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The DOL's Focus on Conflicts of Interest (Part 1): Householding Accounts and

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Recommending Affiliate Funds

BY FRED REISH, JOAN NERI AND JOSHUA WALDBESER

This article is the first in a series and examines the conflict of interest issues that arise under the prohibited transaction rule under ERISA and the Internal Revenue Code known as the self-dealing rule.

The Department of Labor's (DOL) current list of enforcement priorities shows that the DOL is focused on investigating conflicts of interest and fiduciary service provider compensation. The DOL enforces the conflict of interest rules—known as the prohibited transaction rules—under the Employee Retirement Income Security Act of 1974, as amended (ERISA). The Internal Revenue Code (Code) contains virtually identical prohibited transaction rules that apply to Individual Retirement Accounts (IRAs) and private sector retirement plans; however, only the Internal Revenue Service (IRS) can enforce the Code's prohibited transaction rules.

Prohibited transactions can arise in unintended ways for broker-dealers, registered investment advisers, and their representatives (collectively, advisors) who provide fiduciary advice to private sector retirement plans, participants in those plans and IRA owners. This article is the first in a series and examines the conflict of interest issues that arise under the prohibited transaction rule known as the self-dealing rule in the following two circumstances:

1. When an advisor combines a client's retirement accounts and personal accounts to provide the client with a reduced fee—a practice sometimes referred to as "householding;" and
2. When a fiduciary advisor recommends funds managed by the advisor or its affiliate.

In our next articles in the series, we will discuss other circumstances that could result in a self-dealing transaction.

Background—The Self-Dealing Rule

Under the self-dealing rule, a fiduciary advisor, as defined in ERISA and applicable regulations, generally is prohibited from using his or her fiduciary status to cause the advisor or an affiliate of the advisor to receive additional compensation or to receive compensation from a third party in connection with transactions involving plan assets (for example, from providers or investments). [ERISA §§ 406(b)(1), 406(b)(3)] A fiduciary advisor to an IRA or to an ERISA tax-qualified plan, as well as to non-ERISA qualified plans, such as solo 401(k) plans, is subject to a virtually identical self-dealing rule under the Code. [Code §§ 4975(c)(1)(E), 4975(c)(1)(F)]

If a fiduciary advisor commits a self-dealing prohibited transaction and no exemption is available, the advisor must pay back the prohibited compensation, plus interest on that amount. The advisor must also file a Form 5330 with the IRS and pay an excise tax of 15 percent of the amount involved (increased to 100 percent if the prohibited transaction is not timely resolved). [Code §§ 4975(a), 4975(b)] In addition, the DOL could assess a 20 percent penalty on the amount involved, that is, the prohibited compensation, if the DOL and the advisor enter into a settlement on the violation. [ERISA § 502(l)] In sum, engaging in a self-dealing transaction is costly. Self-dealing can arise in a number of circumstances as discussed below.

Householding Accounts

The Self-Dealing Issue

Aggregating retirement accounts and personal accounts to provide a client with a reduced fee through a tiered fee structure is a common practice. Unfortunately, this practice can result in a self-dealing transaction. Here's why. The investor is considered to be a fiduciary of his or her own retirement account. With householding, the investor's retirement and personal account assets are combined to calculate the fee allowing the investor to take advantage of breakpoints in the tiered fee structure to obtain a fee reduction. In effect, the investor (for example, the IRA owner as the primary fiduciary) is using retirement assets to obtain a personal benefit. Technically, the self-dealing is committed by the investor, not the advisor. However, from a practical standpoint, the advisor will want to avoid fee structures that expose the investor to a self-dealing transaction.

Prohibited Transaction Exemption for Certain Brokerage Services

The good news is that the DOL has provided exemptive relief for certain brokerage services. Under the Prohibited Transaction Exemption (PTE) 97-11, the DOL granted relief for combining the value of certain retirement accounts and personal accounts to provide brokerage services at a reduced fee. The retirement accounts covered by the PTE include Keogh plans and IRAs. A Keogh plan refers to a plan not covered by ERISA that covers only self-employed individuals and their spouses. The PTE defines "IRA" broadly to include a traditional IRA, a Roth IRA, a simplified employee pension (SEP) and a savings incentive match plan for employees (SIMPLE IRA). Participant accounts in an ERISA plan, unless it is an ERISA-covered SEP or SIMPLE IRA, are excluded from the PTE. Therefore, the use of such ERISA assets to obtain a reduced fee for personal accounts is prohibited.

For relief under PTE 97-11, a number of conditions apply. Among these conditions are the following:

- The IRA and Keogh plan fees cannot exceed reasonable compensation;
- The services offered to the IRA or Keogh plan must be the same as those offered to other customers with account values of the same amount or the same amount of fees generated;
- With respect to the SEP or SIMPLE IRA, the investor must have the unrestricted authority to transfer the SEP or SIMPLE IRA to another financial institution.

In sum, advisors providing brokerage services can combine an investor's personal account(s) and the specified, but limited, retirement accounts to achieve a reduced fee for the investor, apply the fee reduction to the personal account and/or the retirement account, and avoid a prohibited transaction by complying with the conditions of PTE 97-11.

On the other hand, accounts excluded from the PTE (for example, an ERISA plan) can be combined to achieve the same fee reduction only if all of the fee reduction inures to the benefit of the plan and not to the individual's personal accounts.

No PTE Relief for Investment Advisory or Investment Management Services

Unfortunately, the DOL has not issued a PTE for householding accounts in connection with investment advisory or investment management services. Therefore, advisors providing investment advisory or management services do not have the same opportunity to use householding for Keogh and IRAs as those providing only brokerage services. In that case, one way to avoid self-dealing is to apply the entire discount resulting from householding to the retirement accounts, regardless of whether it is a Keogh plan, IRA, or ERISA plan, with no discount to the personal accounts.

Recommending Affiliated Funds

When a fiduciary advisor to an ERISA plan or an IRA recommends a fund that is managed by the advisor or the advisor's affiliate (that is, an Affiliated Fund), the management fee paid by the Affiliated Fund to the manager (that is, the advisor or its affiliate) is prohibited compensation under the self-dealing rule, unless a prohibited transaction exemption is available.

Recommending an Open-End Mutual Fund

If the Affiliated Fund is an open-end mutual fund, PTE 77-4 provides exemptive relief. PTE 77-4 permits purchases and sales by an employee benefit plan of open-end mutual fund shares when the fiduciary to the plan (or an affiliate of the fiduciary) is also an investment adviser to the mutual fund, as long as certain conditions are met. PTE 77-4 provides exemptive relief for a nondiscretionary fiduciary advisor to the plan who recommends the open-end mutual fund or for a discretionary fiduciary advisor to the plan who selects the open-end mutual fund, as long as the conditions are met. The PTE 77-4 conditions include all of the following:

- No investment management fee may be paid by the plan with respect to assets invested in the shares of the mutual fund. This requirement does not prohibit the fund from paying an advisory fee to the fiduciary adviser (or its affiliate), nor does it prevent the payment of a plan-level advisory or management fee by the plan to the fiduciary adviser that is (i) based on total plan account assets from which a credit has been subtracted representing the plan's pro rata share of the fund-level fee (the "credit method") or (ii) based on only the portion of the plan's assets not invested in the fund (the "offset method").
- No sales commissions in connection with the purchase or sales of the mutual funds are charged to the plan.

- No redemption fees are charged to the plan unless paid to the mutual fund to which it relates and disclosed in its prospectus (both at the time of purchase and time of sale).
- The plan must receive a current fund prospectus and a full disclosure of the fees charged to or paid by the plan and must be notified of any changes.
- The arrangement must be disclosed to and approved by a fiduciary that is independent of the investment adviser to the mutual funds.

On its face, PTE 77-4 applies to employee benefit plans, raising the question of whether it can be used for IRAs. The DOL addressed this issue in the preamble to PTE 2002-13 (a PTE amending other class exemptions) where it noted that, after consulting with the IRS, "plans described in 4975(e)(1) of the Code are included within the scope of relief provided by … PTE 77-4." Code Section 4975(e)(1)(B) defines "plan" to include "an individual retirement account described in Code section 408(a)", or an IRA. Therefore, PTE 77-4 provides exemptive relief for fiduciary advisors who recommend Affiliated Funds that are open-end mutual funds to both private sector plans and IRAs.

Recommending Other Affiliate Funds

Another PTE that can be used for recommending Affiliated Funds is DOL PTE 2020-02. PTE 2020-02 provides exemptive relief as long as the advisor is providing nondiscretionary advice about the Affiliated Fund, meaning that the investor can either accept or reject the advice. DOL PTE 2020-02 is not available if the advisor has discretion to invest in the Affiliated Fund without client approval. Advisors may already be familiar with PTE 2020-02 for rollover recommendations, but may not be aware that it can be used for other conflicts of interest.

In the context of recommending an Affiliated Fund, PTE 2020-02 requires satisfaction of the following four conditions:

1. The advisor and the firm must comply with "Impartial Conduct Standards," consisting of: (a) adherence to a best interest standard (that is, a standard that mirrors the ERISA duties of prudence and loyalty); (b) reasonable compensation, (c) best execution standards; and (d) no materially misleading statements.
2. The firm must furnish a disclosure to the investor before implementing the transaction that consists of: (a) an acknowledgement of the firm's and the advisor's fiduciary status under ERISA and/or the Code; and (b) a description of services and material conflicts of interest.
3. The firm must establish and enforce policies and procedures to ensure compliance with the Impartial Conduct Standards and to mitigate conflicts of interest.
4. The firm must conduct a retrospective review at least annually reduced to a written report that is reviewed and certified by a senior executive officer no later than six months after the end of the period covered by the review.

An alternative to satisfying the conditions of PTE 2020-02 is to consider the compensation structure that was approved in DOL Advisory Opinion 97-15A issued to Frost Bank with respect to ERISA plan investment services and DOL Advisory Opinion 2005-10A issued to Country Trust Bank with respect to IRA investment services. Although they are DOL advisory opinions, not PTEs, they are instructive on how to structure compensation when recommending Affiliated Funds in order to avoid the self-dealing rule.

In those rulings, the banks were providing nondiscretionary and discretionary fiduciary investment services and the DOL found that the bank's receipt of additional fees from mutual funds would not violate the self-dealing rule where they offset, on a dollar-for-dollar basis (that is, reduced), the bank's stated advisory fee charged directly to the plan or IRA. In this way, the bank never received more than the fiduciary advisory fee and therefore, there was no self-dealing. Applying this methodology, a fiduciary advisor to an ERISA plan or IRA can recommend an Affiliated Fund that pays a fund management fee to the advisor's affiliate as long as that fund management fee is applied to offset - dollar-for-dollar - the advisor's advisory fee payable by the ERISA plan or IRA.

Conclusion

Self-dealing under ERISA and the Code can arise in many unexpected ways. As this article explains, advisors should examine their fee practices and procedures in connection with aggregating a client's personal and retirement accounts to ensure that it will not result in a self-dealing transaction for the client. Also, if a fiduciary advisor to a plan or IRA recommends Affiliated Funds that pay a management fee to the advisor's affiliates, the advisor should comply with the conditions of an applicable PTE if available or if not, consider using the Frost Bank/Country Trust fee offset method. ■

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