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DOL Finalizes Fiduciary Investment Advice Guidance

On December 15, 2020, the Department of Labor finalized its new guidelines for fiduciary investment advice. Prohibited Transaction Exemption 2020-02 both clarifies the circumstances under which financial institutions and investment professionals are considered "fiduciaries" under ERISA and the Internal Revenue Code, and establishes a new framework under which such fiduciaries may provide services and receive compensation.

The preamble to the final Exemption provides the Department's long-awaited final interpretation of when investment advice – such as a recommendation to roll over retirement plan assets to an IRA (or between IRAs) – creates a fiduciary relationship under ERISA or the Code. The substantive terms of the Exemption allow investment advisers who *are* fiduciaries to receive compensation and engage in principal transactions that would otherwise violate prohibited transaction rules.

The Exemption applies to SEC- and state-registered investment advisers, broker-dealers, banks, insurance companies, and their employees, agents and representatives that are investment advice fiduciaries under the newly interpreted "five-part" test of fiduciary status.[1] It imposes certain conditions to protect the interests of retirement plans, participants, beneficiaries, and IRA owners. The Exemption is set to become effective February 16, 2021, absent a delay by the Biden Administration.[2] Employers will need to be aware of the Exemption and its conditions in their engagement of (and interactions with) plan service providers.

Background

The Department of Labor issued regulatory guidance in 1975 that established a five-part test for determining fiduciary status under ERISA for individuals and institutions that provide investment advice for a fee. This regulation also applies to the Internal

Revenue Code's definition of fiduciary. Financial institutions and investment professionals that are considered investment advice fiduciaries are prohibited from engaging in certain financial transactions involving retirement plans and IRAs.

In 2016, the Department finalized new, expanded guidance to replace the 1975 regulation, and issued new prohibited transaction exemptions in connection with the new regulation. The 2016 regulation generated significant industry resistance and was challenged in court. In a 2018 ruling, the U.S. Fifth Circuit Court of Appeals vacated the regulation and the new exemptions.

Earlier this summer the Department began the process of filling the void created by the Fifth Circuit's decision by issuing a proposed prohibited transaction class exemption and a technical amendment. The technical amendment removed the 2016 regulation, restored the text of the 1975 regulation, and reestablished Interpretative Bulletin 96-1 relating to participant investment education.

After considering comments and testimony in connection with the proposed class exemption, the Department modified it significantly, but retained the general framework, disclosures, policies, and procedures in the final Exemption.

New Guidelines

The Five-Part Test Reimagined

One of the primary criticisms levied against the DOL's 2016 regulatory guidance was that it attempted to govern investment advice conduct indirectly – primarily through burdensome standards required for compliance with the associated prohibited transaction exemptions, but also through new interpretations of existing rules that were articulated in the preamble to the 2016 regulation. Ironically, the Department has taken the same indirect regulatory approach in its newest attempt to corral investment advisers to ERISA plans and IRAs.[3]

Although the final guidance issued by the Department on December 15 takes the form of a prohibited transaction class exemption, it is the *preamble* to that exemption – that is, the Department's *explanation* of the exemption – that is turning heads. In the preamble, the Department revives and reinterprets the 1975 five-part test for fiduciary status, setting the stage for the new prohibited transaction exemption. If an investment advice provider is not a “fiduciary” under the five-part test, it does not need to rely on the prohibited transaction exemption to provide services and receive compensation (because the transactions that are exempted are only prohibited if an ERISA or Code fiduciary engages in them).

In the preamble, the Department explains that the five-part test provides a clear “roadmap” for determining when financial institutions and investment professionals are (and are not) ERISA and Code fiduciaries. Under the five-part test, a financial institution or investment professional is an investment advice fiduciary if the entity or individual receives direct or indirect compensation or other fees and (1) renders advice regarding the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property (2) on a regular basis (3) pursuant to a mutual agreement, arrangement or understanding with the retirement plan, plan fiduciary, or IRA owner, that (4) the advice will serve as the primary basis for investment decisions with respect to the retirement plan or IRA assets, and that (5) the advice will be individualized based on the particular needs of the retirement plan or IRA. All five prongs of the test must be satisfied for a person or entity to be considered an investment advice fiduciary under ERISA and the Code.

In explaining its interpretation of the five-part test, the Department focuses on the “regular basis,” the “mutual agreement, arrangement or understanding,” and the “primary basis for investment decisions” prongs. That interpretation retains many of the concepts articulated in the Department’s 2016 rulemaking effort, which could expand the circumstances in which investment advisers are deemed to be fiduciaries.

Rollover Advice

In a surprise to many in the financial services industry, the Department’s reimagined and reinterpreted five-part standard for fiduciary status will, in some instances, encompass rollover advice. Prior to its 2016 rulemaking, the DOL had taken the position that rollover advice generally does *not* create a fiduciary relationship between the plan participant or IRA owner and the advice provider. This position – which was articulated in a 2005 Advisory Opinion known as the *Deseret Opinion* – relied on the assumption that rollover advice would not satisfy the “regular basis” prong of the five-part test.

In the preamble to the new prohibited transaction exemption, however, the Department notes that rollover advice is often the beginning of an advisory relationship that is intended to be ongoing in nature. Objective evidence, "such as the parties agreeing to check-in periodically on the performance of the customer's post-rollover financial products" or an adviser holding itself out "as providing such ongoing services" could satisfy the regular basis prong.

The Department acknowledges that a single instance of advice to take a distribution from a retirement plan and roll over the assets would *not* meet the regular basis component of the five-part test. The Department reaches the same conclusion with respect to "sporadic interactions" with investors. By contrast, the Department identifies examples of situations that will meet this requirement because they occur as part of an ongoing (or intended) relationship between an investment advice provider and investor.

Advice to roll over assets from a retirement plan to an IRA that is part of an ongoing relationship in which the investor has previously received advice about investments in his or her retirement plan, or advice to roll over assets to an IRA, as the beginning of a future financial relationship are examples of situations that satisfy the regular basis component of the test.

The Department's new interpretation of the regular basis prong appears to put great emphasis on the intended parameters of the advice relationship at the time the rollover advice is given. Statements in marketing materials, account-opening documents, advisory agreements, and Forms ADV about the nature of the adviser's services will be important in this determination. However, the Department's interpretation of the "mutual agreement or understanding" prong makes it clear that advisers cannot contractually disclaim fiduciary status. When determining whether there is a mutual agreement or understating that the investment advice will serve a primary basis for investment decisions, the Department will consider the reasonable understanding of each party, if no mutual agreement or arrangement is demonstrated. The Department clarifies that "disclaimers of a mutual understanding or forbidding reliance on advice…will not be determinative."

The Final Exemption

Investment professionals and financial institutions that are deemed to be investment advice fiduciaries under the five-part test will now have a new way of providing services and receiving compensation without violating the prohibited transaction rules imposed under ERISA and the Code. Those rules generally prohibit investment advice fiduciaries who provide advice to retirement plans or IRAs from receiving compensation (directly or indirectly) that varies based on their investment advice. They also prohibit many forms of compensation that are paid to the fiduciaries by third parties. In addition, ERISA and the Code prohibit fiduciaries from engaging in principal transactions (i.e., purchases and sales with plans or IRAs on behalf of their own accounts).

Prohibited Transaction Exemption 2020-02 provides relief from the prohibitions and sanctions under ERISA and the Code that would otherwise apply to these transactions if financial institutions and investment professionals meet certain conditions and requirements when providing investment advice. These conditions and requirements include (1) meeting the Exemption's impartial conduct standards, (2) acknowledging in writing fiduciary status under ERISA or the Code (as applicable), and (3) describing in writing the services to be provided and any material conflicts of interest. Further, investment advice fiduciaries are required to document the reasons that a rollover recommendation is in the best interest of an investor and provide such documentation to the investor, if applicable.

Financial institutions that intend to rely on the Exemption must adopt policies and procedures that are designed to ensure compliance with its terms. They must also conduct an annual review and certify compliance with the Exemption's requirements.

Impartial Conduct Standards

To rely on the Exemption, investment advice fiduciaries must comply with its impartial conduct standards by providing advice that is in the best interest of plan fiduciaries, participants and beneficiaries, as well as IRA owners (collectively "investors"). In addition, fiduciaries must charge only reasonable compensation and not make any materially misleading statements about the investment transaction and other relevant matters.

The Exemption defines “best interest” as investment advice that “reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use, based on the investment objectives, risk tolerance, financial circumstances, and needs of the [r]etirement [i]nvestor.” Further, the advice cannot place the financial or other interests of the investment advice fiduciary ahead of the interests of the investor.

The Department explains that the best interest standard is objective. Investment advice fiduciaries are required to investigate and evaluate investments and exercise sound judgment at the time they provide the advice. The Exemption is intended to align with the SEC’s Regulation Best Interest standard.[4] Thus, investment fiduciaries may provide advice even if they have a financial or other interest in the transaction, as long as they do not place their interests ahead of the interests of their investors.

The impartial conduct standards under the Exemption also require investment advice fiduciaries to charge only reasonable compensation. This obligation is an established standard under ERISA and the Code, regardless of fiduciary status. It requires compensation to be reasonable in relation to the services that are being provided. While no one factor is determinative, the nature of the services, the market price for services or underlying assets, the scope of monitoring, and the complexity of the investment product are some factors that may inform whether compensation is reasonable.

As part of the reasonable compensation standard, investment advice fiduciaries are also required to seek the best execution of the investment transaction reasonably available under the circumstances. Best execution requires advice fiduciaries to seek to execute an investor’s trades at the most favorable terms reasonably available under the circumstances. The Department will apply the best execution requirement in a manner consistent with the federal securities laws.

Finally, the impartial conduct standards require that statements by investment advice fiduciaries about a recommended transaction and other relevant matters not be materially misleading at the time such statements are made. The

Department describes other relevant matters as including fees, compensation, material conflicts of interest, and "any other fact that could reasonably be expected to affect the [r]etirement [i]nvestor's investment decisions." The Department considers it materially misleading for advice fiduciaries to include any exculpatory clauses or indemnification provisions in an arrangement with an investor that are otherwise prohibited by applicable law.

Disclosure

Financial institutions are required to provide a written disclosure to investors *before* engaging in a transaction for which relief under the Exemption is sought. In the disclosure, the financial institution must acknowledge that it and its investment professionals are ERISA and Code fiduciaries, as applicable. In addition, the disclosure must accurately describe the services to be provided and any material conflicts of interest. If applicable, the financial institution and investment professionals must document and disclose to the investor the reasons that a recommendation to roll over assets from a retirement plan to an IRA (or to another plan or IRA), or from one type of account to another (e.g., between brokerage and advisory accounts), is in the investor's best interest.

The Department notes that the disclosure requirement can be satisfied through any disclosure or combination of disclosures required to be provided by other regulators, as long as the information required by the Exemption is included.

In connection with the disclosure, the Exemption's preamble provides model language that will satisfy the fiduciary acknowledgement requirement, as well as an explanation of the Exemption's terms. Further, financial institutions may rely (in whole or in part) on other regulatory disclosures, such as disclosures regarding the SEC's Regulation Best Interest and Form CRS, to satisfy the Exemption's disclosure requirements. However, the Exemption does *not* include a specific safe harbor if such other disclosures are used for purposes of the Exemption.

Application of Exemption to Rollovers

Generally, the Department believes that a recommendation to roll assets out of a retirement plan is advice to liquidate or transfer assets and a participant's related interests in plan investments.[5] Thus, an adviser making a rollover recommendation who otherwise is considered an investment advice fiduciary under the five-part test would be required to comply with an applicable exemption to avoid any prohibited transactions under ERISA and the Code.

The Exemption requires financial institutions to give investors documentation of the specific reasons that the recommendation to roll over assets is in their best interest *before* engaging in the rollover transaction. This documentation requirement must be included in the financial institution's written policies and procedures. These requirements emphasize the significance of the rollover decision and the importance that investment advice fiduciaries take the time to make and document a prudent recommendation that can be reviewed later.

Factors that should be considered and documented in connection with the rollover disclosure include (1) the investor's alternatives to a rollover, including leaving the money in his or her current plan (if permitted), and selecting different investment options; (2) the fees and expenses associated with both the plan and rollover IRA; (3) whether the employer pays some or all of the plan's administrative expenses; and (4) differences in the services and investment options available under the plan and the rollover IRA. Recommendations to roll assets from one IRA to another IRA, or to change from a commission-based account to a fee-based arrangement, also must be documented. The Department believes that a prudent recommendation would include consideration and documentation of the services that would be provided under the new arrangement. In addition, investment advice fiduciaries may need to consider and document other factors that are important to a particular investor as part of their rollover recommendation.

Before making a rollover recommendation, the Department expects advice fiduciaries to make diligent and prudent efforts to obtain information about the investor's existing plan. If the investor is unwilling to provide the information, the adviser should reasonably estimate the expenses, asset values, and risk and return characteristics of the plan based on publicly available information, but only (1) after providing a full explanation to the investor of the significance of the information, and (2) if the information is not otherwise readily available. In such cases, the rollover disclosure should document and explain the assumptions used and their limitations.

Compliance

Financial institutions are required to establish, maintain, and enforce written policies and procedures that are designed to ensure that the institution and its professionals comply with the Exemption's requirements, including conducting periodic compliance reviews.

These policies and procedures must mitigate conflicts of interest "to the extent that a reasonable person reviewing the policies and procedures and incentive practices as a whole would conclude that they do not create an incentive for a [f]inancial [i]nstitution or [i]nvestment [p]rofessional to place their interests above of the interests of the [r]etirement [i]nvestor." The Exemption's preamble provides several examples of business models and practices that may present conflicts of interest that a financial institution would need to address through its policies and procedures.

Finally, financial institutions are required to conduct a review (at least annually) of their policies and procedures to detect and prevent violations and maintain compliance with the impartial conduct standards and other requirements. A senior executive officer, such as the financial institution's chief compliance officer, must certify the results of the compliance review annually.

Conclusion

The Department of Labor's "clarification" of the five-part standard for defining investment advice fiduciaries, and the final Prohibited Transaction Exemption articulating new operating procedures for such fiduciaries, are certain to change the relationships between investment advisers, plans, plan participants, and IRA owners. The Exemption provides relief that is broader and more flexible than the other prohibited transaction exemptions that are currently available for investment advice fiduciaries. Many aspects of the Exemption align with existing regulatory requirements for ERISA fiduciaries, registered investment advisers, and broker-dealers. However, compliance with those other requirements is not deemed to constitute compliance with the Exemption. Thus, financial institutions and investment professionals should carefully analyze the Exemption to determine whether they want (or need) to rely on it based on their business models and practices.

Employers that engage financial institutions and investment professionals for their plans should be aware of the Exemption and its requirements so that they understand whether and how it applies.

This blog was drafted by Beth Miller, an attorney in the Spencer Fane Overland Park, Kansas office. For more information, visit www.spencerfane.com.

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[1] The Exemption does not apply if the investment advice fiduciary (or any affiliate) is the employer of the employees covered by the plan, or a named fiduciary or plan administrator that was selected to provide advice to a plan by a fiduciary who is not independent of the investment advice fiduciary (and its affiliates). The Exemption also does not apply to investment advice generated solely by a robo-adviser.

[2] The Department also announced that the enforcement relief provided by Field Assistance Bulletin 2018-02 will remain in effect until December 20, 2021.

[3] Although the preamble reflects the Department's view of fiduciary status, and the position that the Department is likely to take in regulatory enforcement actions and audits, it is not clear whether courts will adopt the same position. Agency positions reflected in the preamble to regulations, rather than the text of regulations or formal agency guidance, are not always afforded judicial deference.

[4] While the best interest standard in the Exemption is intended to be consistent with the securities law standards, compliance with the standards as interpreted by the SEC and FINRA does not necessarily constitute compliance with the Exemption. The Department will coordinate with other regulators on enforcement and interpretive issues, but it will not defer to other regulators on such issues.

[5] The Department notes that the SEC and FINRA have each recognized that recommendations to roll plan assets to an IRA will almost always involve a securities transaction.