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Memorandum

DOL Issues New Guidance Regarding Who Is an Investment Advice Fiduciary and a New Related Class Prohibited Transaction Exemption

July 2, 2020

On June 29, 2020, the Department of Labor (the "DOL") announced two actions with respect to the regulation of investment advice under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the Internal Revenue Code of 1986, as amended (the "Code"). First, the DOL submitted a technical amendment to the Code of Federal Regulations to revert to the 1975 regulation defining who is an investment advice fiduciary in response to the U.S. Court of Appeals for the Fifth Circuit vacating the regulations that were finalized in 2016.[1] Second, the DOL proposed a new prohibited transaction class exemption for investment advice fiduciaries ("Proposed Class Exemption") aligning requirements in the exemption with those of other regulators. In the preamble to the Proposed Class Exemption, the DOL espoused certain viewpoints regarding the application of the 1975 regulation. Most notably, the DOL abandoned its earlier position that giving advice to roll assets out of an ERISA covered employee benefit plan ("ERISA Plan") to an individual retirement account ("IRA") does not constitute investment advice.

Background

Section 3(21)(A)(ii) of ERISA provides that a person is an investment advice fiduciary if the person "renders investment advice for a fee or other compensation, direct or indirect, with respect to moneys or property of such plan, or has any authority or responsibility to do so." In 1975, the DOL issued a regulation providing a five-part test defining who would be considered an investment advice fiduciary. Those regulations remained valid until 2016, when after a lengthy rulemaking process, the DOL finalized a regulation substantially expanding who is a fiduciary as compared to the original 1975 regulation.[2] Because of the expansion of the definition, in 2016, the DOL also issued two new class prohibited transaction exemptions and amended six previously granted class prohibited transaction exemptions.

On June 21, 2018, however, the Fifth Circuit found that the DOL had exceeded its rulemaking authority by arbitrarily expanding the DOL's authority. The Court vacated the final 2016 regulation, the new prohibited transaction exemptions, and the amendments to the six previously granted prohibited transaction exemptions.[3] In response to the decision, the DOL announced a temporary enforcement policy in Field Assistance Bulletin No.

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[1] 29 CFR 2510.3—21.

[2] *See* our prior alert on the 2016 regulation here.

[3] *Chamber of Commerce of the U.S. v. U.S. Department of Labor*, 885 F.3d 360 (5th Cir. 2018).

2018-02. Under that guidance, the DOL provided that it would not pursue prohibited transaction claims against investment advice fiduciaries who work to comply with the impartial conduct standards set forth in the two prohibited transaction exemptions that were vacated by the Fifth Circuit until it could provide further guidance.

Since 2018, other regulatory agencies have addressed conduct standards for investment professionals. For example, on June 5, 2019, the Securities and Exchange Commission (the "SEC") adopted a package of rulemakings and interpretations designed to enhance the quality and transparency of certain investment professionals. This package included Regulation Best Interest, which established a new standard of conduct for broker-dealers when making a recommendation of securities transactions to a retail customer (which would include IRAs).[4] Certain state regulators and standards-setting bodies have also provided conduct standards- including the New York State Department of Financial Services, Massachusetts Securities Division, and National Association of Insurance Commissioners.

Investment Advice Fiduciary

On June 29, 2020, the DOL clarified that the 1975 regulation was reinstated after the Fifth Circuit vacated the 2016 regulation by making a technical amendment to the Code of Federal Regulations. As a refresher, the 1975 regulation provides that a person is deemed to be providing "investment advice" to an employee benefit plan if the person meets each prong in a five-part test. To be a fiduciary, a person must:

1. render advice 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 understanding, arrangement or agreement, written or otherwise;
4. that such advice will serve as a primary basis for investment decisions; and
5. that the advice will be individualized based on the particular needs of the employee benefit plan.

Instead of merely reverting to the 1975 regulation, the notice of the Proposed Class Exemption gives additional insight to the DOL's views on when advice to roll over ERISA Plan assets to an IRA could be considered fiduciary investment advice under ERISA and the Code and, more broadly, the DOL's current interpretation of the five-part test. With respect to IRA rollovers, the DOL no longer intends to apply the analysis in Advisory Opinion 2005-23A (known as the Deseret Letter), which indicated that advice to roll assets out of an ERISA Plan to an IRA would not constitute investment advice. Instead, the DOL expressed its the view that a facts and circumstances analysis should be applied in these situations. In the preamble, the DOL gave specific examples of when the various five prongs would be satisfied in the rollover context. For example, the second prong of the test, "on a

[4] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 FR 33318 (July 12, 2019) (Regulation Best Interest Release).

regular basis," could be satisfied if the service provider had been giving broader financial advice to the individual when the service provider recommended the roll-over of plan assets to the IRA.

More generally, the DOL explained that the fourth prong "does not look at whether the advice serves as 'the' primary basis of investment decisions, but whether it serves as 'a' primary basis. When financial service professionals make recommendations to a Retirement Investor, particularly pursuant to a best interest standard such as the one in the SEC's Regulation Best Interest, or another requirement to provide advice based on the individualized needs of the Retirement Investor,[5] the parties typically should reasonably understand that the advice will serve as at least a primary basis for the investment decision." This suggests that the DOL may borrow from standards of conducts promulgated by other regulatory agencies to argue that the fourth and fifth prongs of the test have been met. The DOL could potentially use this type of analysis to argue that some financial institutions and investment professionals who were not previously considered investment advice fiduciaries may now be treated as fiduciaries subject to ERISA and/or the Code.[6]

Proposed Class Exemption

Because the DOL reinstated the 1975 regulation, it was not necessary for the DOL to issue a new class prohibited transaction exemption. However, the DOL determined that existing class prohibited transaction exemptions provide discrete relief for specifically identified transactions and have not been amended to address compensation structures that have more recently developed. The Proposed Class Exemption was designed to be "broader and more flexible." It would be available to a wide array of regulated financial institutions, including registered investment advisers, banks, insurance companies, and broker-dealers (together, "Financial Institutions"), and individuals who are employees, independent contractors, agents or representatives of Financial Institutions who meet the applicable licensing requirements ("Investment Professionals"). The Proposed Class Exemption would permit Financial Institutions and Investment Professionals, and their affiliates and related entities, to engage in the following transactions as a result of the provision of investment advice: (1) the receipt of reasonable compensation and (2) the purchase or sale of an asset in a riskless principal transaction and certain other principal transactions.

As with all exemptions, the Proposed Class Exemption contains certain conditions protective to retirement plan participants and IRA owners. Specifically, the Financial Institution and Investment Professional would need to comply with "Impartial Conduct Standards," which include the following three components:

- *Best Interest Standard*. The best interest standard requires that the fiduciary satisfy the prudent man standard and the duty of loyalty to the applicable retirement investor in Section 404 of ERISA. According

[5] Retirement Investor is defined as "a participant or beneficiary of a Plan with authority to direct the investment of assets in his or her account or to take a distribution; the beneficial owner of an IRA acting on behalf of the IRA; or a fiduciary of a plan or IRA."

[6] To be clear, IRAs are not subject to ERISA, but IRAs are subject to the prohibited transaction rules under the Code. As a result, the DOL's analysis could not be used to impute the ERISA fiduciary standards on an IRA fiduciary, but it could be used to find that an IRA fiduciary had engaged in a prohibited transaction.

to the preamble, the loyalty portion of the standard is designed to be interpreted and applied consistently with the standard in the SEC's Regulation Best Interest and the SEC's interpretation regarding the conduct standard for registered investment advisers.

- *Reasonable Compensation*. The compensation received by the Financial Institution, Investment Professional, their affiliates and related entities may not exceed reasonable compensation within the meaning of Section 408(b)(2) of ERISA and 4975(d)(2) of the Code. As required under federal securities law, the Financial Institution and Investment Professional must seek best execution of an investment transaction.
- *No Material Misstatements*. The Financial Institution and its Investment Professionals may not make any statements about the recommended transaction or other relevant matters that are materially misleading.

Additionally, the Proposed Class Exemption would require certain written disclosure acknowledging fiduciary status, a written description of services to be provided, and material conflicts of interest. This disclosure is intended to clarify the nature of the relationship and not to create a private right of action. The Financial Institution would be required to establish, maintain and enforce policies and procedures designed to ensure compliance with the Impartial Conduct Standards. Notably, the policies and procedures would be required to specify the reasons why it would be in the best interest of a plan participant to rollover assets from an ERISA Plan to another ERISA Plan or IRA. In addition, the Financial Institution would need to conduct an annual retrospective compliance review to detect and prevent violations of the Impartial Conduct Standards and policies and procedures related thereto. Finally, an Investment Professional or Financial Institution would be ineligible to rely on the exemption for 10 years following the conviction of certain crimes or for certain bad conduct relating to compliance with the Proposed Class Exemption.

Conclusion

Although the DOL has determined to reinstate the 1975 regulation, it seems that the DOL is expanding its view as to who could be an investment advice fiduciary based on the preamble to the Proposed Class Exemption. Nonetheless, if adopted, the Proposed Class Exemption would provide broad relief to investment advice fiduciaries and dovetails with legal obligations such investment advice fiduciaries likely already need to follow in connection with rules issued by the SEC and other regulatory agencies. The DOL has given a short comment period of 30 days for interested parties to submit comments on the Proposed Class Exemption.

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