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If You Give Rollover Advice to IRA Owners, Act Now: The Compliance Deadline Has Passed

By Marcia Wagner, JD, and Kimberly Shaw Elliott, JD, LLM

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Any fiduciary advisor who recommends that a client move assets from a plan to an individual retirement account (IRA) risks engaging in a prohibited transaction if the advisor is paid as a result of the recommendation. This results from new interpretations voiced in the Department of Labor's (DOL) Prohibited Transaction Exemption 2020-02 (the Investment Advice PTE or PTE). The good news is that the Investment Advice PTE provides ready relief if the conditions of the exemption are met. The bad news is that the Investment Advice PTE is now fully effective—the deadline was July 1, 2022.

This could be a bomb that squarely hits unwary wealth managers who give investment advice to IRA owners. The PTE lists a number of inherent conflicts of interest that advisors need to consider, including receiving compensation that varies based upon the investment advice or receiving compensation from a third party in connection with that fiduciary investment advice.

ROLLOVER ADVICE IS CONFLICTED IF THE ADVISOR IS PAID FROM THE IRA

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

Now, if the rollover is recommended with an expectation that the advisor will get paid additional compensation sometime in the future, the PTE must be satisfied. A one-time recommendation by a fiduciary advisor is enough.

Advisors who engage in prohibited transactions risk penalties that may include an excise tax of 15 percent of the compensation received, which, if left uncorrected, can rise to a whopping 100 percent, compounded over time. IRA owners also are at risk if they engage in a prohibited transaction: The Internal Revenue Service (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 law in the Employee Retirement Income Security Act of 1974 (ERISA) forbids an investment advisor 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 advisor goes from receiving no compensation when the recommendation is made (because the advisor 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 traditionally are thought to be rollovers are considered, however.

THE RULES EXTEND TO VARIOUS 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 an:

- 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 IRA, Health Spending Account, Archer Medical Savings Account, Coverdell Educational Savings Account to another similar account); or
- Account to a 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 advisor. 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 constitutes a prohibited transaction.

HOW TO COMPLY

REVISE COMPLIANCE MANUALS

Advisors and their firms must revise compliance manuals to show they are delivering an effective program that meets the impartial conduct standards. This means the investment advice must be, at the time it is given, in the investor's best interest; the compensation must be reasonable in light of the services provided; and the advisor does not make any materially misleading statement.

The procedures should also require the advisor to: acknowledge status as a fiduciary, as described in both ERISA and the Internal Revenue Code; fully describe the services and compensation; address how conflicts of interest will be mitigated; and document the reasons for any recommendation to engage in a rollover. These compliance manuals should have been in place by February 1, 2022. The DOL extended that earlier deadline only for the rollover forms.

TEST, TRACK, AND MAINTAIN COMPLIANCE RECORDS

Just as advisors must file a Securities and Exchange Commission (SEC) annual compliance report, you also must annually report the results of your compliance program to a senior executive officer appointed for this purpose. That executive must certify that you have an effective program, designed to maintain compliance with the Investment Advice PTE.

The Investment Advice PTE contains no specific direction about how effectiveness is measured. We believe it is important to include the kinds of mistakes made, who made them, and the corrective action taken. Keep those records for six years. This will be of interest to not only the DOL. The SEC remains acutely interested in how well any of your compliance programs perform.

PREPARE A NEW ROLLOVER FORM FOR EACH ROLLOVER TYPE

Each form specifically should compare the current arrangement to the proposed arrangement regarding services, investments, fees, and expenses, plus lay out the proposed arrangement and why it is in the best interest of the client. Comparing the current arrangement to the recommended arrangement is problematic for many advisors. Getting the proper investment data is a big task that many are struggling with. We hope that the DOL will release more guidance soon.

DISCLOSE CONFLICTS OF INTEREST

Disclosures about conflicts of interest are key to any effective compliance system and the requirements of the PTE are no exception. Where those disclosures should be made is described below.

Account agreements. The DOL and the courts likely will change how conflicts may be interpreted, so cautious advisors may wish to avoid adding disclosures to contracts. In that way, they will not be bound contractually to anything that may later become incorrect. It may be better to place the disclosures in a document that can be updated readily, without the client's consent, as is true for the ADV and the rollover forms. This would be consistent with common practice because account agreements, whether for wealth management services or specific to retirement plans, typically do not include statements regarding conflicts of interest.

Form ADV. The firm brochure includes a required section on conflicts of interest. This ADV-2a can be refiled easily with the SEC at no charge if the conflicts change (such as when the DOL issues new guidance). If the change in the conflicts of interest is considered non-material, and if the Form ADV remains truthful and accurate, the change simply can be incorporated into the next annual update. If a change in conflicts of interest is deemed to be a material change, refiling cannot wait. The form must be updated and refiled with the SEC, as well as redistributed to all clients at what might be a considerable expense.

Rollover forms. The rollover forms are the easiest place to include conflicts of interest because any rollover form need not be filed with the SEC and may be updated before it is provided to the next client. In that way, each form will always be current. Only rollover clients would receive these forms, however, so advice that is conflicted for another reason must be disclosed in another way.

Stand-alone forms. Disclosures need not be made in any particular way. Advisors are free to draft stand-alone forms to distribute to each client.

RECOMMENDED ACTIONS

Prudent advisors already are meeting the requirements of the Investment Advice PTE. To facilitate this, they do the following:

Review all current disclosures

These include 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.

Reassess all sources of compensation so that they may be disclosed

Check your accounting records for payments you receive, 408(b)(2) disclosures, selling agreements, and other documentation.

Re-examine 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. Keep in mind, however, that the PTE grants protection only to non-discretionary investment advice. Discretionary investment management services typically are offered to IRAs, but discretionary services expressly are excluded from the PTE. Accordingly, advisors 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.

Rollovers are a notable exception. Few contracts grant advisors discretion to take a rollover. Accordingly, even though assets may move from, for example, a qualified plan to a discretionary IRA investment management account, the singular decision to make the rollover is made by the client and not the advisor. The advice to take the rollover is a recommendation and is not a discretionary act. Because the advice is non-discretionary, the conflict resulting from the compensation received for managing the investments in the IRA can be excused by following the PTE, including providing the rollover forms.

Be careful about saying that the decision was made in the absence of a recommendation made by the advisor and using that to avoid providing the rollover form. Theoretically, a client can decide on his or her own to take a rollover, even before meeting the advisor. The DOL has a clear bias in finding that the client acts with the benefit of a recommendation, especially because some investments might be traded in the process. Most conflicts can be cleared with proper use of the form so a smart advisor will resolve any doubt about whether the decision resulted from a recommendation by providing the form.

Train, train, train

All levels of the firm should be trained to understand and appreciate the importance of these rules.

AN IRA IS NOT AN ERISA PLAN

None of this means that IRAs have now become ERISA plans. Many years ago, the DOL was granted authority to interpret prohibited transactions 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 the 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.

IF YOU EDUCATE PARTICIPANTS BUT DO NOT GIVE INVESTMENT ADVICE

The Investment Advice PTE leaves undisturbed the enduring principles of Advisory Opinion 96-1 that investment education to participants in a participant-directed plan is not investment advice. Investment education can be given freely to participants, will not cause an advisor to be a fiduciary, and will therefore not, in and of itself, create a prohibited transaction in need of the PTE. Tread carefully, however, because the DOL will view harshly any attempt to characterize as education what is really a recommendation.

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CONTINUING EDUCATION
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