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Overview of the DOL's New Fiduciary Rules for Retirement Plan Investment Advice

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On June 29, 2020, the Department of Labor ("DOL") announced its new approach to the standards for financial institutions and investment professionals who provide investment advice on a nondiscretionary basis to 401(k) plans, pension plans, or other plans covered by ERISA or to IRAs (collectively, "Retirement Plans") after its prior 2016 regulations (the "2016 Fiduciary Rule") were struck down by the Fifth Circuit in June 2018. (See our article: here).

The DOL released final regulations that reinstate its definition of who is a fiduciary by reason of providing investment advice to Retirement Plans, which reflect a "5-Part Test" (described below) that had been in effect from 1975 until its modification by the 2016 Fiduciary Rule. The final regulation adds several new interpretations and clarifications to the longstanding 5-Part Test.

The DOL also proposed a new prohibited transaction exemption ("PTE") that, if finalized as proposed, will provide rules for financial institutions and investment professionals seeking to (a) receive compensation from a recommended transaction involving a Retirement Plan, including commissions or additional advisory fees received as the result of advice to an individual to roll funds from a Retirement Plan covered by ERISA to an IRA, and/or (b) conduct principal trades with Retirement Plans to which they provide investment advice.

The DOL's new approach, as discussed herein, has no impact on existing standards for financial institutions or investment professionals with discretionary authority over Retirement Plans. Investment professionals who have discretion to manage Retirement Plan accounts (including IRAs) (or otherwise control such accounts) are fiduciaries and as such there is no need to apply the 5-Part Test to determine whether or not they should be deemed fiduciaries.

Background

Prohibited Transactions. Both ERISA plans and IRAs are subject to "prohibited transaction" rules under the Internal Revenue Code (the "Code"), which parallel the prohibited transaction rules under ERISA. Collectively, these rules prohibit most transactions between a Retirement Plan and parties with certain relationships to the Retirement Plan, including a "fiduciary" of the Retirement Plan, unless an exemption applies. For example, a fiduciary to a Retirement Plan is prohibited from receiving additional compensation (such as transaction-based compensation or additional advisory fees) from a Retirement Plan due to a transaction by the Retirement Plan that results from the fiduciary's exercise of authority, control, or responsibility. This prohibition includes a transaction that is the product of investment advice by a fiduciary. Similarly, a fiduciary is prohibited from engaging in a "principal transaction" by buying or selling securities from or to the Retirement Plan's account.

Exemptions to Prohibited Transactions. There are a number of exemptions to the prohibited transaction rules, by statute or issued by the DOL, that provide conditions under which a Retirement Plan may

engage in an otherwise prohibited transaction without violating the prohibited transaction rules. These conditions are generally intended to mitigate the potential for conflicts of interest that may result from the prohibited transactions.

The conditions imposed under PTEs issued by the DOL are an important part of the DOL's regulation of the management of Retirement Plans. For example, one of the primary criticisms of the 2016 Fiduciary Rule was that the DOL overstepped its authority by applying a condition under the Best Interest Contract Exemption (a PTE issued in connection with the 2016 Fiduciary Rule) that financial institutions must enter into a contract with IRAs that imposes fiduciary standards similar to the fiduciary standards that apply to Retirement Plans subject to ERISA. The requirement to enter into a contract could have given IRA owners or beneficiaries a private right of action that they would not otherwise have had under state or federal law.

The 5-Part Test of an Investment Advice Fiduciary

The definition of a "fiduciary" under ERISA and the Code, includes those who (1) have discretionary authority over investments or administration of a Retirement Plan or (2) provide investment advice with respect to a Retirement Plan's assets for a fee or other compensation, whether directly or indirectly. Historically, whether the provision of investment advice meets the definition of a fiduciary is determined through the application of a 5-Part Test.

The 5-Part Test was in place from 1975 until it was modified by the Fiduciary Rule in 2016, and then again presumably (following the Fifth Circuit's vacating of the 2016 Fiduciary Rule) from 2018 to present. The final rule affirms that the 5-Part Test remains effective going forward.

The 5-Part Test provides that if a person (who is not otherwise a Retirement Plan fiduciary by reason of discretionary management or control) provides investment advice for a fee with respect to Retirement Plan, that person is considered a fiduciary (an "Investment Advice Fiduciary") only if that advice is:

1. relating to the value of securities or other property or is a recommendations concerning the advisability of investments (whether in securities, real property, insurance products —including annuities, or other property);
2. provided on a regular basis;
3. pursuant to a mutual understanding or agreement;
4. a primary basis for investment decision-making; and,
5. tailored to the needs of the Retirement Plan.

The DOL's New Interpretation, Clarification of its Application of the 5-Part Test

While the DOL's new regulation, formally reinstating the 5-Part Test, is a retreat from the expansive approach taken in its 2016 Fiduciary Rule, the DOL has now clarified the application of the 5-Part Test in several respects that may result in more financial institutions and financial professionals being deemed a Retirement Plan fiduciary than under the pre-2016 regime.

In announcing its new approach, the DOL emphasized its concern regarding the conflicts of interest that may arise from a recommendation to roll over assets from a 401(k) plan or other ERISA plan to an IRA insofar as the rollover results in an investor's retirement savings losing the protections of ERISA's fiduciary standards (including DOL oversight and a private right of action for fiduciary breach under

ERISA). Because rollover advice is provided with respect to assets of an ERISA plan, the DOL has taken the position that the fiduciary standards of ERISA may apply in addition to the prohibited transaction rules.

In sum, a rollover recommendation may now constitute fiduciary investment advice under the 5-Part Test. This contradicts a 2005 DOL advisory opinion (known as the "Deseret Letter") that generally provided that a party with no prior relationship to an ERISA plan would not become a fiduciary to that plan solely because of a recommendation to roll over the participant's account balance into another ERISA plan or an IRA. In issuing the final regulations on June 29, the DOL has repudiated the Deseret Letter.

The DOL has further clarified the 5-Part Test in some important ways:

Advice at the Start of a Relationship. The DOL explained that the "on a regular basis" element of the 5-Part Test can be established when there is a reasonable expectation by the parties that advice will be provided on an ongoing basis. Accordingly, investment advice may be deemed fiduciary in nature even if there was no prior relationship before the advice at issue was provided.

Disclaimers of Reliance. A disclaimer that a Retirement Plan cannot rely on the advice given as a primary basis of investment decision-making is not dispositive. The DOL requires a mutual understanding or agreement that advice will not be a primary basis of investment decision-making by the Retirement Plan. As such, disclaimers may still be considered as part of the analysis, but the determination of fiduciary status depends on the reasonable understanding of the parties based on all of the facts and circumstances.

Regulation Best Interest ("Reg BI") . Per the DOL, any investment advice subject to the SEC's Reg BI standard (which applies to broker-dealers and their registered representatives) or another similar best interest standard (e.g., state best interest or fiduciary rules, such as those of Nevada, New Jersey, and Massachusetts, or Iowa's proposed best interest standard for insurance sales) would reasonably be understood by the parties as intended to serve as a primary basis of decision-making.

Proposed PTE for Investment Advice Fiduciaries

On June 29, the DOL also proposed a related new PTE that would allow Investment Advice Fiduciaries (as defined by application of the 5-Part Test) to receive additional compensation with respect to advice provided to Retirement Plans and/or to engage in riskless principal transactions with Retirement Plans to which they provide fiduciary investment advice.

As proposed, the PTE for Investment Advice Fiduciaries will be available to financial institutions including registered investment advisers, banks, insurance companies, or registered broker-dealers, as well as the investment professionals who work for these institutions. The proposed PTE would not apply to: 1) an employer or certain named fiduciaries, plan administrators, and related parties with respect to an ERISA plan, 2) certain transactions resulting from "robo-advice" arrangements that do not involve interaction with an investment professional, or 3) transactions in which the investment professional is acting in a fiduciary capacity other than by virtue of providing fiduciary investment advice (as defined by the 5-Part Test) (e.g., an investment professional acting with discretion).

In order to rely on the proposed PTE for Investment Advice Fiduciaries, the financial institution and/or investment professional must satisfy and comply with the following requirements:

Impartial Conduct Standards. The Impartial Conduct Standards require that the investment advice

that leads to the transaction for which the exemption is sought is in the "best interest" of the investor. ("Best interest" is based on the ERISA fiduciary duties of prudence and loyalty and will be interpreted and applied consistent with Reg BI.) The financial institution and/or investment professional must receive no more than reasonable compensation for their services, must seek to obtain "best execution" (as required by securities laws), and must not make any materially misleading statement or omission.

Disclosure Requirements. Prior to effecting the recommended transaction, the financial institution must provide the Retirement Plan with (1) a written acknowledgement of the fiduciary status of the financial institution and the investment professional with respect to the transaction, and (2) a written description of the services provided and an accurate (not misleading) description of all material conflicts of interest. The DOL stated that these statements should not create a private right of action between the financial institution or investment professional and the Retirement Plan investor. Accordingly, these written disclosures should not be deemed a contract reflecting the creation of a fiduciary relationship between the Retirement Plan and the financial institution and/or investment professional.

Policies and Procedures. The financial institution's policies and procedures must be prudently designed to avoid violations of the Impartial Conduct Standards, including: (1) the avoidance of incentive practices that create a conflict of interest (e.g., sales contests), and (2) the documentation of the specific reasons why a recommendation was made to roll over assets from a 401(k) or other ERISA-covered plan to an IRA.

Retrospective Review. The financial institution that relies (or expects to rely) on the PTE for Investment Advice Fiduciaries must conduct a review at least annually to affirm its compliance with the Impartial Conduct Standards. This annual review must include a certification by the CEO or equivalent officer that he or she has determined that the financial institution's policies and procedures are prudently designed to avoid violations of the Impartial Conduct Standards and that there is a prudent process in place to modify such policies and procedures as appropriate for business, regulatory, or legislative changes.

The financial institution must maintain documentation showing its compliance with each of the conditions of the PTE for Investment Advice Fiduciaries for a six-year period. Documentation should be maintained in the financial institution's books and records so that is available for review upon demand by the DOL or a Retirement Plan investor. However, the financial institution is not required to provide information to a Retirement Plan investor that would identify or provide information regarding other client accounts (including investment recommendations), or trade secrets, privileged information, or financial information of the financial institution.

The comment period of the proposed PTE for Investment Advice Fiduciaries ends on August 6. It is uncertain whether or when the DOL will issue a final PTE. However, given the recent activity by the SEC, FINRA, certain states, and professional designation organizations, it seems likely that the DOL will move quickly to implement a final regulation.

In the meantime, there are a number of existing PTEs that address specific arrangements that financial institutions may be able to rely on until the PTE for Investment Advice Fiduciaries is finalized (or as an alternative to the PTE for Investment Advice Fiduciaries once it is finalized). For example, there is an existing PTE that allows those providing nondiscretionary advice to a Retirement Plan (including an IRA)

to receive a commission for the purchase of an annuity (fixed or variable) by the Retirement Plan—so long as the requirements of the PTE are met.

If you have any questions about the DOL's final regulation regarding the definition of a Retirement Plan fiduciary, the proposed PTE for Investment Advice Fiduciaries, or other PTEs available to broker-dealers, registered investment advisers, or insurance agents who work with Retirement Plans, including IRAs, please feel to contact us.