FEATURE

Does Suitability Equal Fiduciary?

FINRA's "reminder" that BDs consider and evaluate more than seven relevant factors to determine suitability when recommending a rollover looks a lot like the prudent process required of a fiduciary.

BY STEVEN SULLIVAN

Generally speaking, automatic enrollment in 401(k) plans is considered a good thing. It bypasses employee inertia, increases participation and improves the overall retirement picture for millions of Americans. But when complex retirement decisions on the other end — like what a terminated employee should do with the balance in his 401(k) account — are made on autopilot, things can get tricky. Especially when sales commissions may be setting that autopilot.

Broker dealers (BDs) are interested in the 401(k) business, of course, but they're also very interested in the rollover business because it's much bigger. Rollovers are so big, in fact, that record keeper Charles Schwab was willing to walk away from $25 billion in business because the firm had been denied access to 401(k) participants. Why? Because the money isn't in record keeping fees; it's in rollovers. According to the Investment Company Institute, there's $6.2 trillion in IRAs, much of which comes from DC plans.

It's probably not surprising, then, that rollovers have attracted the attention of regulators. In March 2013, the Government Accountability Office (GAO) released a report, "401(K) Plans: Labor and IRS Could Improve the Rollover Process for Participants," that was commissioned by members of Congress who wanted to know why so many 401(k) participants were rolling over their account balances into individual retirement accounts (IRAs), and whether they actually understood what they were doing.

To find out, GAO investigators posed as 401(k) participants who were leaving their current employers and called 30 providers' representatives to ask about their alternatives. And they recorded the conversations. Here's a sample of what they were told:

"So [401(k)s] restrict your choices. But you know the reason why they have to restrict your choices is because they can't really provide much guidance. So what we have here is we open up … your choices, but we also have the resources to provide the guidance, so we can still act as fiduciary and you will not get hurt … So just open an IRA with us and you roll that over … You know there are quarterly fees in a 401(k). They haven't always disclosed that but there is just some legislation now where now it's going to be requiring 401(k) administrators to disclose their fees. But, you know, our accounts have no fees."

And another: "It makes no difference on our end. I'm just trying to let you know that if I were in your shoes, and you are not wanting to use the money for a loan, I would head the IRA route."

So that's it, right? Two choices: Roll the money into the new employer's 401(k), or roll it over into the service provider's IRA. Oh, and maybe a third: Take the money as a loan.

Well, no. Those are not the only choices, as any competent financial advisor knows. If a participant has more than $5,000 in her account, she can leave it in the old plan or roll the funds over to a similar qualified plan with her new employer. She could simply take the cash and pay the tax and whatever penalties might apply. Or she could roll it over into an IRA. Each of those decisions has its own advantages and disadvantages, and depends heavily on the participant's own personal situation. Automatically rolling over to an IRA may not necessarily be the best move.

"If an employee of a 401(k) plan I'm an advisor for calls me and says she's leaving the company and wants to roll it over, my response has always been to explain all her options," says Jay Sims, president of Columbia Retirement and Investment Services, Clarksville, Md. "I'll give her an objective evaluation of her options. If she likes the investments and expenses in her current plan compared to the other options, then she should stay there. A disadvantage may be a lack of consolidation — a 401(k) here, an IRA there. But whatever her decision, I will still be available to help her."

To be fair, some feel that GAO investigators weren't talking to the right people — operators in retail call centers rather than specialists at a retirement desk. And not every service provider representative contacted by the GAO conveyed misleading or incomplete information. But as many as half of the 30 representatives did.

"As a result of being allowed to market their IRAs and retail investment products in educational materials or in interactions with participants," the report said, "providers are able to steer participants to their products without the participants clearly being aware that they are being marketed to instead of being advised about their options."

The report also found that navigating the rollover policies of plan sponsors can be daunting because there seems to be no uniformity and many sponsors, through an overabundance of caution, actually create disincentives. Many qualified plan sponsors are afraid to accept funds from an unqualified plan because they fear they may lose their qualified status, even though IRA rules protect them from disqualification if they do so in ignorance. (On April 3, 2014, the IRS issued Revenue Ruling 2014-9, making this process much easier.)

The report also concluded that participants need to have clearly written and uniform explanations of their four choices for rolling over funds from a 401(k), and that service providers need to disclose any financial interest they may have in any of those choices.

Finally, the report made specific recommendations for addressing those problems. Among them was the notion that the DOL and the IRS work more closely together.

Fiduciary in Sheep's Clothing?

Less than a year later, the Financial Industry Regulatory Authority (FINRA) — the industry's independent, non-governmental self-regulator — issued Regulatory Notice 13-45, reminding broker/dealers (BDs) and service providers of their responsibilities when recommending rollovers and marketing IRAs. "Reminding" may have been a disingenuous term for FINRA to use because, according to a January 2014 Groom Law Group issue brief, many BDs and registered representatives "will be surprised by the breadth and depth of the challenging compliance requirements outlined by FINRA in the Notice."

The Notice basically outlines the four choices for dispersing funds from a 401(k), acknowledges their complexity, and asserts FINRA authority over any recommendations a BD might make and any marketing information regarding IRAs. "Any recommendation to sell, purchase or hold securities," the Notice says, "must be suitable for the customer and the information that investors receive must be fair, balanced and not misleading."

This is particularly important, the Notice says, because any compensation a BD or advisor receives from a rollover recommendation constitutes a clear conflict of interest.

"It seems that FINRA is applying a fiduciary standard on the advisability of rollovers while using the word 'suitability,' says Chad Wilson, director of investment consulting for PSA Financial Services in Baltimore. "But it doesn't look or smell to me like a suitability standard. Telling somebody to roll over money to an IRA, whether it costs more or you're getting a commission or there's a conflict of interest, can very easily meet a suitability standard. What FINRA is applying is a best-interest standard, which is a fiduciary standard. But they never use the word 'fiduciary.' The suitability standard seems like a fiduciary standard in sheep's clothing."

"I don't think it's fair to say that it's a fiduciary standard," counters Fred Reish, a partner with Drinker Biddle & Reath in Los Angeles. "It certainly isn't a fiduciary standard in the ERISA sense, because there aren't any prohibited transactions associated with FINRA's guidance, as there are in ERISA. However, it certainly sets a high bar for developing recommendations to participants to take rollovers. And, in some ways, FINRA's expectations exceed those that were thought to be applicable to ERISA fiduciaries. In other words, I believe that, as a practical matter, the FINRA guidance effectively establishes greater responsibilities for ERISA fiduciaries also."

That's Groom Law Group's position too. "In effect, FINRA uses the Notice to establish the premise that a 'recommendation' not only includes the recommendation of what securities to purchase once the rollover occurs, but also includes the recommendation to rollover in the first place. Apparently, FINRA's basis for this conclusion is that the natural consequence of a rollover recommendation is a corresponding recommendation to invest the new IRA assets in one or more securities."

Baffling Balloons

It's not surprising that investment professionals, not to mention plan participants, may find this confusing. Especially when two of the major industry referees, the DOL and the Securities and Exchange Commission (SEC), haven't yet decided exactly how they're going to call it. They've dropped hints and floated balloons, but so far no official pronouncements.

One of those balloons, floated by the SEC, is a proposed "uniform fiduciary standard" that would apply to both BDs and investment advisors. Which may sound good on the surface, but one major difference between a BD and an advisor is how they're compensated. Broker/dealers are supposedly less objective because they're paid commissions and have no duty to monitor an investment once they sell it; it just has to be suitable. Advisors, on the other hand, are perceived to be more objective because they charge fees and are responsible for monitoring their clients' investments. Yet the SEC proposal doesn't intend to change any of that, just make them both fiduciaries.

That is only going to make things more confusing, not less. "Depending on what DOL comes out with, and depending on what it says about IRAs, this could very much affect the industry and the relationship of participants with their advisors," says Ron Triche, NAPA's director of government affairs. "Let's say the DOL does change the rules and makes a person a fiduciary on the IRA side. As a fiduciary under DOL, unless there's a prohibited transaction exemption (PTE), they can't get commissions. On the DOL side, they'd be fiduciaries on both the pension side and the IRA side. But on the SEC side, they can still get commissions on the IRA side. So they're caught in this conundrum: Because I'm a fiduciary now under the DOL rules, I can't give you advice on your IRA rollover. Under the SEC rules I could, but as a fiduciary under the DOL rules I can't. Depending on what comes out, you could very well have people in the investment industry who are not able to continue their relationships with their clients who've been relying on them for years."

So FINRA holds BDs to a suitability

standard, which is "a very lax standard," according to Craig Draper, in-house counsel and retirement plan consultant, Lakeside Wealth Management Group, Chesterton, Ind. And the DOL holds investment advisors to a more stringent fiduciary standard, requiring them to act in the best interests of their clients. But the way FINRA is describing its "suitability" standard sounds very much like a fiduciary standard. And the SEC may be headed in the same direction.

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Education or Advice?

So what happens if you're a BD and not a fiduciary but you're being held to a fiduciary standard? If your only job is to implement a transaction the participant has already decided to make, not much, according to Joan Neri, an attorney with Drinker Biddle & Reath. But BDs who have to answer the question: "What should I do with the money that's vested in the 401(k) plan of the employer I no longer work for?" need to be very careful under Regulatory Notice 13-45.

"Many BDs will have a difficult time obtaining the information that 13-45 requires," she says. "The impact of the Notice is less clear for those BDs who are providing educational information to participants to assist them in making a decision and then implementing the rollover (if the participant so decides). The issue here is that if the BD has a strong customer relationship, the education might start to look a lot like a recommendation."

Safer not to make any recommendation at all, says Groom. Stick to explaining the options and don't even think about suggesting which option the participant should take, which seems to be the approach many BDs have already adopted.

"We saw this coming over a year ago," says Jenny Kiffmeyer, director of educational content for the Retirement Learning Center (RLC) in Brainerd, Minn. "Fair and balanced is the pivotal phrase that must describe any rollover discussion."

The RLC provides a worksheet and an information checklist participants can use when preparing to meet with an advisor about whether to do a rollover. One piece, called a "Retirement DNA Analysis," helps the participant track down any past IRAs, SEPs, and 401(k)s that may still be out there. Again, the material provides the information and the options, but the final decisions are up to the participant.

"We train our representatives to take a fair and balanced approach when educating our customers about their options for their employer plan assets," says Sarah Walsh, vice president of rollover business for Fidelity Investments. "After FINRA issued the regulatory notice, we took the opportunity to perform a review of how we deliver information on this topic to customers. As a result of the review, and to ensure we're covering the considerations outlined in the notice, we're reinforcing training in this area and making some changes to communications materials. Supervisors who have associates engaged in these types of conversations are provided with post-interaction reports to review. In addition, telephone calls may be reviewed and other testing techniques used to ensure that our representatives are servicing customers in accordance with the FINRA notice."

Some firms, like LPL Financial, offer both brokerage and advisory services. Brokerage services are handled by its Worksite Financial Solutions call center. Participants who contact the call center expecting advice are in the wrong place.

"When calls come to our Worksite Desk, we don't provide advice to the participant on which distribution option is the best for them. Rather we educate each participant on all their options so they can make the right decision for themselves," says David Reich, executive vice president of retirement platform development, LPL Financial. "We don't compensate [Worksite Desk] representatives for rolling over or referring a participant to the advisor, or making a 'sale.' All reps are paid a salary and can earn a merit bonus based on call efficiency, quality and thoroughness of information dispensed. But they're not scored based on sales volume. We use written and approved scripting, and we record and review calls for quality and training."

Reich adds, however, "Our advisors may act in either a fiduciary or non-fiduciary capacity, depending on their relationship with the plan and/or the participant. When acting in a fiduciary capacity to a plan, if requested by a participant, we encourage our advisors to provide education on the appropriateness of rollovers, staying in the plan, moving their assets to another plan, or any other available options. If the advisor currently is acting as a fiduciary to a participant, we expect our advisors to provide the appropriate advice given the client's individual circumstances. We believe this construct is consistent with the current regulatory guidance."

But *current* regulatory guidance may not be the *final* regulatory guidance, so it's difficult to draw any conclusions at this point. But investment professionals are concerned. Will DOL's revised definition of fiduciary echo the standards set by FINRA? Will the SEC? Will the result be that both BDs and RIAs are held to the same standard?

"We approach this issue from an RIA's perspective, even if it's on the broker/dealer side, and focus not just on suitability but on whether it's in the client's best interest," says Draper. "I think everyone should be held to a higher standard. Those who do are competing against people who are not always being fully upfront. We believe that being fully upfront and giving them the education they need to make informed decisions is really going to be best long-term. I think that's what the disclosures were meant to do, and that's what the FINRA notice is trying to do. If they go to the next step and make it a fiduciary standard, you're going to have more qualified people providing this service to participants rather than people who are just in it for their own benefit. Suitability is very easy to meet; fiduciary is very difficult. I think everybody should be held to a fiduciary standard. I think participants should expect that."

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