DOL Officially Reinstates Original Fiduciary Rule and Proposes New Class Exemption for Investment Advice Fiduciaries

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On June 29, 2020, the U.S. Department of Labor (the "DOL") issued a **final regulation** reinstating the original 1975 fiduciary rule under the Employee Retirement Income Security Act of 1974 ("ERISA"). The DOL also separately issued a new **proposed prohibited transaction class exemption** allowing financial services companies to (i) receive compensation while acting as investment advice fiduciaries, including in connection with offering advice on individual retirement account rollovers, and (ii) execute certain principal trades for retirement assets to which they act as investment advisers.

Fiduciary Rule

Background. ERISA imposes a strict standard of care and prohibited transaction restrictions on financial institutions ("Financial Institutions") and their investment professionals ("Investment Professionals") who provide investment advice with respect to assets held in employee retirement plans. The prohibited transaction restrictions are mirrored in the Internal Revenue Code (the "Code") and apply to individual retirement accounts ("IRAs"), as well as employee plans.

In 1975, the DOL promulgated a definition of "investment advice" for identifying cases in which a Financial Institution and its Investment Professionals are viewed as acting as fiduciaries in providing advice with respect to assets of an employee plan or IRA (the "Original Fiduciary Rule"). Under the Original Fiduciary Rule, a party would be viewed as providing fiduciary investment advice only if the advice met all of the elements of a five-part test, which required that the advice:

(1) Pertain to the purchase, sale or value of securities or other property;

(2) Be provided on a regular basis;

(3) Be provided pursuant to a mutual agreement, arrangement or understanding between the provider of the advice and the plan, plan fiduciary or IRA owner;

(4) Would, pursuant to the mutual understanding, serve as a primary basis for investment decisions with respect to assets of the plan or IRA; and

(5) Would be individualized to the particular needs of the plan or IRA.

As a carve-out to the Original Fiduciary Rule, in 1996, the DOL issued an **Interpretive Bulletin** clarifying that the provision of various forms of investment education materials and tools to assist individuals in the investment and management of their retirement assets would <u>not</u> constitute the provision of fiduciary investment advice (the "Investment Education Bulletin").

2016 Fiduciary Rule. In 2016, after a protracted regulatory process, the DOL adopted revised rules which significantly broadened the circumstances in which Financial Institutions and Investment Professionals would be viewed as providing investment advice that would give rise to fiduciary status and repealed the Investment Education Bulletin (collectively, the "2016 Fiduciary Rule"). The 2016 Fiduciary

Rule was accompanied by two new prohibited transaction class exemptions—the Best Interest Contract Exemption (the "BIC Exemption") and the Principal Transactions Exemption—intended to help Financial Institutions and Investment Professionals navigate the expanded definition of fiduciary investment advice under the 2016 Fiduciary Rule.[1]

The 2016 Fiduciary Rule was challenged by various financial industry groups, and in **March 2018**[2] the Fifth Circuit Court of Appeals vacated the rule and the related exemptions. In June 2018, the Fifth Circuit issued a "mandate," making its opinion effective and returning the entire regime to the status quo of the Original Fiduciary Rule. In the interim, the two related exemptions were preserved by the DOL in May 2018 through a **Field Assistance Bulletin** to accommodate those Financial Institutions that had already devoted significant resources to complying with the exemptions and might prefer to continue to rely on the exemptions.

June 2020 Fiduciary Rule. The June 29, 2020 action by the DOL seeks to make the return to the Original Fiduciary Rule official. The action formally restores, verbatim, the Original Fiduciary Rule, with its five-part test, and the Investment Education Bulletin and eliminates the BIC Exemption and the Principal Transactions Exemption that accompanied the 2016 Fiduciary Rule.

This DOL action to formalize the return to the Original Fiduciary Rule is presumably intended to prevent any future administration from taking any regulatory shortcuts to modify and rescue the 2016 Fiduciary Rule without the full notice-and-comment process typically required for rule changes. To avoid the full notice-and-comment process for the present action, the DOL (under the current administration) reinstated the Original Fiduciary Rule and the Investment Education Bulletin through a final rule in exactly the form in which they existed prior to the 2016 Fiduciary Rule and without any additional interpretive commentary and, instead, included its commentary in the new proposed exemption described below.

Accordingly, the restoration of the Original Fiduciary Rule and the Investment Education Bulletin is effective immediately.

Proposed Exemption

Concurrent with its restoration of the Original Fiduciary Rule and the Investment Education Bulletin, the DOL published a proposed class exemption that offers a framework for Financial Institutions and Investment Professionals to avoid prohibited transactions when:

- Receiving compensation in connection with the provision of investment advice and recommendation of investment products, including assisting individuals ("Customers") in rolling assets held under a 401(k) or similar plan to an IRA or rolling assets from one IRA to a new IRA; and
- Executing certain transactions for plans or IRAs on a principal basis (the "Proposed Exemption").

Covered Financial Institutions. The relief under the Proposed Exemption would be available to banks, registered broker-dealers, SEC- and state-registered investment advisers and insurance companies. Institutions not within these categories may apply to the DOL to have the exemption extended to them. The DOL's commentary accompanying the Proposed Exemption specifically notes the possibility of extending the exemption to independent marketing organizations, field marketing organizations and brokerage general agencies upon application by companies in those areas.

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[1] For more detail on the 2016 Fiduciary Rule, please see our prior visual memorandum, **The Department of Labor's New Fiduciary Regulation and Its Impact on the Financial Services Industry**, June 3, 2016.

[2] For more detail, please see our blog post discussing this decision, **DOL Fiduciary Rule on Life Support**, March 23, 2018.

Exclusions. The relief under the Proposed Exemption would apply when a Financial Institution and its Investment Professionals are fiduciaries to the Customer solely as a result of providing investment advice and not, for example, when they are exercising investment discretion for the relevant Customer's assets or when the Financial Institution is the employer-sponsor of a plan for which the relevant advice or principal transaction is being offered. The relief would not apply to transactions resulting solely from automated investment recommendations (i.e., robo-advice), but it would apply when a transaction is recommended by an Investment Professional using computer-based investment tools (i.e., "hybrid" robo-advice).

Rollovers. Under the Proposed Exemption, a Financial Institution and its Investment Professionals would not be deemed to violate the prohibited transaction rules of ERISA or the Code when the Financial Institution or Investment Professional stands to benefit from advising a Customer in connection with the rollover of the Customer's retirement savings from an employer-sponsored 401(k) or similar plan to an IRA serviced by the Financial Institution and Investment Professional or from an existing IRA to an IRA serviced by the Financial Institution and Investment Professional, provided that specified conditions are met (see "Conditions of the Proposed Exemption" further below). As discussed below, the exemption would cover situations in which the rollover enables the Financial Institution and Investment Professional to capture the benefits of:

- Transaction fees for initial and future permitted transactions by the IRA;
- Fees and revenues generated by the IRA's permitted investment in proprietary products of the Financial Institution; and
- Any reasonable fees relating to the custodial, advisory or other appropriate services provided to the IRA.

Principal Transactions. The Proposed Exemption would also allow Financial Institutions to execute purchases and sales of certain investments for a plan or IRA on a principal or riskless principal basis on the advice of an Investment Professional of the Financial Institution. ERISA generally prohibits principal transactions between a plan or IRA and a party in interest (e.g., a service provider to the plan or IRA or certain specified affiliates of the service provider), but provides an exemption for such transactions when the service provider is not acting in a fiduciary capacity in connection with the trade. The Proposed Exemption would create a new exception allowing principal trades with a Financial Institution even when the Financial Institution is acting in a fiduciary capacity and the trades are made based on the advice of an Investment Professional of the Financial Institution. The exemption permits the execution of trades and the receipt of a mark-up, mark-down or other payment in connection with the trades, when the trades involve:

- The purchase or sale by a plan or IRA of any asset in a riskless principal transaction;
- The sale by a plan or IRA of any securities or other investment property in a principal transaction; and
- The purchase by a plan or IRA of the following types of debt securities in a principal transaction:
  - U.S. dollar denominated debt security issued by a U.S. corporation and offered pursuant to a registration statement under the Securities Act of 1933;
  - a U.S. Treasury security;
  - a debt security issued or guaranteed by a U.S. federal government agency other than the U.S. Treasury;
  - a debt security issued or guaranteed by a government-sponsored enterprise;
  - a municipal security;

- a certificate of deposit; or
- an interest in a unit investment trust.

The types of debt securities that a plan or IRA may purchase in a principal transaction under the Proposed Exemption are similar to those permitted to be purchased by a plan or IRA under the Principal Transactions Exemption that accompanied the 2016 Fiduciary Rule, but with the addition of municipal bonds under the Proposed Exemption. The Proposed Exemption also allows the DOL to expand the categories of assets permitted to be purchased by plans and IRAs by amending the Proposed Exemption in the future.

Conditions of the Proposed Exemption. The conditions of the Proposed Exemption require that:

- The Financial Institution and Investment Professional comply with specified “Impartial Conduct Standards”, which are conceptually similar to, and utilize the same principles-based approach as, the impartial conduct standards under the BIC Exemption that accompanied the 2016 Fiduciary Rule and which require that:
  - the investment advice (e.g., the rollover or trading advice) is in the “best interest” of the Customer in that the advice does not place the interest of the Financial Institution or Investment Professional ahead of the interests of the Customer and reflects the care, skill, prudence and diligence that would be expected of an experienced financial adviser;
  - the compensation received by the Financial Institution is reasonable (i.e., the compensation is not excessive based on the services provided to the Customer, which will depend on the particular facts and circumstances at the time of the recommendation);[3] and
  - the statements made to the Customer are not materially misleading;
- The Financial Institution and Investment Professional provide the Customer with a written description of the services being offered and an acknowledgement that the Financial Institution and Investment Professional are acting as fiduciaries in providing the investment advice;
- The Financial Institution establishes, maintains and enforces policies and procedures that mitigate conflicts of interest, ensure compliance with the Impartial Conduct Standards and set forth the basis on which the covered advice or trade execution may be offered consistent with the best interest of the Customer; and
- The Financial Institution prepares a written report at least annually reviewing the Financial Institution’s compliance with the Impartial Conduct Standards, and the policies and procedures governing compliance with the exemption and the report is certified by the Chief Executive Officer of the Financial Institution.

Ineligibility. The Proposed Exemption provides a process by which the DOL may review compliance with the exemption by a Financial Institution or Investment Professional and, upon a DOL finding of noncompliance, make the Financial Institution or Investment Professional ineligible to use the exemption for a period of ten years. The Investment Professional and Financial Institution would also lose eligibility to use the exemption for a period of ten years if they are convicted of certain crimes arising out of their provision of investment advice.

[3] In addition, Financial Institutions and Investment Professionals are required to seek to obtain the best execution of the investment transaction reasonably available under the circumstances, consistent with the best execution standard that applies to the particular Financial Institution or Investment Professional under federal securities laws.

Effectiveness. The Proposed Exemption is currently subject to a 30-day comment period, after which the DOL expects to address those comments in preparing a final exemption to be effective 60 days following publication of the final exemption.

DOL Commentary

The DOL commentary accompanying the Proposed Exemption includes a number of salient points, most of which are discussed in connection with rollovers, but to varying degrees apply to purchases and sales as well.

Five-Part Test. The commentary notes that the relief under the Proposed Exemption would only be necessary if, based on the facts and circumstances, a rollover or trade is being effected pursuant to investment advice meeting the five-part test under the Original Fiduciary Rule. Although the DOL had previously averred in a **2005 Advisory Opinion** that IRA rollover advice generally would not constitute investment advice (because it would not meet the first prong of the five-part test), the DOL commentary accompanying the Proposed Exemption expressly departs from this prior view and suggests that discussions between an Investment Professional and a Customer that result in an IRA rollover would likely involve investment advice. In this regard, the commentary notes that, even if a Financial Institution and its Investment Professionals had not regularly provided investment recommendations prior to the IRA rollover, the rollover could constitute investment advice if it begins a relationship in which advice will be regularly provided pursuant to an agreement that the advice will serve as a primary basis for the Customer's ongoing investment decisions.

Referring more generally to the requirement for an agreement that advice will be part of the primary basis for an individual's investment decisions, the commentary notes that when no agreement or arrangement is demonstrated, a reviewer should look to the reasonable understanding of each of the parties. A disclaimer of a fiduciary relationship would not be dispositive, but it should be part of the analysis.

Best Interest. The "best interest" component of the Impartial Conduct Standards closely follows the SEC's recently adopted best interest rule (**Regulation Best Interest**)[4] and requires that a Financial Institution's policies must mitigate any interest that might incline the Financial Institution or its Investment Professionals—consciously or unconsciously—to make a recommendation that is not in the best interest of the Customer. It is also similar to the "best interest" component of the impartial conduct standards under the BIC Exemption, except that, to synchronize with the standard under Regulation Best Interest, the DOL replaced the requirement that the advice be provided "without regard to" the interest of the Financial Institution or Investment Professional with the requirement that the advice does not place the interest of the Financial Institution or Investment Professional "ahead of" the interest of the Customer. Borrowing from the commentary accompanying Regulation Best Interest, the DOL commentary lists a number of compensation approaches that help to mitigate such conflicts, including:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimizing compensation incentives for Investment Professionals to favor one type of account, investment product or manner of transaction execution over another;
- Eliminating compensation incentives within comparable product lines by, for example, capping the credit that an Investment Professional can receive across mutual funds or other comparable products across providers;

[4] For more detail regarding Regulation Best Interest, please see our prior visual memorandum, **SEC Adopts Regulation Best Interest, Form CRS and Related Advisers Act Interpretations**, June 21, 2019.

- Implementing supervisory procedures to monitor recommendations that trigger commission step-ups or special rewards, involve higher compensating products, proprietary products or transactions in a principal capacity or vary from one product class to another;
- Limiting the types of Customers to whom a product, transaction or strategy may be recommended; and
- Adjusting compensation for Investment Professionals and supervisors who fail to adequately manage conflicts of interest.

The DOL specifically suggests supervisory procedures to monitor Investment Professionals' recommendations to roll over or transfer assets from a 401(k) or similar plan to an IRA. The DOL acknowledges that such rollovers might involve the disadvantages of moving assets from a plan platform with a menu of low fee institutional funds vetted and monitored by an independent plan committee to an IRA with potentially higher fees and an unfiltered selection of retail investments. Although there might be other compelling reasons for a Customer to make such a move and exercise more direct and active control and oversight over the relevant investments, the DOL commentary might signal to Financial Institutions that the balancing of these factors might compel Financial Institutions to continually review the type and pricing of the investments and services offered to IRAs. Once they focus on the alternatives, Customers are often inclined to roll their plan accounts to an IRA for personal reasons (e.g., to consolidate assets with one manager or advisor, to access a broader range of investment options or, for some defined benefit pension plan participants, to roll a lump sum benefit payment to an IRA and postpone taxes on the benefit) despite the advantages offered under the plan and, thus, the DOL also seems to be signaling that the advice provided to Customers as they consider this move must at least be balanced and complete.

As for an Investment Professional's assessment of the best interest of a specific Customer in the context of a potential rollover, the commentary states that the Investment Professional should make diligent and prudent efforts to obtain appropriate information about the features of the plan in which the Customer participates and the investments available under the plan, but where the Customer is unable or unwilling to provide this information, the Investment Professional may reasonably estimate the relevant aspects of the Customer's plan and investments.

Finally, like the SEC, the DOL emphasizes that the "best interest" requirement does not impose an obligation on Investment Professionals and Financial Institutions to identify the single best investment for the Customer out of all available investments, assuming such advice were even possible at the time of the transaction.

Proprietary Products. The Proposed Exemption does <u>not</u> exclude covered advice and transactions that would result in the Customer purchasing proprietary products of the Financial Institution or products that generate third-party payments to the Financial Institution. This applies more in the rollover context than in the principal transaction context. The commentary notes that under the rollover relief, a Customer may be offered an IRA that requires the Customer to liquidate existing investments and limits the reinvestment of the Customer's IRA to proprietary products of the Financial Institution. In this context, the commentary emphasizes that the applicable compensation policies and conflict of interest disclosures of the Financial Institution should reflect enhancements that meet the standards expected under the exemption. When an IRA platform allows investment in both proprietary products and third-party products, the commentary notes that the requirements of the "best interest" standard should be applied with greater rigor to ensure that the interests of the Financial Institution and its Investment Professionals in promoting the proprietary products are not placed before the interests of the Customer.

In Conclusion

It is worth noting that the DOL's decision to officially restore the Original Fiduciary Rule will require any new administration to undergo the full notice-and-comment process typically required by administrative law principles before rescuing the 2016 Fiduciary Rule. Still, even absent formal action from the DOL, Financial Institutions, Investment Professionals and legal practitioners have been operating as if the Original Fiduciary Rule were in place since the Fifth Circuit Court of Appeals vacated the 2016 Fiduciary Rule in 2018.

The more significant clarifications or changes resulting from the DOL's action are the:

- Restoration of the Investment Education Bulletin;
- Elimination of the BIC Exemption and the Principal Transactions Exemption that accompanied the 2016 Fiduciary Rule; and
- Issuance of the Proposed Exemption.

If adopted in its current form, the Proposed Exemption could be a game changer in how the DOL provides exemptive relief to investment advice fiduciaries. In contrast to existing prohibited transaction exemptions, which typically provide narrowly-tailored relief for specified transactions, the Proposed Exemption would offer a broad framework under which Financial Institutions and Investment Professionals could provide fiduciary investment advice and rollover recommendations and receive a wide range of compensation that would otherwise violate the prohibited transaction rules of ERISA and the Code.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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