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MEMORANDUM

DATE: July 2, 2020

TO: NAIFA

FROM: Scott Sinder
Kate Jensen

RE: Department of Labor's Proposed "Best Interest" Prohibited Transaction Exemption for Investment Advice Fiduciaries

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Hours before the Securities and Exchange Commission's (SEC) Regulation Best Interest (Reg BI) went into effect, the Department of Labor (DOL) proposed its own "best interest" prohibited transaction exemption (PTE) for investment advice fiduciaries under ERISA and the Internal Revenue Code (Code). A full discussion of DOL's proposal follows, but it is worth highlighting:

- This proposed PTE is *far* less prescriptive than DOL's last attempt at an updated investment advice fiduciary standard of conduct; it is principles-based and neutral with respect to different business models, products and compensation arrangements in the marketplace;

- To promote "regulatory efficiencies" and coordinated compliance efforts within the industry, DOL's "best interest" standard – around which the PTE is structured – will be interpreted and applied consistent with the same standard in Reg BI and the SEC's interpretation of its rule;

- The proposal also generally tracks with Reg BI's framework by establishing impartial conduct standards, disclosure requirements, and policy and procedure obligations for institutions; and

- In another marked change from its last rule, DOL proposes to continue using its 1975 five-part test for determining what constitutes fiduciary "investment advice."

Comments on the proposed PTE are due 30 days after the proposal appears in the Federal Register (expected any day).

BACKGROUND

I. Proposed PTE Compared to the Vacated 2016 DOL Fiduciary Rule

Perhaps most notable about the current proposal are provisions and requirements that are *absent* from it, particularly when compared to DOL's last fiduciary rule. This, according to DOL, is in direct response to the Fifth Circuit Court of Appeals' (rather scathing) opinion vacating the 2016 rule as a dramatic departure from DOL's long-standing interpretation of the law and beyond the scope of DOL's authority.[1]

The proposal, for instance, does ***not***:

- Create a new test for who is an investment advice fiduciary under ERISA and the Code, but rather, sticks with the rule that has been in place for decades;

- Create new private rights of action for individual investors via contract or warranty requirements (instead, investors must rely on the remedies and recourse already available to them under ERISA and the Code);

- Attempt to push the marketplace toward particular products or compensation arrangements by essentially requiring "conflict-free" advice and imposing prescriptive restrictions and requirements on only certain market segments; or

- Impose overly complex or burdensome compliance obligations on institutions or industry professionals.

Among the main criticisms of DOL's previous rule were that it would eliminate competition and options for consumers – particularly for low- and middle-income families who cannot afford expensive advisory fees – and cause industry participants to leave the marketplace because of dramatically increased compliance and administrative costs. By omitting certain features of the 2016 rule like those described above, DOL appears to be trying to avoid those types of consequences from this proposal.

Unlike the prior administration, for example, DOL now makes clear an intent to maintain access to a wide variety of compensation arrangements for professionals who act in their clients' best interest, including: commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs, and revenue sharing payments. Further, advice on proprietary products and otherwise limited product menus is fine, so long as the conditions of the PTE are satisfied.

Even compared to the SEC's Reg BI, the proposed PTE is streamlined and less complex. Structurally, the PTE is similar to Reg BI with a best interest standard, impartial conduct standards, certain disclosure requirements, and policies and procedures for institutions. But DOL's proposed PTE contains far fewer details and what appear to be less robust requirements (e.g., more limited disclosure obligations). We anticipate that Reg BI compliance measures are

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

therefore likely to drive/shape many institutions' and individual professionals' approaches to simultaneously fulfill this PTE's requirements.

II. Restoration of the Five-Part Test to Identify Fiduciary "Investment Advice"

Regarding the threshold question of who is considered an investment advice fiduciary under ERISA and the Code, DOL proposes to go back to its five-part test established in 1975 regulations. Notably, DOL's decision to abandon this test in its 2016 rule and establish a drastically different approach to defining investment advice fiduciary featured prominently in the Fifth Circuit's decision as an example of DOL's overreach.

The five-part test implements ERISA's and the Code's statutory definition of investment advice fiduciary. Specifically, both laws provide:

> "[T]he term 'fiduciary' means any person who renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so."[2]

Since 1975, DOL has interpreted "investment advice" within that definition – under both ERISA and the Code – to mean advice rendered:

- 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
- on a regular basis
- pursuant to a mutual agreement, arrangement, or understanding with the Plan, Plan fiduciary or IRA owner that
- the advice will serve as a primary basis for investment decisions with respect to Plan or IRA assets, and that
- the advice will be individualized based on the particular needs of the Plan or IRA.[3]

The test is designed to capture true "advice" in the context of some ongoing relationship or exchanges between an investment professional and a client, and omit isolated transactional interactions. The proposal contains some clarifications about the elements of the test (covered below), but generally, DOL intends to return to the framework to which industry and investors have been accustomed for 45 years.

<u>DISCUSSION OF THE PROPOSED PTE</u>

I. Scope of the PTE

A. <u>Covered transactions/scope of prohibited transaction relief</u>

[2] ERISA section 3(21)(A)(ii); Code section 4975(e)(3)(B)).

[3] 29 CFR 2510.3-21(c)(1); 26 CFR 54.4975-9(c).

1. Limited prohibited transaction relief to receive *reasonable* compensation

ERISA and the Code contain robust prohibitions on self-dealing by investment advice fiduciaries in transactions involving assets of ERISA-covered employee benefit plans (Plans) and individual retirement accounts and annuities (IRAs).[4] Consequently, under each law's prohibited transaction rules, ERISA and Code fiduciaries generally are prohibited from receiving compensation that varies based on the investment advice they provide or compensation from third parties for that advice, unless an exemption applies.

This proposed PTE would allow investment advice fiduciaries (i.e., those delivering fiduciary "investment advice" as defined under the five-part test above) and their affiliates and related entities to receive ***reasonable*** variable and/or third-party compensation, including commissions, 12b-1 fees, sales loads, revenue sharing payments, etc., for such advice without running afoul of certain prohibited transaction rules.[5]

Per the proposal's preamble discussion, the "reasonable" compensation limitation is meant to be consistent with long-standing ERISA requirements and guidance, and common law principles – *not* to be a new or more onerous restriction than what currently exists. Generally, compensation may not be excessive as measured by market value for the specific services and benefits that are being delivered to the investor. A "reasonableness" determination involves a facts-and-circumstances inquiry looking at factors like market price of services, scope of monitoring, complexity of the product, and value of any guarantees or other benefits (e.g., annuities).

2. Rollovers <u>are</u> covered transactions in certain circumstances

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[4] ERISA section 406; Code section 4975.

[5] Note that the PTE provides *limited prohibited transaction relief* and does not exempt ERISA and Code fiduciaries from general fiduciary responsibilities (e.g., to act prudently and in the sole interest of ERISA Plan participants and beneficiaries, or to operate an IRA for the exclusive benefit of the employees of the employer maintaining the IRA).

The PTE provides relief under the following specific subsections in ERISA and the Code: ERISA section *406(a)(1)(A) and (D) and 406(b)*, and Code sections *4975(c)(1)(A), (D), (E), and (F)*. The PTE also does <u>not</u> therefore provide relief from ERISA or Code prohibited transactions involving lending of money or extensions of credit between fiduciaries and Plans/IRAs or the furnishing of goods, services, or facilities between a fiduciary and Plan/IRA. Under ERISA, there also is not relief for prohibited transactions involving acquisitions of certain real property.

Further, the PTE is supplemental to, not in lieu of, other ERISA/Code exemptions and rules, so investment professionals are able to continue relying on existing PTEs for prohibited transaction relief.

Finally, although not directly relevant to you, the PTE contains additional relief for investment advice fiduciaries who engage in riskless principal transactions.

Recommendations to roll over assets from a Plan to an IRA, from one Plan to another Plan, from one IRA to another, or between account types (e.g., commission-based to fee-based) are covered if they constitute "investment advice" under the five-part test. Rollovers are a particular focus of the proposal and are explicitly identified as a "primary concern" of DOL. DOL notes in the preamble that rollovers are a significant source of revenue for investment advice fiduciaries (who may not otherwise receive any revenue if assets remain in a Plan, for instance). Also, it points out, the decision to roll over assets is "potentially a very consequential financial decision for a Retirement Investor."

Consequently, DOL proposes to stop applying previous guidance (Advisory Opinion 2005-23A, the Deseret Letter), which had suggested that advice to roll over assets out of Plans does not generally constitute fiduciary investment advice. It further proposes specific documentation requirements for any rollover recommendations (discussed in further detail below as part of Financial Institutions' policy and procedure obligations). Finally, DOL cautions that, for ERISA plans at least, the general duties of prudence and loyalty apply to these transactions.

The key limitation on rollover recommendations that are covered under the PTE is whether the recommendation rises to the level of "investment advice" under the five-part test. For example, the "regular basis" prong of the five-part test still applies. Under the proposal, rollover advice will be considered delivered on a "regular basis" if it is part of an ongoing relationship or an *anticipated* ongoing relationship between the Retirement Investor and Investment Professional, determined through a facts and circumstances analysis. On the other hand, a rollover recommendation on an isolated or independent transaction outside of any such ongoing relationship context would not satisfy the "regular basis" prong and therefore would not be considered investment advice.

Similarly, the "mutual agreement" and "primary basis" prongs must be satisfied. Here, DOL clarifies that these will be evaluated based on the reasonable understanding of the parties, if there is no actual recorded agreement.

3. Covered "Plans" and "IRAs"

Regarding the scope of Plans and IRAs covered, the PTE broadly defines them to include:

As "Plans" –

- Employee welfare benefit plans and employee pension benefit plans; and
- Trusts exempt from tax under Code section 501(a) that form part of a qualified pension, profit-sharing, and stock bonus plan; and

As IRAs –

- Individual retirement accounts;
- Individual retirement annuities;
- Archer MSAs
- Health savings account (HSAs); and

- Coverdell education savings accounts.

B. Covered professionals, institutions and investors

The PTE is available to "Financial Institutions" and "Investment Professionals" who provide fiduciary investment advice to "Retirement Investors."

"Financial Institutions" include certain properly licensed and not disqualified or barred entities that employ or otherwise retain (e.g., as an independent agent or registered representative) Investment Professionals. The proposal would limit eligible Financial Institutions to:

- Investment Advisers registered under the Investment Advisers Act of 1940;
- State- or federally-supervised banks, and savings associations;
- Insurance companies;
- Broker-dealers registered under the Securities Exchange Act of 1934; and
- Entities that later are granted relief under this PTE by DOL in the form of an individual exemption.

"Investment Professionals" must be:

- Investment advice fiduciaries under the five-part test;
- Employees, independent contractors, agents, or representatives of a Financial Institution; and
- Properly licensed under insurance, banking, and/or securities laws with respect to a covered transaction (and not disqualified or barred from making investment recommendations).

Finally, "Retirement Investors" include:

- Participants or beneficiaries of Plans with authority to direct the investment of assets in the account or take distributions;
- Beneficial owners of IRAs acting on behalf of the IRA; or
- Fiduciaries of Plans or IRAs.

C. Exclusions from coverage by the PTE

Under the proposal, the PTE would not apply if:

- A Plan is covered by Title I of ERISA and the Investment Professional, Financial Institution, or an affiliate is and employer of employees covered by a Plan, or a named Plan fiduciary or plan administrator selected by a fiduciary who is not independent of the Investment Professional, Financial Institution, or affiliate;

- The transaction is a result of robo-advice that does not involve any personal interaction with, or advice from, an Investment Professional; and

- The transaction involves an Investment Professional acting in a fiduciary capacity *other than* an investment advice fiduciary as defined under the five-part test.

Additionally, the PTE would exclude from eligibility for 10 years Investment Professionals and Financial Institutions who are convicted of certain investment advice-related crimes and/or who engage in repeated or egregious violations of the PTE's requirements

II. PTE Conditions

As noted above, the proposed PTE's requirements are substantially streamlined compared to DOL's 2016 rule and even the SEC's Reg BI. They generally include compliance with:

- Impartial conduct standards, including acting in Retirement Investors' best interest;
- Limited disclosure obligations;
- And obligations that apply only to Financial institutions, such as having reasonable policies and procedures in place, conducting annual compliance reviews, and recordkeeping.

Each requirement is discussed below. To avoid a prohibited transaction, investment advice fiduciaries must comply with all PTE conditions. Neither investment advice fiduciaries nor Retirement Investors may waive or disclaim any of the requirements.

A. Impartial Conduct Standards

1. Act in the best interest of the Retirement Investor

First, at the time it is provided, investment advice must be in the best interest of the Retail Investor. The best interest standard is satisfied if investment 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 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 interest 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."

Again, it is DOL's stated intention that the standard be interpreted and applied consistent with the same standard in Reg BI and the SEC's interpretation of that rule. Consistent with the SEC's approach, notable features of DOL's standard include:

- Not requiring "conflict-free" advice, so, to the extent the standard is otherwise satisfied, Investment Professionals may receive a variety of variable compensation and may recommend proprietary products and investments that generate third-party compensation;
- Utilizing prudent investment professionals in similar circumstances as a benchmark for evaluating whether the standard is satisfied;
- Evaluating compliance with the standard at the time advice is rendered, not in hindsight or based on an investment's subsequent performance;

- Not requiring recommendations of the "the best" investment option or the lowest cost option; and
- Not establishing an ongoing monitoring obligation for Investment Professionals, unless one is established by agreement or understanding with the Retirement Investor.

2. Reasonable compensation, best execution, and no materially misleading statements

Second, consistent with the PTE's scope outline above, compensation received (directly or indirectly) by the Financial Institution, Investment Professional, their affiliates, and their related entities must be reasonable for the services provided. Again, the "reasonable" standard is not new and investment advice fiduciaries may rely on current guidance for "reasonableness" parameters.

Third, as already required by federal securities laws, investment advice fiduciaries must "seek to obtain the best execution of the investment transaction reasonably available under the circumstances." Here, again, DOL has not put any new guidance or restrictions in place, but rather, intends to rely on securities laws and guidance currently in place to establish the parameters of this condition.

Finally, the impartial conduct standards require that statements made by investment advice fiduciaries to Retirement Investors about the recommended transaction and "other relevant matters" not be materially misleading at the time they are made. The preamble identifies as other relevant matters:

- Fees and compensation;
- Material conflicts of interest; and
- "Any other fact that could reasonably be expected to affect the Retirement Investor's investment decisions."

The proposal does not provide further color on these "other matters," including the catch-all category.

B. <u>Disclosure obligations</u>

In general, the proposed disclosures may be delivered through any disclosure or combination of disclosures required by another regulator/rule, so long as the required elements are present. The disclosures need not be tailored to individual investors, but must be in "plain English" and take into consideration the investor's level of financial experience. They must be delivered *prior to* the transaction for which the PTE is needed.

1. Fiduciary status (no new private cause of action)

Investment advice fiduciaries must provide a written acknowledgement of fiduciary status under ERISA and/or the Code, as applicable, for any fiduciary investment advice provided to the Retirement Investor. DOL does ***not*** intend for this condition to create any private right of action and states clearly that Retirement Investors must rely on current remedies in ERISA and the

Code as the *sole* remedies for investment advice fiduciaries engaging in non-exempt prohibited transactions.

1. Services to be provided and material conflicts of interest

Investment advice fiduciaries also must provide written descriptions of services to be provided and any material conflicts of interest. This disclosure must be "accurate and not misleading in all material respects."

The PTE's definition of "conflict of interest" is consistent with Reg BI – "an interest that might incline a Financial Institution or Investment Professional – consciously or unconsciously – to make a recommendation that is not in the Best Interest of the Retirement Investor."

DOL clarifies that investment advice on proprietary products or other limited menu of products (e.g., those that generate third-party compensation) would be considered "material conflicts of interest" and should be completely and accurately disclosed. The proposal contains no further color on these disclosures.

Given the overlap in disclosures between the proposed PTE and Reg BI, to the extent DOL does not provide further detail and an institution/professional is governed by both rules, institutions may opt to base disclosures on the more prescriptive SEC rule and use them to also satisfy DOL's requirements.

C. <u>Financial Institution policies and procedures</u>

This condition applies only to Financial Institutions, not Investment Professionals. It requires those institutions to establish, maintain and enforce written policies and procedures:

- Prudently designed to ensure compliance with the impartial conduct standards;

- *When viewed with the Institution's incentive practices*, reasonably designed to mitigate conflicts of interest and avoid misalignment of investment advice fiduciaries' interests and interests of Retirement Investors; and

- To document the "specific reasons" that any recommendations to roll over assets (Plan to Plan, Plan to IRA, IRA to Plan, IRA to IRA, or account type to account type) is in the best interest of the Retirement Investor.

This section does emphasize the need to address and mitigate potential conflicts of interest arising out of variable compensation, such as commissions (as opposed to flat-fee advisory models). Here, DOL incorporates Reg BI's non-exhaustive list of examples of sufficient mitigation strategies, including, for example:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental sales increases;
- Minimizing incentives that favor one type of account over another; and

- Eliminating compensation incentives within comparable product lines.

Like Reg BI, DOL indicates that these PTE conditions would *bar financial institutions from establishing or permitting sales contests or quotas, or bonuses or non-cash compensation tied to the sale of certain investments within a limited time period.*
Additionally, with respect to proprietary products and other limited menus of products, the Financial Institution must "prudently conclude" that such offerings, in conjunction with its policies and procedures, would not cause a misalignment of interests. DOL also cautions that recommendations of proprietary products may not be made if they cannot satisfy the impartial conduct standards (i.e., if none of the offered products are in the investor's best interest compared with other investments available in the marketplace).

D. <u>Retrospective compliance reviews, report, and CEO certifications</u>

The PTE would establish an ongoing oversight obligation for Financial Institutions to make sure that they and their Investment Professionals are complying with the PTE's conditions and that their policies and procedures remain effective. At least annually, a Financial Institution would conduct a retrospective review designed to detect and prevent violations. The methodology and results of the review would be memorialized in a report, which must be kept for six years and to which DOL must be granted access upon request.

DOL "envisions that the review would involve testing a sample of transactions to determine compliance." This construct likely would result in institutions' imposition of documentation and recordkeeping requirements on their respective Investment Professionals. Indeed, while DOL specifically states that it does not expect documentation on every investment recommendation made pursuant to the PTE, it does suggest that "documentation may be especially important for recommendations of particularly complex products or recommendations that might, on their face, appear inconsistent with the best interest of the Retirement Investor." This approach is consistent with the SEC's Reg BI guidance.

Financial Institutions' chief executive officers (or equivalent) would also have to certify annually that:

- S/he has reviewed the report from the compliance review;
- The Financial Institution has policies and procedures in place in accordance with the conditions described above; and
- The Financial Institution has in place prudent processes to modify its policies and procedures as business, regulatory, and legislative changes warrant, and to periodically test the effectiveness of its policies and procedures.

E. <u>Financial Institution recordkeeping obligations</u>

Lastly, Financial Institutions would be required to maintain records demonstrating compliance with the PTE for six years. These records – insofar as they relate to transactions actually engaged in by a party and are not protect by law – must be made available to: DOL; any fiduciary of a Plan that engaged in a transaction under the PTE; any contributing employer and employee organization whose members are covered by a Plan that engaged in a transaction under the PTE; and any participant/beneficiary of a Plan, or IRA owner that engages in a transaction under the PTE.