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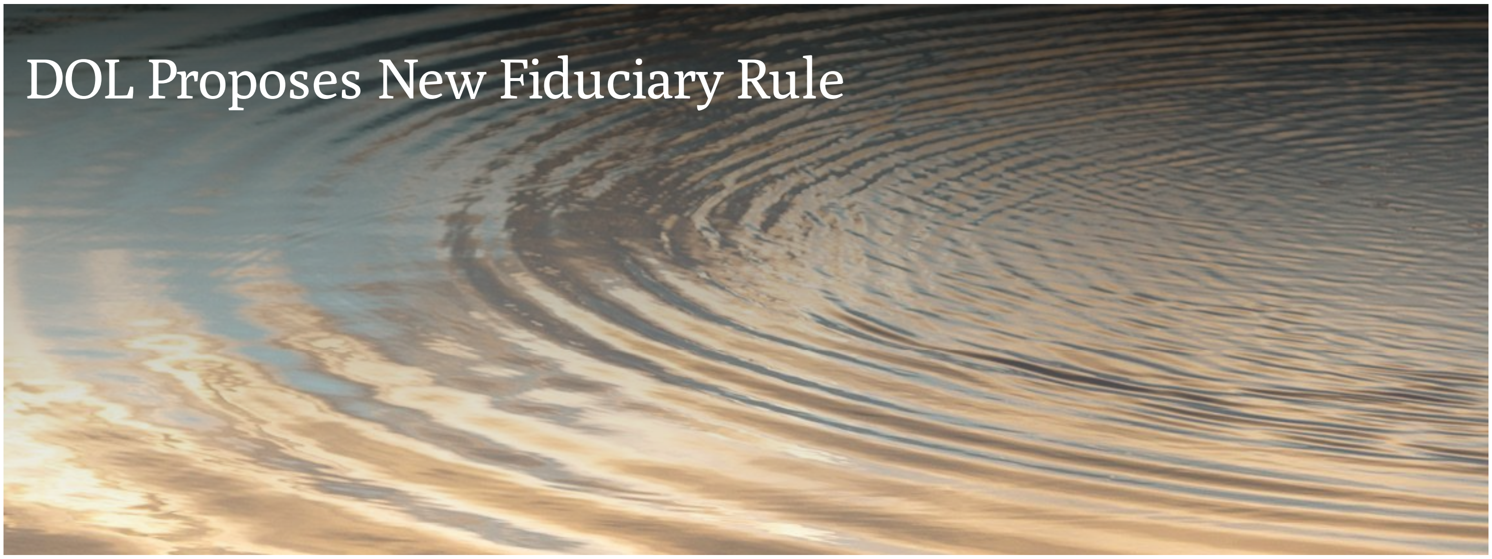
BLOG

DOL Proposes New Fiduciary Rule



JULY 7, 2020

On June 29, 2020, the U.S. Department of Labor (the Department) issued a Notice of Proposed Class Exemption (the Notice) that introduces a new standard to replace the Department's prior "Fiduciary Rule" that was promulgated in 2016, but vacated by the Court of Appeals for the Fifth Circuit in 2018. The Notice has two significant components. First, it confirms that when the Fifth Circuit struck down the "Fiduciary Rule," the Department's original five-part test for determining who constitutes an investment advice fiduciary was effectively restored. Second, the Notice proposes a class prohibited transaction exemption (the Exemption), which allows "investment advice fiduciaries" to engage in certain transactions that would otherwise be prohibited, to the extent certain requirements are satisfied.

Investment Advice Fiduciary and the Five-Part Test

Under the Employee Retirement Income Security Act of 1974 (ERISA), a person will be an "investment advice fiduciary" with respect to an ERISA-covered employee benefit plan (a Plan) if he or she renders investment advice with respect to any moneys or other property of such Plan, or has any authority or responsibility to do so, in return for a fee or other direct or indirect compensation. The Internal Revenue Code of 1986 (the Code) includes a parallel provision that defines a fiduciary of a Plan and an individual retirement account (IRA).

In 1975, the Department issued a regulation establishing a five-part test to determine whether advice constitutes "investment advice" for purposes of fiduciary status. Under the 1975 regulation, for advice to constitute "investment advice," a financial institution or investment professional who is not a fiduciary under another provision of ERISA 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 agreement, arrangement, or understanding with a Plan, a Plan fiduciary or an 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.

The Notice provides that with the vacation of the 2016 Fiduciary Rule, the five-part test is restored and concludes that a financial institution or investment professional that meets this five-part test, and receives a fee or other compensation directly or indirectly, is an investment advice fiduciary under ERISA and the Code. The Notice also provides some additional guidance on some of the five prongs.

- *Rollover Advice*: The DOL affirms that advice to take a distribution and roll it to an IRA or another Plan can be considered fiduciary investment advice if the five prongs are met, meaning the rollover is part of an on-going investment relationship, even if the rollover advice is the first action. This statement revokes a 2005 DOL Advisory Opinion.
- *Mutual Agreement*: When determining whether the advice is issued pursuant to a mutual agreement, determination is made based on the reasonable understandings of each party. Contractual liability disclaiming an agreement or forbidding reliance is not determinative, but may be a factor in demonstrating the agreement.
- *Primary Basis*: In the preamble, the DOL states that to meet the "primary basis" standard, the advice does not need to be "the" primary basis of the investment, but "a" primary basis, a broad standard.

Proposed Class Exemption

The second part of the DOL guidance is the Exemption which allows investment advice fiduciaries to receive compensation for the advice. ERISA and the Code prohibit investment advice fiduciaries from receiving compensation that varies based on their investment advice and compensation that is paid from third parties. ERISA and the Code also prohibit fiduciaries from engaging in purchases and sales with Plans or IRAs on behalf of their own accounts. The Exemption proposed in the Notice is available to registered investment advisers, broker-dealers, insurance companies, banks, and individual investment professionals who are their employees or agents and provides relief from these prohibited transactions if an investment advice fiduciary complies with the following standards: Impartial Conduct, Disclosure, Policies and Procedures, and Retroactive Review.

Impartial Conduct Standards

To satisfy the Impartial Conduct Standards, the advisor must act in the best interest of the investor, receive only reasonable compensation, and avoid misleading statements. First, at the time provided, the investment advice must be in the best interest of the investor, *i.e.*, the advice 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, and second, the advice does not place the financial or other interests of the investment advice fiduciary or any affiliate, related entity, or other party ahead of the interests of the investor, or subordinate the investor's interests.

In addition, the compensation received by the investment advice fiduciary, its affiliates, and related entities for their services must not exceed reasonable compensation within the meaning of ERISA and, as required by the federal securities laws, the investment advice fiduciary must seek to obtain the best execution of the investment transaction reasonably available under the circumstances.

The final impartial conduct standard set forth in the Notice requires that the investment advice fiduciary's statements to the investor about the recommended transaction and other relevant matters are not, at the time the statements are made, materially misleading.

The DOL states that the best interest requirement is to be interpreted consistently with the standard set forth in the Securities and Exchange Commission's Regulation Best Interest. This intent will provide relief to investment professionals by creating consistent best interest standards between ERISA clients and retail customers.

Disclosure

Prior to engaging in a transaction pursuant to the class exemption proposed in the Notice, the financial institution must provide to the investor: (1) 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 provided to the investor; and (2) a written description of the services to be provided and the financial institution's and investment professional's material conflicts of interest that is accurate and not misleading in all material respects.

Policies and Procedures

The financial institution must establish, maintain, and enforce written policies and procedures that are prudently designed to mitigate conflicts of interests and to ensure that the financial institution and its investment professionals comply with the impartial conduct standards. The financial institution must also document 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.*, from a commission-based account to a fee-based account) is in the best interest of the investor.

Retroactive Review

The financial institution must also conduct a retrospective review, at least annually, that is reasonably designed to assist the financial institution in detecting and preventing violations of, and achieving compliance with, these impartial conduct standards and the policies and procedures governing compliance with the proposed class exemption. Moreover, the methodology and results of the retrospective review must be reduced to a written report that is provided to the financial institution's chief executive officer (or equivalent officer), who must certify compliance on an annual basis.

Winston Takeaway

The return to the five-part test to determine investment advice fiduciary status coupled with the broad class exemption appears to provide needed guidance in an area that has been in flux since the fiduciary rule was vacated. That said, to the extent participants are interested in submitting written comments on the proposed class exemption, the Department will accept comments within the 30-day period following the date the Notice is published in the Federal Register. Prudent readers are advised to contact their counsel to learn more.
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