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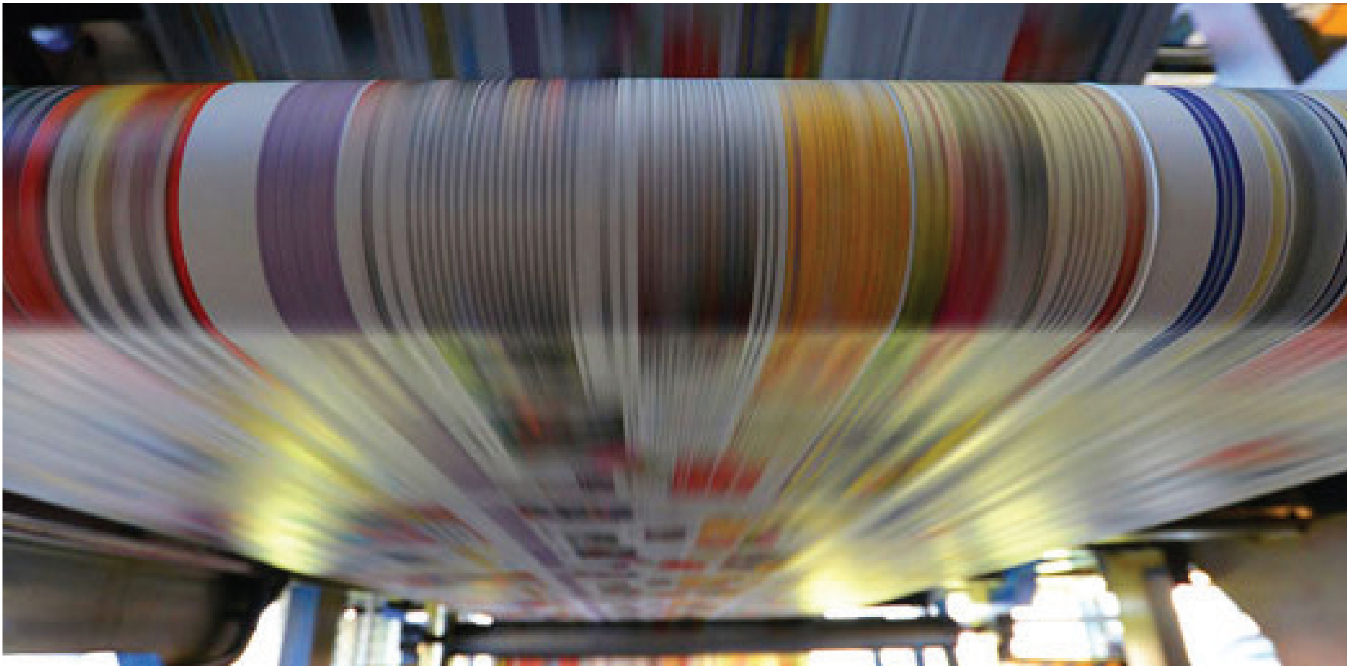
DOL's New Fiduciary Investment Advice Package Presents Significant Compliance Risk



The U.S. Department of Labor (DOL) announced (https://www.dol.gov/newsroom/releases/ebsa/ebsa20200629) last week a series of actions regarding the provision of "investment advice" under the U.S. Employee Retirement Income Security Act of 1974, as amended (ERISA) and the U.S. Internal Revenue Code of 1986, as amended (the Code). Investment advisers, broker-dealers, banks, insurance companies and other financial services firms, which interface with ERISA-covered plans and IRAs, should especially take note. The provision of "investment advice" to ERISA-covered plans and IRAs triggers a need to comply with stringent fiduciary duties and a complex web of prohibited transaction rules (depending on the nature of the advice recipient).

This is part of a long continuum (https://fiduciarygovernanceblog.com/2018/06/22/the-fiduciary-rule-gone-but-not-forgotten/) of federal and state efforts (https://fiduciarygovernanceblog.com/2020/02/24/massachusetts-broker-dealers-now-owe-fiduciary-duties-to-retail-customers/) to more comprehensively regulate communications between financial services firms, especially broker-dealers, and retail investors, such as plan participants and IRA owners. The 2010s were

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largely dominated by DOL efforts (https://fiduciarygovernanceblog.com/2019/01/07/a-fiduciarys-2018-retrospective-and-predictions-for-2019/), including two separate proposals, the latter of which culminated in the controversial 2016 Conflicts of Interest rulemaking, largely known as "the Fiduciary Rule." Since then, the U.S. Securities and Exchange Commission (SEC) published Regulation Best Interest (https://fiduciarygovernanceblog.com/2019/07/11/watch-webcast-the-practical-effects-of-regulation-best-interest-form-crs-and-advisers-act-interpretations-on-broker-dealers-investment-advisers-and-investment-companies/), which went into effect last week, and numerous states have sought to create uniform standards of care (https://fiduciarygovernanceblog.com/2018/10/18/september-morn-trump-administration-has-sec-and-dol-zero-in-on-fall-2019-for-fiduciary-rulemaking/) between broker-dealers and advisers. Both the 2016 DOL Fiduciary Rule and Regulation Best Interest, took aim at investment advice regarding rollovers.

To further complicate matters, the U.S. Court of Appeals for the Fifth Circuit in 2018 vacated the DOL's Fiduciary Rule (https://fiduciarygovernanceblog.com/2018/03/15/george-michael-gerstein-interviewed-by-wsj-on-fifth-circuits-decision-to-strike-down-dol-fiduciary-rule/), sowing both relief and confusion in the industry. During this time, the DOL granted some temporary relief and appeared to let the SEC take the lead on regulating broker-dealer practices, which would be in keeping with the court's decision. The DOL further signaled that any DOL investment advice rulemaking would align with Regulation Best Interest.

The DOL's series of actions (https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/improving-investment-advice-for-workers-and-retirees) last week include reinstating the DOL's longstanding 1975 regulation on investment advice fiduciary status, removal of the 2016 Fiduciary Rule (and its accompanying class exemptions),1 and the proposal of a new (and nimble) class exemption that would enable certain types of investment advice fiduciaries to receive a wide range of fees and other compensation without engaging in non-exempt prohibited transactions.

The comment period for the proposed class exemption closes on Aug. 6, 2020. Firms may wish to evaluate whether they will seek to rely on this new class exemption or instead rely on one or more other (narrower) exemptions that may be available.

Status as an Investment Advice Fiduciary

One is an investment advice fiduciary under ERISA and the Code to the extent he or she provides investment advice for a fee or other consideration (direct or indirect) with respect to monies or other property of the plan (or has any responsibility or authority to do so). Under the newly reinstated

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5-part test, a communication constitutes fiduciary investment advice if a financial institution or investment professional who is not otherwise a fiduciary:

1. Renders advice to the plan as to the value of securities or other property, or make 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 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.

Thus, if a financial institution or investment professional triggers all five conditions and receives a fee or other compensation (direct or indirect), it is an investment advice fiduciary under ERISA and the Code. As noted above, this status would trigger fiduciary obligations and the need to carefully structure the advice and attendant transactions so as to avoid non-exempt prohibited transactions.

Last week's decision to reinstate the traditional 5-part test is important, but perhaps even more noteworthy are the DOL's insights on how it would now interpret the test. For example, the DOL indicated that the first prong would encompass advice to a retirement investor as to whether to take a distribution from a plan or whether to roll out of a plan and into an IRA. This is a notable departure from the DOL's previous position (DOL Advisory Opinion 2005-23A) that advice regarding rollovers were generally not considered investment advice. The first prong also appears to pick up advice on account type (*e.g.*, commission-based or fee-based) and on advice as to persons the retirement investor may hire as an investment advice provider or asset manager.

The second prong would also be interpreted quite broadly. For example, this prong appears to be met if the advice communication at issue is part of an "ongoing relationship or an anticipated ongoing relationship that an individual enjoys with his or her advice provider." For example, if an investment professional already has a relationship with a plan participant pursuant to which he or she provides investment advice, advice on whether to roll assets out of the plan is part of that ongoing relationship, and, therefore, the roll over advice communication meets the "regular basis" requirement. Even if the investment professional lacks an *existing* advice relationship, advice to roll assets out of a plan and into IRA, *in anticipation* of an ongoing advice relationship, will similarly meet this prong. A third-party solicitor, for example, which is paid by a financial institution (that has or may have an ongoing fiduciary investment advice relationship with the recipient), bears greater risk that a recommendation they render will be treated as investment advice under the proposal.

The avoidance of triggering the third prong was often addressed through contractual representations and disclaimers. Yet even here, the DOL cautioned that this approach is not dispositive in establishing that both parties agreed investment advice was being provided.

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Moreover, the 2020 proposal clarifies that prong (iv) of the test does *not* depend on whether the advice serves as *the* primary basis for the investment decision, but whether it serves as a primary basis. On this point, the DOL stated that financial service professionals who make recommendations pursuant to a best interest standard, including as required under Regulation Best Interest, or other requirements to provide individualized advice, will satisfy this prong, meaning, the parties would reasonably understand that the advice in question will serve as at least a primary basis for the investment decision.

It is worth pointing out that a requirement of a financial services firm to provide individualized advice, or to act in the investor's best interest, under other federal law (*e.g.*, Regulation Best Interest) or state law may also work to *establish* that such firm is an investment advice fiduciary to a retirement investor for purposes of ERISA and the Code.

Some communications are unlikely to constitute investment advice, however. One-time sales transactions, and bank networking arrangements are two examples the DOL highlighted. But unlike the 2016 rule, there do not appear any express safe harbors for marketing the fiduciary's own services or investment advice rendered to sophisticated financial professionals as part of arm's-length transactions. Commenters may wish to seek more explicit protection for these types of communications, including, but not limited to, greater consistency with Regulation Best Interest.

New Class Exemption

The proposed class exemption would generally be available to registered investment advisers, broker-dealers, banks and insurance companies (Financial Institutions), their individual employees, agents, representatives and independent contractors (Investment Professionals), as well as their affiliates and related entities, who receive a wide range of fees and other compensation (*e.g.*, 12b-1 fees, commissions, third-party payments, *etc*.) as a result of providing investment advice to retirement investors (*i.e*., ERISA plan participants, beneficiaries and fiduciaries, as well as IRA owners and fiduciaries), including rollover investment advice. For example, this exemption could be handy for an RIA that provides investment advice that causes itself to start earning a fixed fee or a management fee. Another potential prohibited transaction for which this exemption would provide relief is where an RIA gives investment advice to a Retirement Investor that causes its affiliated broker-dealer to earn commissions for executing those transactions.

The exemption would also cover riskless[2] and certain other principal transactions between the Financial Institution and retirement investor. As proposed, a covered principal transaction is defined differently depending on whether the retirement investor is the purchaser or seller. For sales to a retirement investor, the principal transaction would have to involve: (i) a US dollar denominated debt security issued by a US corporation and offered pursuant to a registration statement under the '33 Act; (ii) a US Treasury Security; (iii) a debt security issued or guaranteed by a US federal government agent other than the Treasury Department; (iv) a debt security issued or guaranteed by a government-sponsored enterprise; (v) a municipal security; (vi) a certificate of deposit; (vii) an interest in a unit investment trust; or (vi) any other investment permitted to be sold by an investment advice fiduciary to a retirement investor under an individual exemption granted by the DOL. If the recommendation is with respect to a debt security, the recommendation must be made 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 retirement investor, the principal transaction may cover any type of securities or investment property.

Before describing the conditions to the proposed exemption, it is important to first highlight where the exemption would *not* be available:

A. Where the Financial Institution, Investment Professional or any affiliate is the employer of employees covered by an ERISA-covered retirement plan investor or is a named fiduciary or plan administrator to such plan, or was selected to provide investment advice to the plan by a fiduciary not "independent" of the Financial Institution, Investment Professional or their affiliates.[3] Employers can continue to recover their direct expenses when providing investment advice to their plans.

B. The transaction is a result of robo investment advice generated solely by an interactive website in which computer software-based models or applications provide investment advice based on personal information each investor supplies through the website, without any personal interaction with an Investment Professional. Sections 408(b)(14) and 408(g) of ERISA may provide relief in these instances.

C. The transaction involves the Investment Professional acting in a fiduciary capacity other than providing investment advice (e.g., the Investment Professional has discretionary control over the retirement investor's assets).

The following are the conditions to the exemption:

1. The Financial Institution and Investment Professional complies with the Impartial Conduct Standards. The Impartial Conduct Standards have the following core components:

    a. The investment advice is, at the time it is provided, in the "best interest" of the retirement investor. This is to be interpreted and applied in a manner consistent with Regulation Best Interest and the SEC's interpretive release regarding the conduct standard of registered investment advisers. The "best interest" requirement would permit Financial Institutions and Investment Professionals to provide investment advice despite having a financial or other interest in the transaction, provided they do not place their interests ahead of the retirement investor's. Investment advice on proprietary products, and advice that generates third-party payments, could be consistent with this "best interest" requirement. As with Regulation Best Interest, the "best interest" requirement does not necessarily create a monitoring obligation; however, the DOL indicated that certain investments may be so complex or risky that they may necessitate monitoring by the Financial Institution.

    b. The compensation received (directly or indirectly) by the Financial Institution, Investment Professional, their affiliates and related entities for their services does not exceed reasonable compensation within the meaning of Section 408(b)(2) of ERISA. Whether compensation is "reasonable" is fact-specific, but some factors that may inform the analysis include the

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market price for the services, the scope of monitoring duties (if any), and the complexity of the product.

   c. As required by the federal securities laws, the Financial Institution and Investment Professional seek to obtain "best execution" of the investment transaction reasonably available under the circumstances.

   d. At the time they are made, statements by the Financial Institution and Investment Professional about the recommended transaction "and other relevant matters" (e.g., fees and compensation, material conflicts of interest, etc.) are not materially misleading. The DOL would consider it "materially misleading" for the Financial Institution or Investment Professional to include any indemnification or exculpation clauses that are prohibited by applicable law, including Section 410 of ERISA.

2. Prior to engaging in the transaction covered by the exemption, the Financial Institution provides the following information in one or a combination of written documents, all written in Plain English:

   a. A written acknowledgment that the Financial Institution and its Investment Professionals are fiduciaries under ERISA and the Code (as applicable) with respect to any fiduciary investment advice to retirement investors. Please note that, notwithstanding this requirement, the exemption is not intended to expand the retirement investor's ability to enforce their rights in court or create any new legal claims, in stark contrast to the 2016 Best Interest Contract Exemption.

   b. A written description of the services to be provided. This description does not have to be tailored to the specific retirement investor. It is unclear if Form CRS would suffice for broker-dealers and investment advisers.

   c. A written description of the Financial Institution's and Investment Professional's material conflicts of interest that is both accurate and not misleading in all material respects.

3. Policies & Procedures

   a. The Financial Institution establishes, maintains and enforces written policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards with respect the investment advice and related transactions.

   b. The policies and procedures mitigate "conflicts of interest" (the meaning of this is designed to be consistent with Regulation Best Interest) to the extent the policies and procedures, as well as incentive practices, when viewed as a whole, are prudently designed to avoid a misalignment of interests.

      i. For example, the policies and procedures would likely need to protect retirement investors from making excessive trades or investing in illiquid or risky products.

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ii. Recommending a fee-based account to an investor with low trading activity would also be an impermissible practice.

iii. The policies and procedures would need to specifically address and mitigate the conflicts that arise from advice regarding proprietary products or from a limited menu of products.

iv. The policies and procedures would also have to address and mitigate the conflicts arising out of transaction-based compensation. The compensation structures with respect to which the DOL has concerns include thresholds that disproportionately increase compensation through incremental increases in sales. In the wake of the 2016 DOL fiduciary rule, various firms revised their compensation grids to avoid this situation, so the DOL's concerns in this proposal should not be a surprise or be too onerous to address. Moreover:

1. Differential compensation across investment products, or within product categories, also raise concerns, as do incentives that favor proprietary products. One possible approach to addressing these conflicts is by basing compensation on neutral factors or by levelizing the compensation across fund families.

2. Sales contests, sales quotas, bonuses and non-cash compensation that are based on the sales of certain investments within a limited period of time appear to be per se impermissible.

3. Supervision would be especially important for monitoring recommendations that are near compensation thresholds, or involve products that pay off more compensation, for advice regarding proprietary products, and for rollover advice.

4. Depending on the facts, it may be necessary to limit the type of products that may be recommended to retirement investors.

c. The Financial Institution internally documents the specific reasons that any recommendation to roll over assets from a plan to another plan or IRA, from an IRA to a plan, from an IRA to another IRA, or from one type of account to another (e.g., a commission-based account to a fee-based account), is the "best interest" of the retirement investor. This analysis would include consideration of the alternatives to the rollover, including leaving the assets in the participant's current employer's plan and selecting different investment options, the fees and expenses associated with both the plan and the IRA, whether the employer pays for some or all of the plan's administrative expenses, and the different levels of services and investments available under the plan and IRA. The Financial Institution and Investment Professional could secure the plan-specific information if it is readily available or by requesting it from the participant. If the participant refuses to provide the information, "even after a full explanation of its significance," the Investment Professional could provide a reasonable estimate of estimated expenses, returns, etc. It is somewhat unclear the extent to which the foregoing analysis needs to be shared with the retirement investor.

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4. The Financial Institution conducts at least an annual retrospective review that is reasonably designed to detect and prevent violations of the Impartial Conduct Standards and related policies and procedures. The review would have to be certified by the Chief Executive Officer or equivalent. The DOL indicated that this review process is based on FINRA's rules governing how broker-dealers supervise associated persons. The review would have to be completed within six months following the end of the reviewed period and would have to be retained for six years. It appears that only the DOL and other federal and state regulators (including SROs) would be privy to this report, though commenters may wish to seek confirmation on this point.

5. Neither the Financial Institution nor Investment Professional has been convicted of any crime described in Section 411 of ERISA arising out of the provision of investment advice, absent special permission from the DOL.

6. The Financial Institutions maintains all the records demonstrating compliance with the exemption for six years, and makes available such information to the DOL, a plan fiduciary, a plan sponsor or any participant, unless such information constitutes a trade secret or is privileged, etc., in which case the Financial Institution would have to provide a written notice of such determination to the requester within 30 days of the request.

The comment period for this proposed class exemption closes on Aug. 6, 2020.

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[1] The DOL also reinstated Interpretive Bulletin 96-1 regarding the types of communications with plan participants that amount to investment education (rather than advice).

[2] A riskless principal transaction is a transaction in which a Financial Institution, after having received an order from a retirement investor to buy or sell an investment product, purchases or sells the same investment product for the Financial Institution's own account to offset the contemporaneous transaction with the retirement investor.

[3] The DOL would view a party as "independent" of the Financial Institution and Investment Professional if: (i) the person was not the Financial Institution, Investment Professional or an affiliate, (ii) the person did not have a relationship to, or an interest in, the Financial Institution, Investment Professional or any affiliate that might affect the exercise of the person's best judgment in connection with transactions covered by the exemption, and (iii) the party does not receive and is not projected to receive within the current federal income tax year, compensation or other consideration for his or her own account from the Financial Institution, Investment Professional or an affiliate in excess of 2% of the person's annual revenues based upon its prior income tax year.

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