor to be a fiduciary under the original ERISA regulations.

If the Fiduciary Rule is repealed, the BICE and the PTE will be irrelevant:

If the Fiduciary Rule is repealed, the BICE and the PTE will presumably be repealed along with that rule. To the extent that you have adopted procedures to ensure that certain transactions qualify for the BICE or the PTE, those procedures will not provide an exemption from the transaction from being an ERISA prohibited transaction. If you are considered an ERISA fiduciary, you must either avoid prohibited transactions or rely on the ERISA prohibited transaction exemptions that existed prior to the Fiduciary Rule.

Consider avoiding strategies that rely on the BICE and the PTE in the short-term:

Due to the uncertain future of the Fiduciary Rule (and the BICE and the PTE that are included in such rule), consider avoiding use of the BICE and the PTE to engage in transactions that would otherwise be considered "prohibited transactions." If the Fiduciary Rule is vacated in accordance with the recent court decision, then the Fiduciary Rule may be considered void from the beginning in all jurisdictions. As a result, to the extent that you are treated as an ERISA fiduciary regardless of the Fiduciary Rule, the BICE and the PTE may be considered an invalid means of avoiding prohibited transactions. Note that, if you would not have been treated as an ERISA fiduciary but for the Fiduciary Rule, the particular transaction may not constitute a prohibited transaction under ERISA and the Code.

Consult with a Legal Advisor or Legal Counsel:

We recommend you consult with a qualified legal advisor or counsel concerning the legal status of the Fiduciary Rule and the impact of the Fiduciary Rule, ERISA and the applicability of the BIC and PTE exemptions or any other applicable exemption prior to offering or providing investment advice for compensation.

ABOUT THE AUTHOR

Caitlin Sawyer, a Tax Associate at Hunton & Williams LLP, helps clients navigate complex federal income tax issues. She focuses on corporate mergers, acquisitions and reorganizations, fund formation, and transactions involving partnerships, limited liability companies, and other pass-through entities. Caitlin assists clients with tax issues involved in mergers, acquisitions and other complex transactions. She has significant experience regarding the tax aspects of corporate mergers, acquisitions and reorganizations (including transactions involving banks and S corporations) and drafting tax provisions in partnership and limited liability company (LLC) agreements. She also has extensive experience calculating Section 280G payments and drafting 280G shareholder vote documents in connection mergers and acquisitions. Caitlin also has experience with drafting tax provisions in a variety of disclosure documents, including proxy statements and prospectuses. She regularly advises clients regarding the Foreign Account Tax Compliance Act (FATCA) as well as the Bipartisan Budget Act of 2015 (the New Partnership Audit Rules).

ABOUT HUNTON & WILLIAMS LLP

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