DOL PROPOSES NEW "FIDUCIARY RULE" EXEMPTION, UPENDS LONGSTANDING GUIDANCE ON ROLLOVER ADVICE

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On 29 June 2020, the U.S. Department of Labor (DOL) proposed an exemption (the Exemption)[1] for Employee Retirement Income Security Act (ERISA) and Internal Revenue Code (Code) fiduciary investment advice that opens a new chapter in DOL's "fiduciary rule"[2] saga.

Unlike the 2016 fiduciary rule, the Exemption would not change the regulatory definition of what it means to be a fiduciary under ERISA or the Code by reason of providing investment advice to a plan subject to ERISA or the Code (including an individual retirement account (IRA)). That definition would remain tied to the five-part test,[3] which was restored as applicable law in 2018 when the U.S. Court of Appeals for the Fifth Circuit (Fifth Circuit) vacated the 2016 fiduciary rule. A financial institution or investment professional that is an ERISA fiduciary by reason of providing investment advice (an investment advice fiduciary) risks engaging in a prohibited transaction if the fiduciary uses their fiduciary authority to generate additional fees for itself or a person in whom the fiduciary has an interest that may affect their best judgment as a fiduciary,[4] unless an exemption applies.

The Exemption would allow certain investment advice fiduciaries to engage in transactions otherwise prohibited under ERISA and the Code provided certain conditions, including "Impartial Conduct Standards" (as described below), are met. These transactions include receiving otherwise prohibited compensation in connection with providing investment advice (including advice about rollovers) and engaging in certain principal transactions.[5] The Exemption would provide relief that is broader and more flexible than the existing statutory exemption for investment advice fiduciaries.[6] However, DOL's updated guidance in the Exemption preamble (discussed further below) would make it more difficult to avoid fiduciary status when providing rollover advice.

THE FINAL DEATH OF "DESERET" AND NEW LIFE FOR ROLLOVER (AND OTHER) INVESTMENT ADVICE

A main focus of DOL in the Exemption's preamble is on advice with respect to rollovers from employee benefit plans to IRAs. In Advisory Opinion 2005-23A (the Deseret Letter), DOL had expressed the view that merely advising a plan participant to take an otherwise permissible plan distribution, even when that advice was combined with a recommendation as to how the distribution should be invested, did not generally constitute fiduciary "investment advice." In the 2016 fiduciary rule package, DOL revoked the Deseret Letter. However, when the Fifth Circuit vacated the 2016 fiduciary rule package, that revocation was undone along with all of the other items the package put in place. In the Exemption preamble, DOL now disavows the conclusion in the Deseret Letter, stating that:

> The Department believes that the analysis in the Deseret Letter was incorrect and that advice to take a distribution of assets from an ERISA-covered Plan is actually advice to sell, withdraw, or transfer investment assets currently held in the Plan. A recommendation to roll assets out of a Plan is necessarily a recommendation to liquidate or transfer the Plan's property interest in the affected assets, the participant's associated property interest in the Plan investments, and the fiduciary oversight structure that applies to the assets. . . . Accordingly, the better view is that a recommendation to roll assets out of a Plan is advice with respect to moneys or other property of the Plan.

As a result, whether one is an investment advice fiduciary under ERISA or the Code over rollover advice would depend upon whether each requirement of the five-part test is met. DOL acknowledged that not all rollover advice would be fiduciary investment advice under the five-part test. For example, advice to take a distribution from a plan and roll over assets could be an "isolated and independent transaction that would fail to meet the regular basis prong." However, DOL's explanation in the Exemption's preamble will make it more difficult for advisers and brokers to avoid fiduciary responsibility over rollovers, a position aligned with other regulators.[7] If rollover advice is provided as part of an ongoing advice relationship to an individual (even if the advice relationship has not previously involved the plan), DOL expressed the view that such advice is likely to meet the regular basis requirement and be considered fiduciary investment advice. According to DOL, "advice to roll over Plan assets can occur as part of an ongoing relationship or an anticipated ongoing relationship that an individual enjoys with his or her advice provider." Moreover, even if the rollover advice provider has no prior relationship with the plan or individual, "the rollover recommendation may be seen as the first step in an ongoing advice relationship that could satisfy the regular basis prong of the five-part test depending on the facts and circumstances."

Persons seeking to avoid status as an investment advice fiduciary sometimes have sought to eliminate the third and fourth prongs of the five-part test by, for example, obtaining a client's written acknowledgment disclaiming a mutual understanding to provide fiduciary advice or to rely on particular advice or recommendations as a primary basis for client investment decisions. According to DOL, however, written statements disclaiming a mutual understanding or forbidding reliance on advice as a primary basis for investment decisions "are not determinative, although such statements are appropriately considered in determining whether a mutual understanding exists."

Therefore, if the advice could generate additional fees to the investment advice fiduciary—as would be the case if, e.g., the advice included a recommendation to roll over into a product managed by the investment advice fiduciary—such rollover advice may be prohibited in the absence of an exemption. The Exemption would cover such rollover advice provided its conditions are met. Whether the conditions of the five-part test and of the Exemption are met requires a careful examination of the facts and circumstances of each situation.

IMPLICATIONS FOR REGISTERED INVESTMENT ADVISERS, BROKERS, AND OTHER FINANCIAL INSTITUTIONS

Despite the focus on rollover advice, the Exemption as proposed is not limited to providing relief in those circumstances. The Exemption would provide relief to investment advice fiduciaries that are "Financial Institutions" (currently defined to include registered investment advisers, banks, insurance companies, and brokers or dealers) and their "Investment Professionals" (i.e., their employees, agents, representatives, or independent contractors) in connection with any investment advice provided in accordance with the Exemption.[8] Registered investment advisers generally act as fiduciaries under ERISA or the Code, as applicable, to their retirement clients (e.g., IRAs and sponsors of 401(k) plans and defined benefit plans). Services and programs either (1) do not involve prohibited conflicts of interest,[9] or (2) are structured to comply with existing prohibited transaction exemptions, such as PTE 77-4 for programs that include advice regarding proprietary mutual funds and exchange-traded funds.

Discretionary programs and services cannot use the Exemption. Similarly, brokers who provide recommendations that do not rise to the level of fiduciary investment advice (i.e., that do not meet the five-part test) are not investment advice fiduciaries and, therefore, cannot rely (and would not need to rely) on the Exemption. The Exemption, however, could provide a planning opportunity for advisers and brokers that provide nondiscretionary investment advice. For example, firms could offer new programs that are structured to comply with the Exemption or could restructure existing programs to comply with the Exemption rather than a current exemption. A restructured program could enable a firm to have a different fee structure.

IRA rollovers. An adviser or broker could engage in impermissible self-dealing by providing fiduciary investment advice to a plan participant to roll over his or her assets to an IRA where the adviser's or broker's compensation is greater than the compensation the firm was earning on such assets prior to the rollover. Currently, to address this concern, some advisers and brokers structure their IRA rollover services in a manner to avoid fiduciary responsibility with respect to the rollover itself (a position that had been supported by the Deseret Letter). Some firms provide non-fiduciary education regarding rollovers or specifically disclaim fiduciary responsibility over the client's rollover decision. To begin receiving compensation, these advisers and brokers rely on the statutory exemption set forth in Code section 4975(d)(2), which has modest requirements—the contract or arrangement between the firm and the client, including the fee, must be reasonable. However, DOL takes the position that Code section 4975(d)(2) is unavailable if the arrangement involves fiduciary self-dealing.

As discussed above, DOL's explanation in the Exemption's preamble will make it more difficult for advisers and brokers to avoid fiduciary responsibility over rollovers. Some firms may want to change their services and programs to be fiduciary in nature under ERISA and the Code rather than risk engaging in prohibited self-dealing in the event the firm fails to avoid fiduciary status under the five-part test. Other firms may want to change their services and programs for commercial reasons (e.g., some clients may prefer to work with a fiduciary). As fiduciaries, firms may need to rely on the Exemption to avoid engaging in prohibited transactions. These firms would need to take several steps, including (1) developing model disclosures of conflicts of interest (a condition of the Exemption, as described below), and (2) reviewing their policies and procedures to ensure compliance with the Impartial Conduct Standards (described below).

Rollover and other recommendations made by a broker-dealer to a retail customer are subject to the recently effective Regulation Best Interest[10] adopted under the Securities and Exchange Act of 1934. Because the conditions of the Exemption were designed to harmonize with Regulation Best Interest, brokers that are investment advice fiduciaries and that are in compliance with Regulation Best Interest may be able to comply with the Exemption (as well as any applicable state regulations (e.g., New York and Massachusetts)), as proposed, with minor effort.[11]

Although investment advisers and brokers may be the most impacted by the proposed Exemption and the new guidance included in its preamble, any Financial Institution that has, or has considered having, a nondiscretionary investment advisory program should consider how best to make use of the relief provided by the Exemption, if finalized. Moreover, any Financial Institution that makes rollover recommendations through directed marketing or personalized contact with individuals should analyze how DOL's updated position on rollover recommendations may impact those recommendations.

EXEMPTION CONDITIONS

Relief under the Exemption would be conditioned on the investment advice fiduciary providing advice in accordance with the Impartial Conduct Standards (discussed further below). In addition, the Exemption would require Financial Institutions:

1. to acknowledge their (and their Investment Professionals') fiduciary status under ERISA and the Code, as applicable, in writing;
2. to describe in writing the services to be provided and the Financial Institutions' and Investment Professionals' material conflicts of interest;
3. to adopt, maintain, and enforce written policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards and mitigate conflicts of interest; and
4. to conduct a retrospective review of compliance at least annually.[12]

The disclosures described in (1) and (2) above would need to be provided to the advice recipient prior to engaging in a transaction pursuant to the Exemption. In addition, with respect to rollover advice, the Financial Institution would need to document the specific reasons that any recommendation to roll over assets is in the "Best Interest" of the Retirement Investor.[13]

IMPARTIAL CONDUCT STANDARDS

The proposed Impartial Conduct Standards would require that:

(1) Investment advice be, at the time it is provided, in the "Best Interest" of the Retirement Investor. Best Interest is defined in the Exemption as 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 in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, and does not place the financial or other interests of the Investment Professional, Financial Institution or any affiliate, related entity, or other party ahead of the interests of the Retirement Investor, or subordinate the Retirement Investor's interests to their own;"

(2)(A) The compensation received, directly or indirectly, by the Financial Institution, Investment Professional, their affiliates and related entities for their services must not exceed reasonable compensation within the meaning of ERISA section 408(b)(2) and Code section 4975(d)(2); and (B) as required by the federal securities laws, the Financial Institution and Investment Professional must seek to obtain the best execution of the investment transaction reasonably available under the circumstances; and

(3) The Financial Institutions' and its Investment Professionals' statements to the retirement investor about the recommended transaction and other relevant matters must not be, at the time statements are made, materially misleading.

The Exemption leaves a number of key concepts undefined. Aside from the usual requirement that compensation not exceed "reasonable compensation," the Exemption does not elaborate on the requirement that the fiduciary not place its financial or other interests "ahead" of those of the Retirement Investor or "subordinate the Retirement Investor's interests to its own." Pending additional guidance from DOL, fiduciaries will need to look to analogous pronouncements by the SEC in the context of Regulation Best Interest, as well as DOL itself in the context of the 2016 fiduciary rule.

COMMENT PERIOD

Comments should be submitted to DOL by 6 August, 30 days after publication in the Federal Register. Thirty days is an unusually short period of time for a comment period, and 60 days would be more typical. The short 30-day comment period appears to be an attempt to avoid having the Exemption invalidated under the Congressional Review Act should there be changes in control of Congress and the administration in January. On 2 July, Democratic congressional leaders sent DOL Secretary Eugene Scalia a letter requesting that the comment period be extended.[14]

TECHNICAL AMENDMENT

Along with the Exemption, DOL issued a "technical amendment" as a final rule,[15] not subject to further comment. When the Fifth Circuit vacated DOL's 2016 fiduciary rule package, its ruling legally undid the changes put in place by that package. The technical amendment takes the ministerial action needed to officially clean up the items impacted by the 2016 fiduciary rule and its vacatur. The technical amendment:

> 5. reinstates the investment advice regulation at 29 C.F.R. Section 2510.3-21 as it existed before being amended by the 2016 fiduciary rule (i.e., the five-part test is reinstated);
> 6. removes the two prohibited transaction exemptions published with the 2016 fiduciary rule:
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> PTE 2016-01, the Best Interest Contract Exemption; and
>
> PTE 2016-02, the Class Exemption for Principal Transactions;
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> 7. reinstates Interpretive Bulletin 96-1 on participant education; and
> 8. undoes the changes made to existing PTEs 75-1, 77-4, 80-83, 83-1, 84-24, and 86-128.

FIELD ASSISTANCE BULLETIN 2018-02

After the 2016 fiduciary rule package was vacated, DOL announced a temporary policy in Field Assistance Bulletin (FAB) 2018-02 that it (and the Internal Revenue Service) would not pursue claims against fiduciaries who were working in good faith to comply with the impartial conduct standards set out in the now vacated Best Interest Contract Exemption until it issued further administrative guidance. DOL has indicated that FAB remains in place while the Exemption is being considered.[16] However, if finalized, the Exemption is likely to be considered as such further administrative guidance and FAB 2018-02 will no longer be available. Any Financial Institution currently relying on FAB 2018-02 should prepare to comply with the Exemption instead (if finalized) or otherwise ensure it does not need to rely on FAB 2018-02 going forward.

FOOTNOTES

[1] Improving Investment Advice for Workers & Retirees, Notification of Proposed Class Exemption, 85 Fed. Reg. 40834 (July 7, 2020).

[2] Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,945-21,002 (Apr. 8, 2016) (the 2016 fiduciary rule, and collectively with its related prohibited transaction exemptions (PTEs) and other issuances, the 2016 fiduciary rule package). The 2016 fiduciary rule package was vacated by the 5th Circuit in 2018. *Chamber of Commerce of the USA v. U.S. Dep't of Labor*, No. 17-10238 (5th Cir. Mar. 15, 2018).

[3] Under the five-part test, a person is considered to be a fiduciary by reason of providing “investment advice” if the person: (1) Renders advice to the plan (including an IRA) as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property (this has been interpreted by DOL to include providing advice as to investment managers); (2) on a regular basis; (3) pursuant to a mutual agreement, arrangement, or understanding, written or otherwise, with the plan, plan fiduciary, or IRA owner; that (4) the advice will serve as a primary basis for investment decisions with respect to plan or IRA assets; and that (5) the advice will be individualized based on the particular needs of the plan or IRA. 29 C.F.R. § 2510.3-21; 26 CFR § 54.4975(c).

[4] 29 CFR § 2550.408b-2(e)(1).

[5] Although this Alert focuses on the part of the Exemption that covers investment advice, importantly, the Exemption would also provide relief to Financial Institutions (as defined below) to enter into riskless principal transactions and certain other covered principal transactions and receive a mark-up, mark-down, or other payment in connection with such transaction. For sales to a plan or IRA, covered principal transactions would include the following types of securities: (1) a U.S. dollar denominated debt security issued by a U.S. corporation and offered pursuant to a registration statement under the Securities Act of 1933; (2) a U.S. Treasury Security; (3) a debt security issued or guaranteed by a U.S. federal government agency other than the U.S. Department of Treasury; (4) a debt security issued or guaranteed by a government-sponsored enterprise; (5) a municipal security; (6) a certificate of deposit; (7) an interest in a Unit Investment Trust; or (8) any investment later permitted by DOL under the Exemption. If the recommended investment is a debt security, the security must be recommended pursuant to written policies and procedures adopted by the Financial Institution that are reasonably designed to ensure that the security, at the time of the recommendation, has no greater than moderate credit risk and sufficient liquidity that it could be sold at or near carrying value within a reasonably short period of time. For purchases from a plan or IRA, principal transactions involving any securities or investment property would be covered.

[6] ERISA §§ 408(b)(14) and 408(g) of ERISA, with parallel provisions at Code §§ 4975(d)(17) and 4975(f)(8), as implemented in 29 C.F.R. § 2550.408g-1 (collectively, the statutory exemption for investment advice). *See* Kristina M. Zanotti et. al., *DOL Issues Final Rule on Investment Advice . . . Again*, K&L GATES (Nov. 23, 2011).

[7] The U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) have each recognized that recommendations to roll over plan assets to an IRA almost always involves a securities transaction. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318, 33339 (July 12, 2019); FINRA Regulatory Notice 13-45, Rollovers to Individual Retirement Accounts (Dec. 2013).

[8] Note that the Exemption would cover only arrangements involving interaction with a human investment advice fiduciary; advice arrangements relying only on robo-advice would not be covered. Robo-advice could be covered by the statutory exemption for investment advice.

[9] Which may be achieved in a number of ways, such as charging level fees regardless of how a client's assets are allocated to different investment types or through carefully structured fee waivers or offsets.

[10] Richard F. Kerr et al., *SEC Adopts A New Best Interest Standard of Conduct*, K&L GATES HUB (June 19, 2019), http://www.klgateshub.com/details/?pub=SEC-Adopts-A-New-Best-Interest-Standard-of-Conduct-06-19-2019.

[11] We note that, similar to Regulation Best Interest, the Exemption would not establish a monitoring requirement for Financial Institutions or Investment Professionals. However, in the preamble to the Exemption, DOL states that "Financial Institutions should carefully consider whether certain investments can be prudently recommended to the individual Retirement Investor in the first place without ongoing monitoring of the investment. Investments that possess unusual complexity and risk, for example, may require ongoing monitoring to protect the investor's interests. An Investment Professional may be unable to satisfy the [E]xemption's best interest standard with respect to such investments without a mechanism in place for monitoring.

[12] The Exemption as proposed *would not* require that the review be conducted by an independent party, allowing Financial Institutions to self-review. DOL considered and decided against requiring an independent audit to avoid the significant cost burden such a requirement would impose.

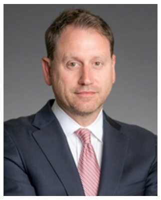
[13] As defined in the proposed Exemption, a Retirement Investor includes participants or beneficiaries of a plan with authority to direct the investment of assets in his or her account or to take a distribution, IRA owners acting on behalf of an IRA, or a fiduciary of a plan or IRA.

[14] Letter from Robert C. Scott, Chairman, House Comm. on Educ. and Labor & Patty Murray, Ranking Member, Senate Comm. on Health, Educ., Labor, and Pensions to Eugene Scalia, Secretary, U.S. Dep't of Labor (July 2, 2020), available here.

[15] Conflict of Interest Rule—Retirement Investment Advice: Notice of Court Vacatur, Final rule; technical amendment, 85 Fed. Reg. 40589 (July 7, 2020).

[16] U.S. Dep't of Labor, Emp. Benefits Sec. Admin, *Improving Investment Advice for Workers & Retirees*.

KEY CONTACTS



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