PURSUING ROLLOVERS IN AN EVOLVING REGULATORY LANDSCAPE

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We understand how important rollovers are to your business. As one of the nation's leading providers of IRAs, rollovers are important to our business too. In fact, McKinsey estimates that rollovers are expected to drive 40% to 50% of net new money for wealth managers through 2015.[1] We all know this is a significant opportunity. And with any opportunity, to be successful, it's important to understand the drivers, as well as potential obstacles.

At the end of first quarter 2013, IRA assets totaled $5.7 trillion and accounted for 27% of U.S. retirement assets.[2] This figure is up $300 billion from just three months earlier, with rollovers from employer-sponsored retirement plans driving much of that growth.[3] The ongoing demographic shift in the U.S. population has triggered this phenomenon, as Baby Boomers seek more in-depth planning to help them feel secure about retirement.

However, against this backdrop, there are regulations that could impede your retirement business. It is important for all of us to understand the current and proposed regulations and the impact they may have on rollovers. With that in mind, Pershing has partnered with Fred Reish, a nationally recognized ERISA attorney and retirement plan expert, to provide you with a map to help you navigate the uncertain terrain ahead.

As you begin this journey, the question is not whether you can continue to capture rollovers, but what you need to consider in doing so.

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PURSUING ROLLOVERS IN AN EVOLVING REGULATORY LANDSCAPE

By Fred Reish, Partner, Drinker Biddle & Reath LLP

INTRODUCTION

Who should read this?

If you are an advisor who provides services to retirement plans or retirement plan participants and seeks guidance on capturing rollovers to grow your business, you should read this whitepaper. Advisors who understand the implications of the current and proposed regulations are well situated to benefit from the developing landscape and provide valuable services to job changers and retirees.

What are the opportunities and issues?

The Baby Boomers are aging in a defined contribution world. Their impending retirements suggest that billions of dollars will continue to move from retirement plans into rollover IRAs at an increasing rate. Advisors at broker-dealers and RIA firms will help manage most of that money.

At the same time, retirement plan distributions and IRA rollovers are becoming more regulated. For example, the Department of Labor (DOL), the Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority® (FINRA®) have all focused on fiduciary, rollover or IRA issues. In addition, the Government Accountability Office (GAO) and Congress have expressed concerns about distributions, rollovers and retirement investing. It is important for advisors to understand the complex regulatory environment.

This paper provides an overview of the current regulatory environment and the anticipated developments pertaining to capturing rollovers. It then discusses the government guidance and steps for advisors to consider in light of that guidance, and ends with possible changes to the DOL fiduciary advice regulation and the impact on advisors.

FIDUCIARY VS. NONFIDUCIARY

The DOL guidance distinguishes between advisors who are acting as fiduciaries and those who are not. As a result, the definitions of fiduciary and nonfiduciary advisor services are critical to understanding the DOL view of the rollover process.

What does it mean to be a fiduciary?

ERISA closely regulates the conduct of "fiduciaries," since they have responsibility for the investments, services and retirement benefits of participants. As a result, once a person becomes a fiduciary, they are subject to the fiduciary standard (the "prudent man rule") and to restrictions on dealings with plans (the fiduciary prohibited transaction rules).

While most fiduciaries have control or discretion over plan investments and operation, there is one category of fiduciary that just gives advice. A fiduciary advisor is one who makes recommendations about investments and investment managers that are "individualized" and based on the particular needs of a plan (or of a participant). The definition is functional, so it is not a question of titles or even agreements; it is based on the conduct of the advisor.

In other words, an advisor may be an ERISA fiduciary if the advisor makes individualized investment recommendations to plan participants about their accounts or has discretionary investment management authority for a plan or a participant.

What additional standards apply to the fiduciary definition under ERISA?

If an advisor becomes a fiduciary, he must comply with two sets of ERISA rules—the fiduciary rules and the prohibited transaction rules.

The fiduciary rules require that the advisor act:

- solely in the interest of the participants;
- for the exclusive purpose of:
  - providing benefits to the participants; and
  - incurring only reasonable expenses for the plan
- with the care, skill, prudence and diligence of a knowledgeable person (i.e., the prudent man rule)
- to diversify the investments to minimize the risk of large losses.

In performing these duties, the prudent man rule requires that the fiduciary advisor engage in a prudent process to develop, deliver and document his recommendations.

The fiduciary prohibited transaction rules forbid a fiduciary advisor from engaging in certain conflicts with a plan. For example, a fiduciary advisor cannot receive any compensation from investments or third parties—unless the compensation is disclosed and offset against the advisor's fee.

When is an advisor not considered a fiduciary?

When an advisor serves as a registered representative of a broker-dealer and limits their services to providing education, information or non-individualized materials to plans or participants, they may not be considered a fiduciary. But, ERISA has a "functional" definition of fiduciary, and an advisor may become a fiduciary under ERISA if they provide individualized investment advice to a plan or to a participant.

CURRENT REGULATIONS AND THEIR IMPACT ON ROLLOVERS

What is the legal and regulatory landscape?

In Advisory Opinion 2005-23A, the DOL discussed whether a recommendation that a participant take a distribution from his or her 401(k) plan and roll the funds to an IRA is subject to ERISA.

The DOL said that where an advisor who is not a fiduciary to a plan or participant and subsequently makes a recommendation to a participant, that advisor would not become a fiduciary—even where they offered investment advice for the IRA and received compensation for that advice.

However, the DOL went on to say that if the advisor was already a fiduciary, a recommendation to take a distribution or to roll over to an IRA, advice on how to invest the funds in the IRA or even answering questions about these matters, could be subject to both ERISA's fiduciary responsibility and prohibited transaction rules.

In effect, the DOL is taking the position that a fiduciary advisor has such influence over participants' thinking that the advisor has expanded his or her fiduciary responsibility to include distributions, rollovers and IRA investing. That conclusion is contrary to well-established law.[4] While it is possible that, in an individual case, a fiduciary advisor could have undue influence over a participant—because of the advisor's fiduciary status—that would be highly unusual and is certainly not the ordinary situation. As a result, it will be difficult for the DOL to show that, in the typical case, a fiduciary advisor has "controlled" a participant's decision.

Nonetheless, the DOL has laid down a marker with its advisory opinion, and a prudent approach should be considered for advisors who serve as ERISA fiduciaries.

Since the DOL frames the issue in terms of "control" or "undue influence," providing participants with unbiased educational information would not result in fiduciary status for distributions and rollovers, as long as the information is accurate and not misleading or incomplete. The importance of clear, thorough and unbiased educational materials was highlighted by a recent GAO Report.[5] The GAO—which reports to Congress—found that, in many cases, participants were receiving biased, partial and inaccurate information about their distribution and rollover options. The DOL agreed with those conclusions, however, there has been significant industry discord over the report findings.

In 2010, the DOL addressed the broad issue of rollovers again in the preamble to its proposed regulation expanding the definition of fiduciary investment advice.[6] The DOL expressed concern that there might be abuses in capturing rollovers and invited comments on "*whether and to what extent the final regulation should define the provision of investment advice to encompass recommendations related to taking a plan distribution.*"[7]

In other words, the DOL is considering expanding its interpretation to include non-fiduciary advisors who make recommendations that participants take distributions. It appears the department is concerned that some participants may be encouraged to take distributions from relatively low-cost retirement plans and roll over their money into higher cost individual retirement accounts and annuities.

What should advisors consider when working with participants on rollovers?

For advisors who are not fiduciaries, the DOL position is clear today: they can help participants with distributions and rollovers.

Advisors who are fiduciaries should consider a prudent approach for assisting participants with rollovers, even though the DOL interpretations are questionable. Here are points to be considered in developing a prudent approach:

› The advisor should clearly define the fiduciary services provided to a plan so as not to include rollovers.

› The decision to take a distribution and to roll over to an IRA should be the participant's, without their advisor's encouragement. The advisor should consider obtaining acknowledgment from the participant that the rollover decision was theirs, and that they were not unduly influenced by the advisor's role with respect to the plan.

› The GAO report supports and encourages the distribution of unbiased educational materials to participants about their alternatives for taking or leaving money in a 401(k) plan. The DOL has agreed with that report. The advisor should be prepared to provide participants with unbiased educational materials regarding distribution alternatives and rollover services.

› The advisor should consider providing written disclosure of fees and expenses for the IRA and its investments, as well as the advisor's compensation.

There are also factors that could increase the likelihood of a DOL challenge—particularly for fiduciary advisors. Those include:

› Recommending that a participant take a distribution from a plan, especially problematic if the participant is still employed at the plan sponsor (i.e., an in-service distribution)

› Recommending an investment or service that has hidden or nondisclosed costs, surrender charges or imposes other costs or limitations on the participant

› Making a recommendation that results in what the DOL considers unusually high advisor compensation, or that is not disclosed or only partially disclosed to the participant

› Recommending high risk or speculative investments that are inconsistent with investing money for retirement purposes for the particular investor

› Providing information that does not discuss the advantages of leaving the participant's money in their current plan or transferring it to a new employer plan

There are also factors that could weigh in favor of capturing rollovers. Those include:

› Assisting participants who are already the advisor's wealth management clients

› Charging fees in the IRA that are the same as the advisor's fees in the plan

› Charging fees that do not increase because of the rollover, e.g., a set fee for financial planning or wealth management services that covers all the individual's assets and remains the same whether a participant takes a distribution or leaves money in the plan

› Assisting participants who are sophisticated and experienced investors

› Potentially lowering costs compared with keeping assets in the plan

› Providing a broader array of investment options

These are suggestions, not requirements. The key is to have a prudent approach based on education and on accurate and unbiased information that is fully disclosed.

PROPOSED REGULATION ON FIDUCIARY ADVICE

The DOL is working on a proposed regulation to broaden the definition of fiduciary advice (and perhaps increase the regulation of distributions and rollovers to IRAs).

The effect of an expansion of the fiduciary definition—in the context of rollovers—would be to increase the number of advisors whose conduct would be regulated by ERISA and who, therefore, should take a prudent approach for documenting their rollover practices. In addition, it is possible that future DOL guidance on IRA rollover services could extend to non-fiduciaries, such as broker-dealers and their advisors.

In 2010, the DOL proposed a regulation that redefined and expanded the definition of fiduciary advice. While that proposal was subsequently withdrawn, it is commonly believed that the new proposal will be similar. As a result, the best "predictor" of the anticipated guidance is the withdrawn proposal, together with statements made by Phyllis Borzi, the Assistant Secretary of the DOL's Employee Benefit Security Administration (EBSA).

To understand those proposed changes, it helps to start with the five-part test in the current definition of fiduciary advice:

- An advisor makes recommendations about buying or selling investments
- The advice is rendered on a "regular basis"
- The advice is rendered with a "mutual" agreement or understanding
- The recommendations will serve as "a primary basis" for plan investment decisions
- The recommendations are individualized investment advice based on the particular needs of the plan

The withdrawn proposal said, in part, that fiduciary investment advice includes cases in which an advisor:

> *makes recommendations about the advisability of investing in, purchasing, holding, or selling securities or other property; or provides advice or makes recommendations about the "management" of securities or other property.*
>
> *. . . to a plan, a plan fiduciary or a plan participant or beneficiary . . . pursuant to an agreement . . . or understanding . . . that such advice may be considered in connection with making investment or management decisions . . . and will be individualized to the needs of the plan . . . or a participant . . . . [Emphasis added.]*

The withdrawn proposal would have expanded the number of advisors who qualify as fiduciaries because it would have removed these criteria from the definition of fiduciary advice:

› The advice is rendered on a "regular basis"

› The advice is rendered with a "mutual" agreement or understanding

› The recommendations will serve as "a primary basis" for plan investment decisions

If these changes are made, fiduciary status could apply even if the recommendations by advisors were not made on a regular basis (e.g., if they were made only once); if there was not a mutual understanding about the significance of the recommendations (e.g., whether the recommendations were meant to be advice); or if they were not meant to be a primary basis for investment decision-making.

In other words, almost any "individualized" investment recommendation could result in fiduciary status under the anticipated proposal.

However, for advisors to retirement plans—and particularly 401(k) plans—these changes may not materially expand the definition since many 401(k) advisors make investment recommendations on a regular basis (perhaps quarterly or annually) with a "mutual" understanding that the fiduciaries will consider the recommendations as a "primary basis" for making investment decisions.

The critical factor in defining fiduciary advice will likely continue to be whether the investment recommendations were "individualized" and based on "the particular needs of the plan" (or of the participant). If so, the recommendations would satisfy part of the fiduciary definition. "Advice" that is not individualized to the plan or participant is considered education and, therefore, does not result in fiduciary status.

If these changes are made, it will focus more attention on fiduciary status and will make it easier for the DOL and plaintiffs' and claimants' attorneys to prove fiduciary status. As a result, both the perception of fiduciary status and the reality of fiduciary litigation are likely to expand.

However, these changes will be highly controversial and, even if proposed, may not be finalized in this manner. It is difficult to know what the rules, exceptions and exemptions will be or when they will be finalized. Advisors should consider their practices based on the current regulatory environment until the pending changes become clearer.

In addition to the DOL changes, the SEC is considering a uniform fiduciary standard for financial advisors and investment advisors. Many in the financial community, and some in Washington, D.C., are encouraging the DOL and SEC to work in tandem to develop a "harmonized," or similar, definition of fiduciary. If that argument prevails, the DOL regulatory process will be delayed for a considerable period of time.

CONCLUSIONS AND NEXT STEPS FOR ADVISORS

Non-fiduciary advisors can “capture” rollovers under the DOL guidance. For non-fiduciary advisors, recommendations to participants concerning distributions, rollovers and IRA investments are not regulated by ERISA. Therefore, non-fiduciary advisors are not covered by the existing DOL guidance.

Fiduciary advisors can provide information to participants and IRA rollover services to plans without violating ERISA’s fiduciary or prohibited transaction rules—if they take steps to satisfy DOL concerns described in this paper. However, fiduciary advisors should consider a prudent approach to capturing IRA rollovers. That approach should accommodate DOL concerns about a fiduciary advisor exercising control or undue influence to cause a participant to take a distribution and to invest in an IRA that compensates the advisor. This paper suggests several ideas in the Current Regulations and Their Impact on Rollovers section for developing a prudent approach that should accomplish that goal.

All advisors are encouraged to refer to the following table for a summary of key points and additional considerations related to existing and proposed DOL guidance.

PERSHING COMMENTARY

Here’s the bottom line regarding rollovers. The DOL has issued regulations that shape the current environment in which you operate. However, the 2010 DOL proposal (which was withdrawn in September 2011) and its current efforts to revive that proposal indicate a potential shift in the regulatory environment. While you can rely on the regulations currently in force, it is important to understand the potential impact of the changes as signaled by the DOL. The DOL has indicated its desire to cast a broader net, which would consider more advisors ERISA fiduciaries. Now is the time to take inventory of your current business practices and begin to take steps to prepare for change.

FINAL CONSIDERATIONS FOR ADVISORS

Considerations for Fiduciary Advisors	Considerations for Nonfiduciary Advisors
Under the current DOL regulations, fiduciary advisors can provide information to participants and IRA rollover services to plans if they take steps to satisfy DOL concerns.	Under the current DOL regulations, nonfiduciary advisors may capture rollovers without becoming fiduciaries and without being subject to transaction rules prohibited under ERISA. As a result, it is permissible for non-fiduciary advisors to capture IRA rollovers from plans, and to assist in the investment of those rollovers.
When advisors serve plans or participants as fiduciaries, a prudent approach is recommended because the DOL guidance is not clear on proposed regulations. See Section #3 in the white paper for suggestions on developing a prudent approach.	A nonfiduciary advisor with regard to a plan or a participant will not become an ERISA fiduciary because of recommendations related to distributions or rollovers and/or receiving compensation for IRA investment services under the regulatory guidance currently in effect.

Considerations for All Advisors	
	While the DOL may propose to regulate all advisors in their distribution and rollover recommendations, these regulations have not yet been proposed or finalized.
	Until the pending changes become clearer, advisors should consider continuing their current practices, taking into account existing guidance from the DOL.
	Participants can be given information about their distribution alternatives, e.g., leaving the money in the current plan; transferring it to the plan of their new employer; rolling into an IRA of their choice; or working with the advisor to identify and use a suitable IRA provider.
	Rollover materials should be educational, not promotional. Descriptions of advisor services could cover investment services and strategies, the role of the advisor, and selection of the IRA provider and its fees. The materials should not encourage participants to take distributions from plans.
	The advisor should consider obtaining written acknowledgment that the participant decided to take a distribution from the plan, roll over to an IRA and work with the advisor, and that the participant was not influenced by the advisor's status as a fiduciary.
	Disclosures should be made prior to the participant's making a decision. Advisors should consider obtaining the participant's signed acknowledgment for the receipt of that information. Advisors should also consider making disclosures similar to the 408(b)(2) disclosures (i.e., services, status and compensation).

[1] McKinsey & Company, *Capturing IRA Rollovers: The Net New Money Opportunity For Wealth Managers, July 2011*.

[2] ICI Research Report, *Defined Contribution Plan Participants' Activities,* 1Q2013.

[3] ICI Research Perspective, *The Role of IRAs in U.S. Households' Saving for Retirement*, December 2012.

[4] Interestingly, the DOL's conclusion was based on "management" — which requires some control—under ERISA §3(21)(A)(i), rather than on investment advice under ERISA §3(21)(A)(ii).

[5] GAO 13-30, *401(k) Plans, IRS and DOL Could Improve the Rollover Process for Participants*, March 7, 2013.

[6] *Reich v. McManus*, 883 F.Supp. 1144 (N.D. Ill. 1995).

[7] Preamble to Prop Reg §2510.3-21, Definition of "Fiduciary," 75 Fed. Reg. 65276, 65266, October 22, 2010.

[8] Prop Reg §2510.3-21, Definition of "Fiduciary," 75 Fed. Reg. 65276, October 22, 2010.

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WP-PER-ROLL-IRA-10-13

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