Insights: Alert

DOL's Latest Update to Fiduciary Rule Focuses on Relationships

November 7, 2023

Written by **R. Sterling Perkinson**

On November 3, 2023, the Department of Labor (DOL) published in the Federal Register its long-awaited proposed update to its "fiduciary rule" that defines when a person becomes a fiduciary to a retirement plan subject to ERISA or an IRA (each, together with their respective fiduciaries, participants, owners and beneficiaries, a "retirement investor") as the result of providing "investment advice" for a fee or other compensation.[1] The White House stated that this rule was aimed at "junk fees in retirement products," and targets, among other things, sales of investment products not regulated by the SEC (like a fixed index annuities), as well as advice to roll assets out of 401(k) plans.[2]

This proposed rule (once finalized) would likely require registered investment advisers, financial institutions, and other retirement plan service providers to review their current offerings to retirement investors and update their compliance procedures, particularly as they relate to 401(k) plan rollovers or sales of annuity products.

Under the proposed rule, a person would be a fiduciary by virtue of investment advice if:

i. the person makes a recommendation regarding investments of a plan (including an IRA or an employee retirement plan, such as a 401(k) plan or other ERISA plan);
ii. the recommendation is made in the context of a professional relationship where the investor would have a reasonable expectation that the other party should be acting in their best interest, based on criteria set out in the regulation as described below; and
iii. the person receives compensation for the advice, either directly or indirectly, such as through a commission.[3]

While the latest update is broader than the current "five-part test" (as described under the "Background" section below), the DOL has taken into account criticisms of its prior efforts to expand the fiduciary rule, which were ultimately invalidated by courts. For example, the preamble notes that the proposed rule "avoids concerns that the rule could sweep so broadly as to cover, for example, the car dealer who suggests that a consumer finance a purchase by tapping into retirement funds."[4] In this iteration, the DOL has focused on situations where a retirement investor may have a reasonable expectation that the other party should be acting in their best interest.

The DOL also modified the prohibited transaction exemptions that may apply to transactions that result from fiduciary investment advice.[5] The DOL intends these exemptions to allow for transactions with retirement plans to continue, while imposing safeguards to protect the plan. Parties who provide "investment advice" to retirement investors may need to comply with the conditions of these updated exemptions to the extent that they receive additional compensation because of a transaction they have recommended.

Background

Under ERISA, the statutory definition of a "fiduciary" for purposes of ERISA includes anyone who has discretion over plan assets or plan administration, as well as any person who provides "investment advice" for a fee or other compensation, or who has authority to do so.[6]

In 1975, the DOL issued regulations providing a "five-part test" to determine when a person would be an investment advice fiduciary. Investment advice would only be fiduciary in nature if a person (i) rendered investment advice, (ii) on a regular basis, (iii) under a mutual understanding or agreement, (iv) that the advice would serve as a primary basis for investment decisions, and (v) the advice is individualized for the plan.[7] This definition applies for purposes of employer plans, such as 401(k) plans and pension plans, as well as for IRAs, which are subject to prohibited transaction rules but are not covered by ERISA's fiduciary standards.

The DOL has long believed that this definition is outdated for the current retirement plan landscape. In 2016, the DOL issued an updated fiduciary rule that greatly expanded the definition of an "investment advice" fiduciary so that virtually any advice provided to a retirement investor could be considered fiduciary in nature, even in circumstances where the "advice" was merely a sales pitch. Further, a prohibited transaction exemption issued in connection with the 2016 rule, known as the "Best Interest Contract Exemption," required parties relying on the exemption to enter into a contract with the retirement investor that incorporated the fiduciary standards of ERISA. As a result, even though fiduciary standards do not apply to IRAs under the Internal Revenue Code, parties transacting with IRAs may have needed to subject themselves to fiduciary standards by contract to comply with the prohibited transaction rules. The 2016 rule was struck down by the Fifth Circuit in 2018 as an overreach of the DOL's authority.[8]

In 2020, the DOL amended its regulations to re-instate the five-part test and issued Prohibited Transaction Exemption (PTE) 2020-02, a class exemption that sets forth required disclosures and other conditions under which registered investment advisers, banks, and other financial institutions and their affiliates can receive a greater fee as the result of investment advice provided to a retirement investor. However, in doing so, the DOL announced that it would now interpret the five-part test so that advice given to a plan participant to roll funds out of a 401(k) or other employer plan could be considered fiduciary investment advice. This interpretation reversed the position the DOL took in a 2005 opinion letter (known as the "Deseret Letter") that rollover advice would not ordinarily be viewed as investment advice. In February 2023, a district court in Florida vacated the DOL's reinterpretation of the 1975 rule that a rollover could be the start of the "regular basis" of a relationship when the investor rolls assets out of an employee benefit plan into an IRA.[9] The district court invalidated the DOL's position because the court found the

rule “impermissibly unmoors the focus of the inquiry into whether an individual is a fiduciary away from a specific ERISA plan, rendering it inconsistent with the statute and previous guidance.”[10]

In announcing the proposed rule, the DOL cites to other developments covering investment advice, including the SEC's “Regulation Best Interest.”[11] However, the DOL believes that there are some holes in the application of Regulation Best Interest, including sales of non-securities (such as annuities) or advice with respect to retirement plans that are not considered retail investors.[12]

Professional Relationship

One of the most significant changes in the proposed regulation is to identify certain relationships between the investment advice and the retirement investor in which the retirement investor may have a reasonable expectation that the investment advice fiduciary is acting in his or her best interest. This approach is responsive to challenges to the 2016 rule because people argued that the 2016 rule could potentially result in counterparties to many transactions becoming fiduciaries, for example, because of a sales pitch to a retirement investor.

While the “professional relationship” criteria are more limited than the 2016 rule, the new proposal is a significant expansion upon the five-part test. Under the proposed rule, it would no longer be required that advice be provided to the retirement investor on a regular basis or under an agreement or understanding that it would be a primary basis of investment decisions.

1. Discretionary management of other assets

A person will be a fiduciary if the person directly or indirectly has discretionary authority or control with respect to purchasing or selling securities or other investment property for the retirement investor. Under ERISA, a person is a fiduciary if the person has discretionary authority over assets of a plan. But this aspect of the professional relationship prong is broader because it can apply when the advisor has discretionary authority over non-plan assets of the retirement investor (e.g., a taxable brokerage account of an IRA owner). Moreover, this prong may be satisfied even if the authority or control is not given pursuant to an agreement, arrangement, or understanding. For example, a person who gives one-time asset allocation advice with respect to the investor's IRA account would likely satisfy the professional relationship prong if the person has discretion over a taxable account of the IRA owner.

2. In the business of providing investment advice

A person will be a fiduciary if the person makes investments recommendations to investors on a regular basis *as part of their business* and the recommendation is provided under circumstances that would indicate that it is based on the retirement investor's individual needs and can be relied upon as a basis of for investment decision that are in the retirement investor's best interest. The investment recommendation must be personalized to the investor and may be relied upon by the investor as a basis for the investment decision. The focus here is different than in the “regular basis” prong of the five-part test. In that case, the question is whether advice is provided to the particular retirement investor on a regular basis, while under the proposed rule the question is whether the advisor is provided on a regular basis to clients of the advisor in general as part of the advisor's business.

As a result, an investment adviser who provides recommendations to a retirement investor would generally meet the professional relationship component if the adviser provides a recommendation that is particular to the retirement investor, which is still a factual question. Unlike under the five-part test, it does not matter whether the investment adviser actually provides recommendations to a retirement investor on a regular basis.

3. *Acknowledgement of Fiduciary Status*

A person will be a fiduciary if the person making the recommendation represents or acknowledges that the person is acting as a fiduciary when making investment recommendations. This provision expands the current rule to situations where a person told an investor that advice or recommendations would be made in a fiduciary capacity.

The reverse is not true. Disclaimers of fiduciary status will not be effective if the disclaimers are inconsistent with oral communications, marketing materials, other laws, or other interactions. The goal with this provision is to tie the acknowledgment to the reasonable expectations of the investor.

Investment Recommendations

The proposed rule also addresses what it means to render “investment advice” to a retirement investor. The proposed rule will generally apply to the “recommendation of any securities transaction or other investment transaction or other investment strategy involving securities or other property”, which include recommendations as to the following:

i. the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property; investment strategy; or how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA;
ii. the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., account types such as brokerage versus advisory) or voting of proxies appurtenant to securities; and
iii. rolling over, transferring, or distributing assets from a plan or IRA, including recommendations as to whether to engage in the transaction, the amount, the form, and the destination of such a rollover, transfer, or distribution.[13]

The DOL's comments reflect how the investment recommendation criteria will apply to some specific circumstances.

1. Rollover Advice

The proposed rule covers a recommendation to rolling over, transferring, or distributing assets from an employee benefit plan or IRA, and continues the DOL's longstanding effort to regulate the IRA rollover market, which the DOL most recently did with its reinterpretation of the 1975 rule in 2020.[14] As noted above, the

proposed rule shifts the regular basis test from whether the investor starts a relationship for the advisor to whether the advisor provides investment advice on a regular basis.

This aspect of the rule will likely be the subject of future litigation, similar to past attempts to regulate the rollover market. A district court in early 2023 invalidated the DOL's most recent interpretation of the five-part test because it was inconsistent with the previous regulations. Given the focus of new proposed rule on relationships, it is unclear how future regulatory challenges with respect to rollover advice will turn out.

2. Valuations

The DOL specifically noted the valuation services, appraisal services, or fairness opinions are not covered as a category of covered recommendations.[15] The DOL noted that valuation or appraisal services by themselves will not be fiduciary investment advice under the proposed rule. The DOL said that these issues should be addressed in a separate rulemaking.

3. Investment Education

The DOL also stated that it did not include a specific provision about investment education. The DOL noted that the provisions of its prior guidance in Interpretive Bulletin 96-1[16] continue to apply and that, providing education information and materials would not be treated as recommendations subject to the proposed rule. In particular, the DOL noted that the benefits of increasing contributions in an employee benefit plan would be an example of investment education.

This distinction is important considering the proposed rule and prior attempts to regulate the rollover market. For example, in an attempt to avoid the requirements of PTE 2020-02,[17] some took the position that they were providing education about rollovers and were not providing investment advice. This distinction is especially relevant in the context of service providers that may cross the line by providing investment recommendations that go beyond education.

4. Platform Providers

The DOL noted that a platform provider that offers a selection of investment alternatives is not necessarily a fiduciary under the proposed rule. The preamble notes that a platform provider may be a fiduciary depending on whether the provider's communications to a retirement investor constitute a recommendation.[18] Although identifying investment alternatives using objective criteria like expense ratios, fund size, or asset types standing alone may not be enough, a platform provider that provides individually tailored advice about a selective list of securities applicable to the retirement investor may provide a recommendation for purposes of this rule.

The DOL also noted that the same analysis will apply to pooled employer plans (or PEPs), which are a new form of retirement plans that were established under the SECURE Act of 2019.[19] In a PEP, a pooled plan provider (which is a named fiduciary of the PEP) and other platform providers may provide a recommendation to individual employers about investment options under the plan.

5. Swaps Counterparties

The DOL also stated that a swap dealer or major participant in the swap market may under certain circumstances fall within the proposed rule by making specific investment recommendations to retirement investors.[20] The consideration with swap transactions is especially important now because the proposed rule does not contain any special provision for recommendations to sophisticated investors, which was included in the 2016 proposed rule. The preamble notes that dealers may wish to structure their relationship in a way to avoid making investment recommendations to plans.[21]

The DOL also specifically mentioned that clearing firms would not provide investment advice under the proposed rule only because of providing information about valuation, pricing, and liquidity.[22]

Fee or Other Compensation (Direct or Indirect)

The DOL has always maintained an expansive view of what it means to receive a fee or other compensation, directly or indirectly for investment advice, dating back to its 1975 regulation. Fees, of course, would include direct fees for advice provided under an investment advisory agreement. This would also include compensation received indirectly because of the advice provided, including commissions or other transaction-based fees, referral fees or gifts. Direct compensation provided for advice under an advisory agreement may qualify for the statutory exemption for “reasonable compensation” under Section 408(b)(2) of ERISA. However, if the fiduciary may receive additional compensation as the result of a transaction for which it has provided investment advice, the fiduciary may need to rely on another prohibited transaction exemption for investment advice fiduciaries.

Related Prohibited Transaction Exemptions

Given the many entities potentially affected by the new proposed fiduciary rule, the DOL also proposed modifications to the prohibited transaction exemptions available to entities that will be investment fiduciaries under the new rule.

Most significantly, the DOL made a number of changes to PTE 2020-02,[23] including the following:

- The DOL changed a number of requirements in the rollover disclosure forms, including adding an explicit statement that advisors are providing fiduciary investment advice to retirement investors and are fiduciaries under ERISA and the Tax Code. Currently, investment advisors only need to provide this written acknowledgment to the extent that they provide investment advice. The change means that investment advisers will need to determine whether they are providing fiduciary investment advice and need to rely on the exemption rather than providing disclosures as a failsafe in the event that it is determined that fiduciary investment advice has been provided.
- The DOL added certain requirements for the Senior Executive Officer review, including a representation that the financial institution has filed or will file any Forms 5330 for any non-exempt prohibited transactions. However, there are certain circumstances where self-correction is available for a failure to satisfy the exemption.

- Robo-advisors, which were excluded from the original PTE 2020-02, and would have needed to rely on a statutory exemption under ERISA, are now eligible to be covered by the proposed exemption.

Furthermore, in an effort to make PTE 2020-02 the primary exemption for investment advice fiduciaries, the DOL limited the scope of a number of other PTEs for investment advice fiduciaries, including PTE 75-1 (relating to securities transactions involving broker-dealers, reporting dealers, and banks), PTE 77-4 (relating to discretionary investment manager allocation to proprietary mutual funds), and PTE 86-128 (relating to executing securities transactions and recapture of commissions).

PTE 84-24 would also be amended to limit relief for investment advice to independent insurance producers, including independent insurance agencies, that recommend annuities from an unaffiliated financial institution to retirement investors on a commission or fee basis.

Fiduciaries who previously relied on these exemptions may need to adjust their service or investment offering or find another exemption to rely on. For example, any non-discretionary advisors that relied on PTE 77-4 for proprietary mutual funds may instead need to rely on PTE 2020-02 going forward.

In sum, if these changes are finalized, many investment providers who are fiduciaries to retirement investors will need to acknowledge fiduciary status and comply with PTE 2020-02 to continue offering or providing recommendations for certain investment products or services. Along with the expanded scope, the additional compliance requirements may take considerable amount of time to implement.

Next Steps

The DOL will hold a public hearing for this proposal around December 18, and the comment period for the rule will close on January 2, 2024. The DOL stated that the final rule is proposed to be effective 60 days after it is published in the Federal Register.

This rule seems to be a high priority for the administration, and retirement investors and investment managers should be prepared for a final rule in 2024. As with the past fiduciary rules, it is likely that some aspects of this rule will be challenged in court.

Footnotes

---

[1] https://www.federalregister.gov/documents/2023/11/03/2023-23779/retirement-security-rule-definition-of-an-investment-advice-fiduciary, 88 FR 75890 ("Proposed Fiduciary Rule").

[2] https://www.whitehouse.gov/cea/written-materials/2023/10/31/retirement-rule/.

[3] Proposed Fiduciary Rule at 75977.

[4] Proposed Fiduciary Rule at 75902.

[5] https://www.federalregister.gov/documents/2023/11/03/2023-23780/proposed-amendment-to-prohibited-transaction-exemption-2020-02, https://www.federalregister.gov/documents/2023/11/03/2023-23781/proposed-amendment-to-prohibited-transaction-exemption-84-24, https://www.federalregister.gov/documents/2023/11/03/2023-23782/proposed-amendment-to-prohibited-transaction-exemptions-75-1-77-4-80-83-83-1-and-86-128.

[6] ERISA Section 3(21)(A)(ii). There is also a parallel provision in Section 4975(e)(3)(B) of the Internal Revenue Code of 1986, as amended.

[7] 29 C.F.R. Section 2510.3-21.

[8] Chamber of Commerce v. United States Dep't of Labor, 885 F.3d 360 (5th Cir. 2018).

[9] https://kilpatricktownsend.com/Blog/erisa/2023/2/federal district court narrows interpretation of fiduciary rollover advice.

[10] *Id.*

[11] https://www.sec.gov/regulation-best-interest.

[12] Proposed Fiduciary Rule at 75922.

[13] Proposed Fiduciary Rule at 75978 and 75979.

[14] https://kilpatricktownsend.com/en/Insights/Alert/2020/8/Fiduciary-Rule-2-0-What-You-Need-to-Know-About-the-DOLs-New-Fiduciary-Rule.

[15] Proposed Fiduciary Rule at 75908.

[16] https://www.federalregister.gov/documents/1996/06/11/96-14093/interpretive-bulletin-96-1-participant-investment-education.

[17] https://kilpatricktownsend.com/en/Insights/Alert/2021/4/PTE-2020-02-for-Investment-Advice-Fiduciaries-Overview-and-Checklist.

[18] Proposed Fiduciary Rule at 75908.

[19] https://kilpatricktownsend.com/Blog/erisa/2019/12/congress%20passes%20secure%20act%20with%20significant%20changes%20to%20retirement%20plans.

[20] Proposed Fiduciary Rule at 75908.

[21] *Id.*

[22] *Id.*

[23] https://kilpatricktownsend.com/en/Insights/Alert/2021/4/PTE-2020-02-for-Investment-Advice-Fiduciaries-Overview-and-Checklist.

Related People



R. Sterling Perkinson

t 919.788.1664

sperkinson@ktslaw.com