Retirement Income
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Advisers, Beware of PTE 2020-02: Wagner Law

By Wagner Law Group *Wed, Oct 13, 2021*

ERISA expert Kimberly Elliott of the Wagner Law Group tells wealth managers how to avoid running afoul of the Department of Labor's Prohibited Transaction Exemption 2020-02 when counseling plan participants on rolling qualified assets over to a brokerage IRA.

New interpretations voiced in the Department of Labor's ("DOL") Prohibited Transaction Exemption 2020-02 (the "Investment Advice PTE") could be a bomb that hits squarely on unwary wealth managers who give investment advice to IRA owners. In the Investment Advice PTE, effective as of February 16, 2021, the DOL announces that most recommendations to make a rollover are considered fiduciary investment advice.

The PTE lists a number of inherent conflicts of interest you need to consider addressing, including receiving variable compensation or compensation from a third party in connection with that fiduciary advice in order to avoid a prohibited transaction. The good news is that the Investment Advice PTE provides ready relief.

Rollover Advice is Conflicted Investment Advice if the Adviser is paid from the IRA

Many may be surprised to learn that this ruling impacts all wealth managers who recommend rollovers, even if the advisers had no advisory relationship with a plan itself. This is a major departure from past practice, since historically advice to roll assets out of a Title I Plan, even when combined with a recommendation as to how the distribution should be invested, did not constitute investment advice.

Now, any fiduciary adviser who recommends that a client move assets from a plan to an IRA risks engaging in a prohibited transaction if the adviser is paid as a result of the recommendation. This is true, even for new clients, if the rollover is recommended with an expectation that the adviser will get paid additional compensation sometime in the future. A one-time recommendation by a fiduciary adviser is enough.

Advisers who engage in prohibited transactions can be punished severely, including a whopping excise tax of up to 100 percent of the amount involved, compounded over time. The IRS might disqualify the IRA, resulting in the entire value of the IRA being included in the income of the IRA owner in the year of the breach.

How did we get here?

Long-standing ERISA law forbids an investment adviser from receiving additional compensation as a result of a recommendation to a plan or plan participant, unless an exemption is available. Under the new interpretation, the rollover advice is itself likely conflicted. This is true even if the adviser goes from receiving no compensation when the recommendation is made (because the adviser does not advise the plan) to any compensation in the future from the IRA (which makes it “additional compensation”). The advice is considered fiduciary investment advice because it is necessarily a recommendation to liquidate or transfer the plan’s property interest in the affected assets and the participant’s property interest in plan investments. More transactions than what are traditionally thought to be rollovers are considered, however.

The New Rules Extend to IRAs and Five Different Types of Rollovers

The Investment Advice PTE and its preamble broadly define the DOL’s views about what is fiduciary investment advice for both IRAs and ERISA plans.

As noted, a recommendation to make a rollover is fiduciary investment advice. The Investment Advice PTE defines a rollover to include a transfer of assets from a(n):

- ERISA-covered plan to an IRA,
- ERISA-covered plan to another ERISA-covered plan,
- IRA to an ERISA-covered plan,
- IRA to another IRA, to the extent permissible under the Code (including an Individual Retirement Account, Health Spending Account, Archer Medical Savings Account, Coverdell Educational Savings Account to another similar account), or
- different account type, such as converting from a brokerage account to an advisory relationship or from a commission-based account to a fee-based account.

The final item, change in account type, follows the earlier, withdrawn fiduciary rule but may lay the path to a trap for an unwary wealth adviser. Recommending a move from a brokerage account to an advisory arrangement is likely fiduciary investment advice under the rule. Wealth managers commonly recommend such transfers, believing them to be in the best interest of the client. These recommendations are now subject to the DOL’s new interpretation of what is a prohibited transaction.

Is an IRA Now an ERISA plan?

This does not mean that IRAs have now become ERISA plans. Many years ago, the DOL was granted authority to interpret what is a prohibited transaction for ERISA plans and IRAs. This eliminated the need to have both the IRS and the DOL ruling on essentially the same subject matter. The new guidance confirms that the DOL has authority to conclude what is "investment advice" for either type of retirement program so that it can properly evaluate whether a prohibited transaction has occurred. The IRS, however, remains the sole enforcer of the tax rules that affect IRAs.

Conflicts of Interest Can Be Resolved by Strict Compliance with the Investment Advice PTE.

Fortunately, relief available under the Investment Advice PTE is broad-based, extending to conflicts created by all types of compensation that would otherwise be prohibited. It forgives the receipt of third-party compensation such as 12b-1 fees, revenue sharing, and sub-TA fees, as well as commissions, bonuses and other forms of unlevel compensation. The cost for this clemency is that:

a. Any recommendation must meet the Impartial Conduct Standards, meaning that it must be in the best interest of the client, that all compensation the adviser receives as a result of the recommendation is reasonable, and that the adviser makes no materially misleading statements.

b. Extensive disclosures be made in writing to the client, including a written acknowledgement that the adviser acts as a fiduciary and specific descriptions of the services to be provided, and a description of any major conflicts of interest.

c. All rollover recommendations must be specially documented and presented to the client before the transaction. The recommendation must describe the alternatives to the rollover and compare the investment options, fees and expenses, both in the current plan or arrangement and in the recommended IRA or other arrangement. The disclosure must explain why the adviser's recommendation is in the best interest of the client and whether the employer pays for any of the administrative expenses. It should also compare the different services available in the current arrangement to what is recommended.

d. The adviser must maintain effective policies and procedures to comply with the above and to mitigate any conflicts of interest.

Your firm is to be commended if you adopted forms to comply with the prior rule's standards for the Best Interest Contract Exemption ("BICE"). You may continue to use them until December 20, 2021. After that date, you must replace the BICE forms with forms that meet the requirements of the Investment Advice Exemption.

Recommended Actions

Prudent advisers will prepare to meet the requirements of the Investment Advice PTE. This includes:

a. Review all current disclosures, including Form ADV-2a, Form ADV-2b, Form CRS, 408(b)(2) reports and other documents to be certain that the proper disclosures are made, including all conflicts of interest.

b. Reassess all sources of compensation so that they be may disclosed. Check your own accounting records for payments you receive, 408(b)(2) disclosures, selling agreements and other documentation.

c. Prepare a new rollover form for each rollover type that specifically compares the current arrangement to the proposed arrangement regarding services, fees and expenses, as well as the investments, plus lays out what the proposed arrangement is and why it is in the best interest of the client.

d. Revise compliance manuals to provide an effective program to meet the Impartial Conduct Standards, describe services and compensation and acknowledge fiduciary status.

e. Test, track and maintain records of how effective your compliance program is. Include what kinds of mistakes are made, who made them, and what corrective action was taken.

f. Report annually the results of your compliance program to a senior executive officer appointed for this purpose who must certify that you have an effective program, designed to maintain compliance with the Investment Advice PTE. Keep those records for six years. The DOL will likely request this report upon any audit.

g. For all advisers, examine your investment advisory arrangements with care. The PTE provides protection for a broad range of conflicts, including conflicts arising from variable compensation, third party compensation, proprietary products, and principal trading. Be aware that these conflicts apply to both discretionary and non-discretionary investment services but the relief of the PTE is available only to non-discretionary advice. Discretionary management is expressly excluded. Accordingly, advisers should take care to see that any conflicted discretionary management arrangements satisfy other exemptions or DOL guidance or they will be left without any relief from prohibited transaction penalties.

h. Train, train, train all levels of the firm to understand and appreciate the importance of these rules.