JOURNAL of PENSION BENEFITS

ISSUES IN ADMINISTRATION, DESIGN, FUNDING, AND COMPLIANCE
Volume 32 • Number 1 • Autumn 2024

The Best Interest Process for Plan-to-IRA Rollover Recommendations under the DOL's New Fiduciary Rule

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The effective date of the Department of Labor's new definition of fiduciary advice and the amendments to PTE 2020-02 have been stayed pending the outcome of the lawsuits challenging the rule and the amended PTE. However, there will still be instances when advisers will be considered fiduciaries under the current DOL fiduciary rule when recommending rollovers and as such, may need to comply with the current version of the PTE and undertake the best interest process described in this article. We will discuss the circumstances when an adviser can be considered a fiduciary under the current DOL fiduciary rule when recommending rollovers in our next article.

The September 23, 2024, effective date of the Department of Labor's (DOL) new fiduciary definition for advice provided to private sector retirement plans, participants in those plans, and individual retirement account (IRA) owners (the New Fiduciary Rule) has been stayed. Therefore, the DOL's current DOL fiduciary rule remains in effect—at least for now. As we will discuss further in our next article, some kinds of rollover recommendations by broker-dealers, registered investment advisers, and their representatives (collectively, advisors) will be fiduciary advice under the current DOL fiduciary rule.

Fiduciary recommendations that are conflicted—for example, where advisors receive compensation as a result of a recommendation—are prohibited transactions under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (Code). The conflicted compensation is the money that will be earned from the rollover IRA. As a result, advisors will need to rely on Prohibited Transaction Exemption (PTE) 2020-02 and satisfy its conditions, in order to avoid engaging in a prohibited transaction.

Among the PTE's requirements are Impartial Conduct Standards, including a Care Obligation and a Loyalty Obligation (together a best interest standard). The Securities and Exchange Commission (SEC) imposes a similar best interest standard on rollover recommendations, but that standard applies to a much broader array of retirement plans and accounts, including plans not subject to the DOL fiduciary advice rules, such as governmental plans (for example, qualified governmental pension plans, 403(b) plans for public schools and universities, and 457(b) plans).

This article discusses the process that should be undertaken to satisfy the DOL's and SEC's best interest requirements for plan-to-IRA rollover recommendations. While this article only focuses on plan-to-IRA rollovers, be sure to note that the current DOL fiduciary rule could apply to other recommendations, such as IRA-to-IRA transfers, as we will discuss in our next article.

Background

Both the DOL and the SEC have issued guidance on rollover recommendations and the process needed to support the best interest standard, which the DOL has now re-named the care and loyalty obligations in amended PTE 2020-02. The DOL's guidance is found in PTE 2020-02 (in its current form), its preamble, and a set of Frequently Asked Questions (FAQs). The SEC's guidance is in Regulation Best Interest: The Broker-Dealer Standard of Conduct for Broker-Dealers (Reg BI), the SEC's Interpretation Regarding Standard of Conduct for Investment Advisers, and the Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (Staff Bulletin), which was issued in a question-and-answer format.

The guidance issued by these two agencies describes a common process, namely:

1. Obtaining relevant information about the participant (which the DOL refers to as a "retirement investor" and the SEC refers to as a "retail investor"), including the retirement investor's options,

Commissioner's Award and District Director's Award; the Eidson Founder's Award by ASPPA; and the ASPPA/Morningstar 401(k) Leadership Award.

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2. Obtaining and evaluating relevant information about the investor's current retirement account, including the investments, services and expenses in the plan and considering the investments, services and expenses available and appropriate for the retirement investor, for example, in a rollover IRA; and
3. Determining whether the rollover recommendation is in the investor's best interest and documenting that determination.

We explore each of these steps in detail below.

Step 1: Retirement Investor's Characteristics and Options

The DOL's best interest standard (or care obligation), as defined in PTE 2020-02 in its current form, requires that the recommendation be "based on the investment objectives, risk tolerance, financial circumstances and needs" of the plan participant. [PTE 2020-02, Section V(b)] The SEC is more specific about the information to be gathered, explaining that in order to have a reasonable basis to believe a recommendation is in the retirement investor's best interest, the advisor should consider investor characteristics, such as—

> the retail investor's: financial situation (including current income) and needs; investments; assets and debts; marital status; tax status; age; investment time horizon; liquidity needs; risk tolerance; investment experience; investment objectives and financial goals; and any other information the retail investor may disclose to you in connection with an account recommendation. The staff also believes that you should consider, without limitation, the retail investor's: anticipated investment strategy (for example, buy and hold versus more frequent trading); level of financial sophistication; preference for making their own investment decisions or relying on advice from a financial professional; and the need or desire for account monitoring or ongoing account management. [Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors Q&A-2a]

Therefore, in the view of both the DOL and the SEC, the best interest process is not a one- size-fits-all approach, but instead requires that the advisor consider what is important for satisfying that particular investor's needs, for example, asset allocation services, active management, periodic withdrawals, sustainable income, etc. Moreover, the advisor will need to gather sufficient information from the investor to ensure that the recommendation is not based on incomplete or materially inaccurate information.

This process should also include a consideration of the investor's other options. In PTE 2020-02 (in its current form) and in the FAQs, the DOL points out that as part of a best interest process, the advisor needs to consider the alternatives to a rollover, including leaving the money in the investor's employer's plan, if permitted. Similarly, the SEC observes that—

> it would be difficult to form a reasonable basis to believe that a rollover recommendation is in the retail investor's best interest and does not place your or your firm's interests ahead of the retail investor's interest, if you do not consider the alternative of leaving the retail investor's investments in their employer's plan, where that is an option. [Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors Q&A-4b]

Other possible options may include rollover to a plan maintained by a new employer (if the investor is switching jobs and the new plan accepts rollovers) or taking a taxable distribution. The failure to obtain and consider adequate information about the investor and the investor's options in accordance with this guidance could be a red flag for the regulators (and probably for claimants' or plaintiffs' attorneys).

Step 2: Relevant Information about the Investor's Current Retirement Plan Account Versus a Rollover IRA

Both the SEC and the DOL describe relevant factors to be considered as part of a best interest determination. The SEC identifies the following relevant factors that may be considered:

> These factors include, without limitation, costs; level of services available; features of the existing account, including costs; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; and holdings of employer stock. [Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors Q&A-4a]

The DOL also identifies a number of factors in the Preamble to PTE 2020-02, many of which are similar to those identified by the SEC, including

- the alternatives to a rollover, including leaving the money in his or her current employer's Plan, if permitted;
- **the fees and expenses associated with the Plan and the IRA;**
- **whether the employer or other party pays for some or all of the Plan's administrative expenses; and**
- **the different levels of services and investments available under the Plan and the IRA.** [Preamble to PTE 2020-02 (in its current form), 84 Fed. Reg. 8279831] (Emphasis added)

Clearly, both the SEC and the DOL consider costs, services, and investments in the plan and in the IRA to be key factors in evaluating whether a rollover is in the investor's best interest.

Costs

Both the SEC and the DOL say that cost is a material consideration when evaluating whether a rollover is in the investor's best interest. This means that additional factors need to be considered when recommending a higher cost retirement account. For example, in most cases, an IRA will be more expensive than the investor's plan account (and many 401(k) and other plans will offer self-directed brokerage accounts with very broad investment choices), meaning that a plan-to-IRA rollover recommendation usually would have to be based on the IRA offering a broader range of services to justify the additional cost to the investor. (However, in certain cases, the availability of particular investment options that are not in the plan may provide value to the investor. *See* the discussion of Investments and Services below.) The SEC agrees, explaining that other factors need to be considered as based on the investor's particular needs—

> if you recommend a higher cost account, you must have a reasonable basis to believe the account recommendation is nonetheless in the retail investor's best interest based on other factors and in light of the particular situation and needs of the retail investor. [Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors Q&A-3a]

As stated above by the DOL, the advisor should also consider whether or not the employer is paying for the plan's administrative expenses. Unfortunately, obtaining information about this may be difficult. For example, if some or all of the plan expenses are paid out of revenue sharing funds on the plan line-up, it may not be easy to track the plan costs borne by the employer.

And this leads to a related question: What costs should be considered? The SEC provides a detailed list of costs that may be relevant:

> In the staff's view, you should consider the total potential costs when evaluating whether an account is in a retail investor's best interest, including indirect costs that could be borne by the retail investor. Examples of costs can include account fees (for example, asset-based, engagement, hourly), commissions and transaction costs (for example, markups and markdowns), tax considerations, as well as indirect costs, such as those associated with payment for order flow and cash sweep programs. When applicable, cost of an account also includes fees associated with the investment products that are available through the account, such as the internal expenses of funds, including management fees, distribution and servicing fees, and the costs of investing in funds, including front-end and back-end fees. The effect of certain costs, such as distribution and servicing fees and transaction costs related to purchasing fund shares, may depend on the investor's anticipated investment horizon. In these cases, you should consider the potential impact of those costs on the investor's account based on an understanding of that horizon. [Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors Q&A-3b]

Further, the DOL points out that the long-term impact of costs should be considered.

> As relevant, the analysis should include consideration of **factors such as the long-term impact of any increased costs**; why the rollover is appropriate notwithstanding any additional costs; and the impact of economically significant investment features such as surrender schedules and index annuity cap and participation rates. [New Fiduciary Advice Exemption: PTE 2020-02 *Improving Investment Advice for Workers & Retirees* Frequently Asked Questions Q&A-15] (emphasis added)

Consideration of the long-term impact of increased costs would require the advisor to forecast the future impact of costs on the particular investor and his or her financial security in retirement. It is not entirely clear what the DOL intends by this language, but at a minimum, it would suggest that the compounded effect of additional costs on investment returns should

be considered over the likely investment time horizon of the individual.

Nevertheless, based on the guidance issued by the SEC and DOL, it is clear that an advisor should obtain comprehensive cost information about the plan and its investments and services and compare those to the costs of the services and investments in the potential rollover.

Investments and Services

In the view of the SEC and DOL, the investments and services available in the investor's current retirement plan account and the recommended rollover account are material considerations in a best interest analysis. IRAs offer a wide universe of investments and therefore, it is easy to conclude that this could be viewed as a best interest reason for an IRA rollover (unless the plan offers a self-directed brokerage account feature). However, the fact that an IRA offers more investments does not, by itself, justify a rollover. The SEC explains this further:

> With respect to available investment options, we caution broker-dealers not to rely on, for example, an IRA having "more investment options" as the basis for recommending a rollover. Rather, as with other factors, broker-dealers should consider available investment options in an IRA, among other relevant factors, in light of the retail customer's current situation and needs in order to develop a reasonable basis to believe that the rollover is in the retail customer's best interest. [Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031, 84 FR 33318, 33383 (June 12, 2019)]

In addition, the DOL points out that the existing plan line-up should be considered as part of the best interest evaluation:

> When considering the alternatives to a rollover, the financial institution and investment professional generally should not focus solely on the retirement investor's existing investment allocation, without any consideration of other investment options in the plan. [New Fiduciary Advice Exemption: PTE 2020-02 *Improving Investment Advice for Workers & Retirees* Frequently Asked Questions Q&A-15]

While the intent of the DOL in making the above statement is not clear in some respects, it is probably fair to assume that if an investor's best interests would be served by keeping his or her money in an employer-sponsored retirement plan and simply changing investments rather than rolling over to an IRA, recommending the IRA may not be in the investor's best interest absent other considerations. On the other hand, it is fair to assume that, if the investor is not knowledgeable about investing and has not allocated his or her plan account appropriately, he or she would likely benefit from additional advisory services (and perhaps even discretionary account management), which may be a favorable factor for an IRA if its service offerings would be a "value-add" as compared to what is available in the plan.

Further, even if the plan line-up includes investments that would benefit the investor, a recommended rollover could still be in the investor's best interest if the rollover offers investments with unique features not available on the plan line-up. For example, if the plan does not offer guaranteed income products, a rollover to an individual retirement annuity—where the product features align with the investor's investment objectives, financial circumstances and needs—may be in the investor's best interest. But advisors should make sure they are considering the specific appropriateness of any annuities (or other complex products) and their appropriateness for the investor. For example, the DOL previously described the product features that should be considered in evaluating an indexed annuity as follows:

> Assessing the prudence of a particular indexed annuity requires an understanding, inter alia, of surrender terms and charges; interest rate caps; the particular market index or indexes to which the annuity is linked; the scope of any downside risk; associated administrative and other charges; the insurer's authority to revise terms and charges over the life of the investment; the specific methodology used to compute the index-linked interest rate; and any optional benefits that may be offered, such as living benefits and death benefits. In operation, the index-linked interest rate can be affected by participation rates; spread, margin or asset fees; interest rate caps; the particular method for determining the change in the relevant index over the annuity's period (annual, high-water mark, or point-to-point); and the method for calculating interest earned during the annuity's term (for example, simple or compounded interest). [Proposed Best Interest Contract Exemption for Insurance Intermediaries, 82 FR 7336, 7344 (January 19, 2017)]

That language suggests that the DOL expects an advisor to have a detailed understanding of the product being recommended.

Obtaining the Relevant Information

In undertaking this process, the biggest challenge may be the ability to obtain all of the relevant information. In the Preamble to PTE 2020-02 and the FAQs, the DOL says that, in order to obtain the relevant information, an adviser should make "diligent and prudent" efforts to get information about the participant's plan. But, unfortunately, the DOL does not describe what is required for the efforts to be "diligent and prudent." The DOL notes that this information about a 401(k) plan is "readily available" from the 404a-5 participant disclosure statement for the participant's plan. However, obtaining this information may not be easy, especially if the participant is not willing or able to provide it.

The DOL explains how to address this situation, that is, where a participant will not provide the information, even after a full explanation of its significance, and the information is not otherwise readily available. While the DOL does not say what the explanation should cover, one interpretation is that it should point out that the lack of accurate information about the plan could result in a recommendation that is not in the participant's best interest.

In those circumstances, the DOL says that an advisor can make a reasonable estimation of expenses, asset values, risk and returns based on publicly available information and could rely on "alternative data" sources (for example, the most recent Form 5500, reliable benchmarks on typical fees and expenses for the type and size of plan at issue). The DOL makes clear that the assumptions and their limitations must be documented and explained to the participant.

Step 3: Best Interest Determination and Documentation

PTE 2020-02 requires that the firm and the advisor document the bases for the rollover recommendation, in other words, document the prudent analysis of why a rollover recommendation is in the retirement investor's best interest, and provide that documentation to the investor to be considered before a decision is made. (Note that while compliance with PTE 2020-02's Impartial Conduct Standards, including a determination of what is in the best interest of the participant, begins September 23, 2024, the requirement to provide the written reasons for a rollover recommendation to the participant does not apply until September 23, 2025.)

While the SEC does not impose a specific documentation obligation, the SEC Staff points out the importance of documentation of compliance:

> Additionally, in the Staff's view, when making a rollover recommendation, it may be difficult for a firm to assess periodically the adequacy and effectiveness of its policies and procedures or to demonstrate compliance with its obligations to retail investors without documenting the basis for the recommendation. [Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors Q&A-6]

The SEC Staff also stresses the importance of complying with the conditions of PTE 2020-02 if the advisor is relying on it—in that case, documentation is required.

> If you are relying on Prohibited Transaction Exemption 2020-02 (PTE 2020-02), you may want to review guidance from the Department of Labor on factors to consider in making a rollover recommendation, as well as relevant documentation requirement. [Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors Q&A-4a]

In addition to documenting the prudent analysis, PTE 2020-02 requires that the firm disclose to the investor, in advance of implementing the rollover, the bases for why the rollover recommendation is in the investor's best interest. Once the process of obtaining and considering the relevant information, and documenting the best interest conclusion is complete, it should be clear whether a rollover recommendation is in the best interest of a participant. For example, some best interest reasons for recommending a plan rollover to an IRA could include the following, depending on the needs and circumstances of the participant:

- The rollover IRA offers financial and retirement planning services that are not otherwise available under the plan and the participant needs those services.
- The participant lacks investment experience and will not be able to devote time to management of

his own investments due to work demands. As a result, the participant would benefit from active management and ongoing oversight of the participant's IRA.

- The participant needs help in managing investments in a manner that is consistent with withdrawing income at a sustainable level and that service is provided to the IRA.
- The participant has a large plan account that would benefit materially from an allocation to alternative investments and provide the participant with the advantages of lower costs.
- The advisor is already managing other accounts for the participant and the participant would benefit from an integrated approach to managing those investments, for example, tax efficient allocations to different accounts and/or overall portfolio allocations considering the different accounts.

Conclusion

To comply with the best interest standard required by the DOL and SEC, advisors should follow an approach that focuses on the individual needs and circumstances of the retirement investor and includes a thorough evaluation of the services, costs, investments, and other relevant features of the investor's current retirement plan account and other options, including (but not necessarily limited to) a rollover IRA. Firms should review their current policies and procedures to ensure they are consistent with this approach. ■

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