STRADLEY RONON

# Fiduciary Governance

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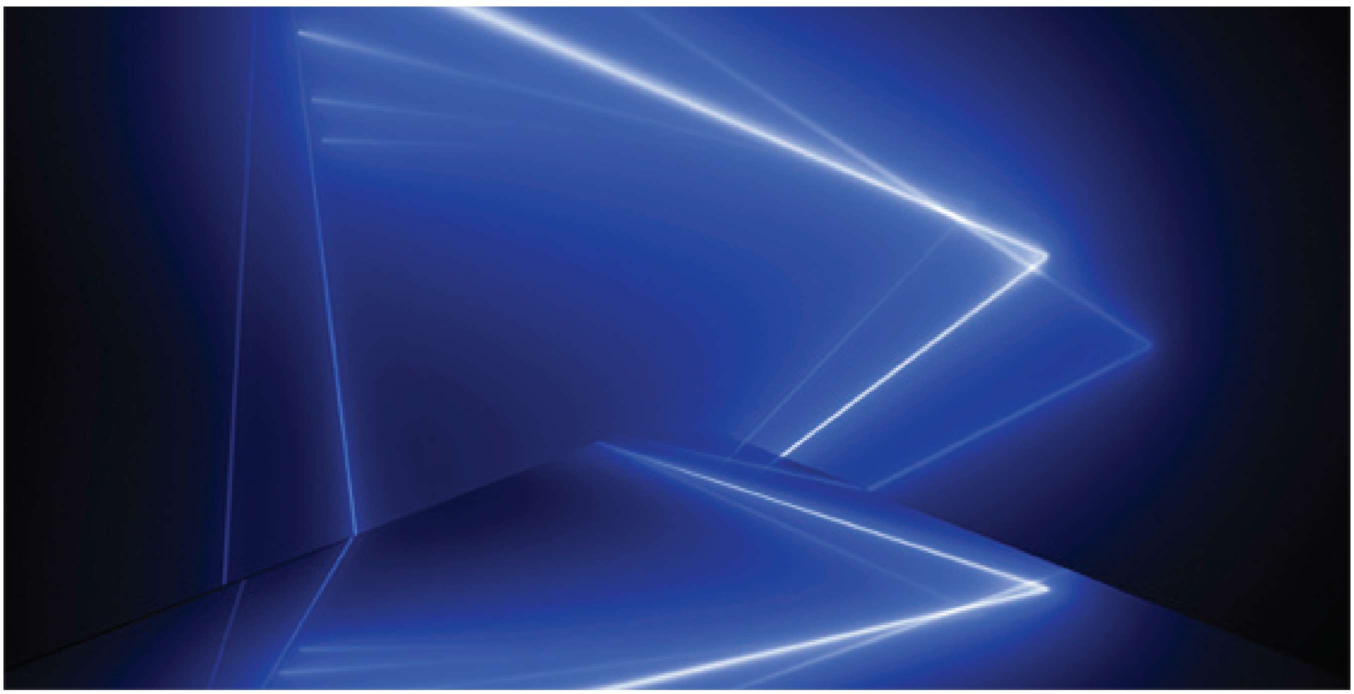
## DOL's Optical Illusion – Fiduciary Investment Advice Status



The U.S. Department of Labor (DOL) has reinstated the five-part test for when one becomes a fiduciary under ERISA to retirement investors (*e.g.*, ERISA plan sponsors, participants, IRA owners, etc.) by reason of giving non-discretionary investment advice. While at first blush, the reinstatement seems to offer great relief to various financial institutions that were possibly ensnared under the DOL's tricky 2016 conflicts of interest rule, private fund sponsors, broker-dealers and investment advisers should proceed with caution. Interpretations by the DOL over the second half of 2020 suggests it will liberally interpret (and enforce) the five-part test for when one becomes an investment advice fiduciary. Tellingly, that the Trump administration opted to expansively interpret the five-part test to the point that it has more than a passing resemblance of the 2016 conflicts of interest rule under the Obama administration suggests that, regardless of which party controls the Executive Branch, the risks of becoming a fiduciary have increased and the opportunities to avoid such status have inexorably winnowed.

Under the test, a person provides "investment advice" if he or she: (1) renders advice to a plan 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; (2) on a regular basis; (3) pursuant to a mutual understanding; (4) that such advice will be a primary basis for investment decisions; and that (5) the advice will be individualized to the plan. In addition to satisfying the five-part test, a person must also receive a fee or other compensation to be an investment advice fiduciary.

All five conditions of the test must be satisfied, plus the receipt of compensation (direct or indirect), for there to be fiduciary investment advice.

The linchpin is that, in order to be an investment advice fiduciary, the financial institution must receive a direct or indirect fee or other compensation incident to the transaction in which investment advice has been provided, in addition to satisfying the 5-part test. The DOL reiterated its longstanding position that this requirement broadly covers all fees or other compensation incident to the transaction in which the investment advice to the plan has been rendered or will be rendered. This could include, for example, an explicit fee or compensation for the advice that is received by the adviser (or by an affiliate) from any source, as well as any other fee or compensation received from any source in connection with or as a result of, the recommended transaction or service (e.g., commissions, loads, finder's fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, underwriting compensation, payments to firms in return for shelf space, recruitment compensation, gifts and gratuities, and expense reimbursements, etc.).

**Condition #1: "renders advice to a plan 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"**

The DOL appears to interpret "securities or other property" broadly to include not only recommendations of specific investments but also any recommendation that would change fees and services that affect the return on investments. This means:

- A recommendation of a specific security or fund would meet this requirement.
- A recommendation of a third-party investment advice provider (likely both non-discretionary discretionary, though this is not clear) would meet this requirement.
- A recommendation of one's own products or services, which is accompanied by an investment recommendation, such as a recommendation to invest in a particular fund or security, would meet this requirement.[1]
- A recommendation to switch from one account type to another (*e.g.*, brokerage vs. advisory, commission-based to fee-based) would meet this requirement.

**For more information, please contact:**

**George Michael Gerstein**
*Co-Chair, Fiduciary Governance*
202.507.5157
ggerstein@stradley.com

- A recommendation of a third party who provides investment advice for which a referral fee is paid would most likely meet this requirement.

- A recommendation to take a distribution/rollover from a plan into an IRA or from one IRA to another IRA would most likely meet this requirement.[2]

- A recommendation of an investment strategy/policy or portfolio composition may meet this requirement.

But some communications will not, without more, give rise to a "recommendation" under prong #1. These include:

- Marketing one's products and services.[3]

- Investment education, such as information on general financial and investment concepts (*e.g.*, risk and return, diversification, dollar-cost averaging, compounded return, and tax deferred investment).

- Simply describing the attributes and features of an investment product.

**Condition #2: "on a regular basis"**

Looks can be deceiving, and that is certainly the case with the "regular basis" requirement. While it would appear to be self-evident, the DOL's expansive view of this condition should cause service providers to tread carefully. This is because:

- A one-time sales transaction that is a recommendation would be on a "regular basis" if it were deemed part of an existing or future investment advice relationship with the retirement investor or there is otherwise an expectation by the investor that the sales communication is part of an investment advice arrangement.

- An investment recommendation would be on a "regular basis" if it were made on a recurring and non-sporadic basis, and recommendations are expected to continue. Advice need not be provided at fixed intervals to be on a "regular basis."

- A rollover recommendation to a participant who has previously received investment advice from the financial institution would be on a "regular basis."

- One-time investment advice to a plan sponsor of an ERISA plan, when the financial institution has provided the plan sponsor investment advice with respect to its other ERISA plans, would be on a "regular basis."

On the other hand:

- Sporadic or one-off communications are unlikely to be considered on a "regular basis."

**Conditions #3 and #4: "pursuant to a mutual understanding" "that such advice will be a primary basis for investment decisions"**

Whether there is a mutual understanding between the parties that communications are—or are not—investment advice turns on the contractual terms and the surrounding facts and circumstances. Here are some markers:

- Does the written agreement expressly provide for investment advice, or does it expressly and clearly disclaim that any investment advice is intended to be provided? The answer to this is not determinative, but it will factor into the position the DOL takes on whether this condition was met for purposes of the 5-part investment advice test.

- Would a Retirement Investor reasonably believe the financial institution was offering fiduciary investment advice based on the financial institution's marketing and other publicly available materials? Does the financial institution hold itself out as a "trusted adviser"?

The DOL also confirmed that the advice need only be a primary basis, not the primary basis.

**Condition #5: "the advice will be individualized to the plan"**

The DOL did not elucidate on this requirement in the new rule. A good rule of thumb, however, is that the more individually tailored the communication is to a specific recipient, the more likely the communication will be viewed as a recommendation by the DOL.

Financial institutions, especially those that believe they do not provide investment advice to retirement investors, should carefully consider whether the DOL's expansive view of these requirements alters their status as a fiduciary so that they do not inadvertently cause a non-exempt prohibited transaction. An accompanying class exemption goes into effect on February 16, 2021, and would be available for those who become investment advice fiduciaries.

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[1] It is crucial to note that the DOL's 2016 conflicts of interest rule included an exception for incidental advice provided in connection with counterparty transactions with a plan fiduciary with financial expertise. As the DOL noted then, "[t]he premise... was that both sides of such transactions understand that they are acting at arm's length, and neither party expects that recommendations will necessarily be based on the buyer's best interests, or that the buyer will rely on them as such." The new rule, however, contains no such exception.

[2] In the DOL's eyes, a financial institution that recommends a rollover to a retirement investor can generally expect to earn an ongoing advisory fee or transaction-based compensation from the IRA, whereas it may or may not earn compensation if the assets remain in the ERISA plan.

[3] As noted above, the DOL will only treat the marketing of oneself as a "recommendation" if such communication is accompanied by a specific recommendation of a product or service. It is unclear whether the DOL will look for a recommendation of a product or service in fact or in effect, a thorny issue similarly raised under the predecessor 2016 rulemaking.