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# The DOL's Focus on Conflicts of Interest (Part 2): Custodian Revenue

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# Sharing Payments

BY FRED REISH, JOAN NERI, AND JOSHUA WALDBESER

*This article is the second 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.*

This is our second article in a series that examines conflicts of interests that are prohibited transactions under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (the Code). The Department of Labor (DOL) enforces the prohibited transaction rules that apply to plans that are subject to ERISA and the Internal Revenue Service (IRS) enforces the prohibited transaction rules under the Code, which apply not only to qualified retirement plans that are subject to ERISA, but also to other private sector qualified retirement plans such as Solo 401(k)s and Keogh Plan (collectively, Plans) and Individual Retirement Accounts (IRAs). The prohibited transaction rules under the Code are virtually identical to the ERISA prohibited transaction rules.

In this article, we focus on a prohibited transaction that can arise when broker-dealers, registered investment advisers, and their representatives (collectively, advisors) accept revenue sharing payments from custodians in exchange for investing in certain types of funds, for example, No Transaction Fee (NTF) funds. The prohibited transaction, known as self-dealing, can arise if the advisor is a fiduciary under ERISA or the Code and uses his or her fiduciary status to invest Plan or IRA assets in the NTF fund in exchange for the custodian revenue sharing payment. The good news is that, if the fiduciary advisor provides nondiscretionary advice with respect to the NTF fund investment, then the advisor can comply with the conditions of prohibited transaction exemption (PTE) 2020-02 to avoid treatment as a prohibited transaction.

## Background—Revenue Sharing Payments and the Self-Dealing Rule

The self-dealing rule under ERISA and the Code prohibits a "fiduciary" advisor, as defined under ERISA and the Code, from using his or her fiduciary authority to receive compensation from a third party in connection with transactions involving Plan or IRA assets. [ERISA § 406(b)(3); Code § 4975(c)(1)(F)]. Under this rule, if a third party makes a payment to the fiduciary advisor in exchange for investing Plan or IRA assets in certain funds, then the receipt of that payment as compensation is prohibited. Also, as described in Part 1 of this series, [*Journal of Pension Benefits*, Vol. 32:03, Spring 2025] there are other costs to the fiduciary advisor that result from a prohibited transaction, including an excise tax that is applied under the Code.

## Custodian Revenue Sharing Payments for Investing in NTF Funds

One example of this issue arising is when a fiduciary advisor accepts revenue sharing payments from a custodian in exchange for investing in NTF funds. An NTF fund is a mutual fund share class for which the custodian does not charge fees for purchases. This means that, if NTF shares are bought or sold, there is no sales charge. However, NTF funds typically have higher expense ratios than funds that charge transaction-related fees.

Some custodians have arrangements with advisors under which they pay advisors a percentage amount, such as .2 percent of the assets held in NTF funds. If a fiduciary advisor receives this revenue sharing payment in exchange for investing Plan or IRA assets in NTF funds, then the advisor has engaged in a self-dealing transaction and the revenue sharing payment is prohibited, unless a PTE is available.

## PTE 2020-02 for Nondiscretionary Advice

If the fiduciary advisor provides nondiscretionary advice about the NTF fund that the Plan fiduciary, Plan participant or IRA owner (collectively, retirement investors) can accept or reject, then the fiduciary advisor typically can use PTE 2020-02 for exemptive relief.

Unfortunately, if the fiduciary advisor has discretion to invest in the NTF fund without client approval, the issue is not as clear. In that instance, PTE 2020-02 is not available because it only provides relief for prohibited transactions resulting from nondiscretionary investment recommendations. There is an alternative

exemption, PTE 86-128, which (subject to a number of requirements and restrictions) allows a fiduciary to cause a Plan or IRA to pay the fiduciary a fee for executing securities transactions. On its face, PTE 86-128 can be logically read to cover forms of compensation such as revenue sharing for NTF funds; however, certain DOL pronouncements may indicate that its position is that PTE 86-128 only applies to traditional forms of transaction-based compensation, such as brokerage commissions, and not to revenue sharing or similar third-party payments. Another alternative that would be available to a discretionary advisor in certain cases would be to offset (reduce) its investment management fee from the Plan or IRA on a dollar-for-dollar basis by the revenue sharing received, thus "levelizing" its total compensation and potentially avoiding a prohibited transaction.

PTE 2020-02, for nondiscretionary advice, requires satisfaction of four conditions, each of which are discussed below in the context of recommending NTF funds.

### 1. Adherence to the Impartial Conduct Standard

Under PTE 2020-02, both the fiduciary advisor and its firm must comply with "Impartial Conduct Standards." These standards consist 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.

A fiduciary advisor to an ERISA plan or ERISA account of a plan participant is already subject to the ERISA duties of prudence and loyalty when recommending the NTF fund and so, compliance with the PTE's best interest standard should not impact the process that the fiduciary advisor would otherwise undertake in recommending the NTF fund. If, on the other hand, the fiduciary advisor is recommending the NTF fund for an IRA or a non-ERISA tax-qualified plan (for example, a solo 401(k) plan), the Code does not impose prudence and loyalty conduct standards on the recommendation. However, the Securities and Exchange Commission (SEC) imposes a similar standard on investment recommendations, that is, the best interest standard, and advisors to Plans and IRAs are subject to this standard. The SEC guidance on this standard is found in Regulation Best Interest: The Broker-Dealer Standard of Conduct for Broker-Dealers (Reg BI) and the SEC's Interpretation Regarding Standard of Conduct for Investment Advisers.

Based on the SEC and DOL guidance, a fiduciary advisor should undertake a three-step process to comply with the best interest standard. First, the fiduciary advisor should use a prudent process to investigate and evaluate the merits of the investment as based on prevailing investment industry standards. This process should include an evaluation of the relevant qualitative and quantitative characteristics of the investment, including among other things, its costs and risk and return factors, and the fiduciary advisor should give appropriate weight to those characteristics. Second, the fiduciary advisor should ensure that the recommendation does not place its interests ahead of that of a retirement investor; in other words, the advisor has to act with loyalty. Third, the advisor should ensure that the investment aligns with the investment objectives of the retirement investor.

In the context of recommending an NTF fund, the fiduciary adviser would need to undertake this process to evaluate whether the NTF fund is in the best interest of the retirement investor. Under both the DOL and SEC guidance, costs are an important consideration in this process. NTF funds produce lower costs in the short-term because there is no transaction fee; however, NTF funds generally have higher expense ratios, which add up over time. Therefore, in the long-term, it may be more cost-effective to pay a transaction fee rather than the higher expense ratio. If the investment objectives for the Plan, Plan participant, or IRA owner have a strategy built on a long-term time horizon, it likely would not be in the best interest to recommend the NTF fund. Where it is not in the best interest of the retirement investor, PTE 2020-02 could not be used for exemptive relief. On the other hand, if the investment objectives of the retirement investor involve short-term holdings as part of a higher turnover investment strategy, that is a factor that would support a determination that recommending the NTF fund is in the retirement investor's best interest.

### 2. Disclosure Obligation

PTE 2020-02 requires that the firm furnish disclosures to the retirement investor before investing in the NTF fund. The disclosure must include an acknowledgement of the firm's and the advisor's fiduciary status under ERISA and/or the Code and a description of the services and material conflicts of interest, namely, the receipt of the custodian revenue sharing payment in exchange for investing in the NTF fund. The SEC also requires that this conflict of interest be disclosed to investors. Registered investment advisers

are required to disclose the revenue sharing arrangement in Part 2 of the Form ADV, which must be provided to the investor and filed with the SEC. In addition, broker-dealers must describe conflicts under Regulation Best Interest. Also, both registered investment advisers and broker dealers must provide a Form CRS (Client Relationship Summary) to retail investors, including IRAs and Plan participants, describing any conflicts of interest.

### 3. Adoption and Implementation of Policies and Procedures

A third condition under PTE 2020-02 is that the firm adopt and implement policies and procedures to ensure compliance with the Impartial Conduct Standards and mitigate conflicts. This means that firms should review and modify, as needed, policies and procedures to reflect the best interest process that will be undertaken in determining whether to recommend NTF funds to retirement investors and to ensure compliance with the other conditions of the PTE.

### 4. Annual Retrospective Review

PTE 2020-02 requires that at least annually, a firm must conduct a retrospective review of compliance with the requirements of the PTE and document the results in a report that is reviewed, signed, and certified by a senior executive officer. This review and reporting process must be completed no later than six months following the end of the period covered by the review. Firms should identify the title of the individual who will conduct the review and the senior executive officer (usually, the chief compliance officer) who will sign and certify the report.

## Conclusion

Fiduciary advisors to Plans, Plan participants, and IRA owners who receive custodian payments in exchange for recommending NTF fund investments should ensure that their policies and procedures support compliance with PTE 2020-02, as well as with SEC requirements. Fiduciary advisors who have discretionary investment management authority over Plan and IRA assets should review their current practices to make certain that they receive and retain no custodian payments in exchange for investing in NTF funds. If they do receive and retain custodian payments, the fiduciary advisor has two choices to avoid engaging in a self-dealing prohibited transaction: (1) get comfortable that there is exemptive relief available under the circumstances and comply with the conditions of the exemption; or (2) self-levelize their compensation by reducing their investment management fee by the amount of the custodian payments. ■