THE WAGNER LAW GROUP

LAW ALERT
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DOL Reinstates Five-Part Fiduciary Status Test and Proposes Class Exemption

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On June 29, 2020, the DOL issued a rulemaking package consisting of a final rule ("Final Rule") implementing the vacatur of the DOL's 2016 regulation defining who is a fiduciary under ERISA ("2016 Rule"), and a proposed class exemption titled "Improving Investment Advice for Workers and Retirees" ("Proposed Exemption"). The Final Rule, which is solely a ministerial action, restored the original five-part test for fiduciary status as set forth in the 1975 regulation; eliminated the Best Interest Contract Exemption and the principal exemption associated with the 2016 Rule; and restored to their pre-2016 form six prohibited transaction class exemptions that were modified to conform to the 2016 Rule.

The Proposed Exemption would create a pathway allowing investment advice fiduciaries under ERISA and the Internal Revenue Code ("Code") to (i) receive compensation, including that which derives from rendering advice to roll over assets from employee benefit plans to IRAs, and (ii) engage in certain principal transactions that would otherwise violate the prohibited transaction provisions of ERISA and the Code. The Proposed Exemption would apply to registered investment advisers, broker-dealers, banks, insurance companies, and their employees, agents, and representatives who are investment advice fiduciaries. The Proposed Exemption is intended to align with the SEC's Regulation Best Interest ("Regulation BI"), and to generally mirror similar principles articulated under various state law initiatives. The primary condition of the Proposed Exemption is the Impartial Conduct Standards, which are rooted in the 2016 Rule. This Alert discusses the highlights of the Proposed Exemption.

New Approach to Rollover Advice

The preamble to the Proposed Exemption indicated that the DOL will take a revised approach with respect to rollover advice. Currently, DOL Advisory Opinion 2005-23A (also known as the "Deseret Letter") is the governing authority concerning rollover advice. It suggested that advice to take a distribution and roll assets out of a plan to an IRA does not generally constitute investment advice. The preamble indicated that the DOL will take the position that advice to take a distribution of assets from an ERISA-covered plan is actually investment advice because it is advice to sell, withdraw, or transfer investment assets currently held in the plan. It specifically states, "the Department does not intend to apply the analysis in Advisory Opinion 2005-23A" and "believes that the analysis in the Deseret Letter was incorrect." Thus, rollover advice would be investment advice and such advice would be fiduciary in nature, and therefore subject to ERISA's fiduciary requirements and the prohibited transaction rules of ERISA and the Code, if each component of the five-part test described below is satisfied with regard to the person providing the advice.

Five-Part Test for Fiduciary Status

The 2016 Rule dismantled the so-called five-part test for fiduciary status set forth in the 1975 regulation ("Five-Part Test"). The DOL had become highly critical of the Five-Part Test in the years following its adoption for all too often, in its estimation, allowing investment advice professionals to narrowly escape fiduciary status when providing advice to plans, participants, or IRAs. The Final Rule, however, formally reinstated the Five-Part Test as it existed before the 2016 Rule, thereby confirming the effect of the 2018 Court of Appeals decision that vacated the 2016 Rule. Under the Five-Part Test, the adviser was determined to be a fiduciary if, for a direct or indirect fee or other compensation, he or she: (i) rendered advice as to the value of securities or other property, or made recommendations as to the advisability of investing in, purchasing or selling securities or property (ii) on a regular basis, (iii) pursuant to a mutual agreement, arrangement, or understanding, written or otherwise, between the plan, plan fiduciary, or IRA that (iv) the advice would serve as a primary basis for investment decisions with respect to plan or IRA assets, and (v) the advice would be individualized based on the particular needs of the plan or IRA. The preamble to the Proposed Exemption indicated the manner in which the DOL would now propose to enforce the Five-Part Test; in other words, it will interpret the five prongs in a manner to avoid artificial or technical exclusions from fiduciary status.

With regard to the "primary basis" component, the DOL indicated that the rollover recommendation does not have to be *"the"* primary basis for the recommendation, so long as it was *"a"* primary basis.

With respect to the condition that the arrangement reflect the "mutual agreement or understanding of the parties that the advice be a primary basis for the investment decision," this determination would be based upon the "reasonable" understanding of the parties. As a contractual matter, specific language indicating that there was no mutual agreement or understanding of the parties would be permissible and would be given some effect, but would not be determinative.

With regard to the "regular basis" prong of the Five-Part Test, the DOL indicated that "regularly" would be read broadly. Thus, a preexisting relationship with a plan participant can be taken into account, as well as a potential future relationship of which the rollover into an IRA is simply the first step. This interpretation may require investment advisers to reconsider their relationships with unrelated outside solicitors. In other words, the DOL may view a one-time recommendation by an outside solicitor for a registered investment adviser as advice provided on a "regular basis" if that rollover recommendation was the first step in a future, ongoing relationship with the investment adviser managing the IRA assets of the participant.

Taken together, the text in the preamble to the Proposed Exemption indicated that it would be more difficult for a party providing a rollover recommendation to successfully maintain the position that he or she was not acting as a fiduciary.

Key Terms and Exclusions Under the Proposed Exemption

The Proposed Exemption provides relief from the prohibition transaction provisions of ERISA and the sanctions imposed by the Code if "Financial Institutions" and "Investment Professionals" provide fiduciary investment advice in accordance with its prescribed conditions. Consequently, they will be permitted to receive a wide variety of variable compensation structures that would otherwise violate the prohibited transaction rules (e.g., commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs, and revenue sharing payments from investment providers or third parties).

Key Terms

The Proposed Exemption provides relief under ERISA and the Code, and is initially available to: (1) "Financial Institutions" defined as banks, insurance companies, investment advisers, and broker dealers (with the potential for adding additional entities to the list based upon individual prohibited transaction exemptions); and (2) their employees, agents, and representatives ("Investment Professionals") who provide fiduciary investment advice to plan participants and beneficiaries, IRA owners, and fiduciaries of plans or IRAs ("Retirement Investors"). The preamble to the Proposed Exemption indicated that advice to a plan is deemed to be advice to a plan participant as well, a point worth noting as to its potential consequences. For this purpose, IRAs are not restricted to traditional and Roth IRAs, but also include health savings accounts, Archer Medical Savings Accounts, and Coverdell Education Savings Accounts.

Note that a Retirement Investor would not be able to waive the conditions of the exemption (described below) and would not have a private right of enforcement.

Exclusions

The exemptive relief is unavailable if: (i) the plan is covered by Title I of ERISA and the Financial Institution or Investment Professional is the employer or a named fiduciary or plan administrator selected to provide advice to the plan that was selected by a fiduciary that is not independent of the Financial Institution or Investment Professional; (ii) the advisor is a robo-advisor; or (iii) the transaction involves the Investment Professional acting in a fiduciary capacity other than as an investment advice fiduciary.

Conditions of the Proposed Exemption

Impartial Conduct Standards

The Impartial Conduct Standards consist of (i) a best interest standard, (ii) a reasonable compensation standard, and (iii) the requirement to make no materially misleading statements about recommended investment transactions and other relevant matters.

The "Best Interest of Retirement Investor" is defined as advice that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like manner 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 tolerances, financial circumstances and needs of the Retirement Investor, and does not place the financial or other interests 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. One of the objectives of the Proposed Exemption is "regulatory efficiencies," and a broker-dealer who satisfied the Regulation BI best interest standard should also satisfy the Proposed Exemption best interest standard.

Disclosure

Before engaging in the transaction, the Financial Institution must provide the Retirement Investor with a written acknowledgment that the Financial Institution and the Investment Professionals are fiduciaries under the Code and ERISA, as applicable, with respect to any fiduciary investment advice they provide, and a written description of the services they will be providing and their material conflicts of interest that is accurate and not misleading in any material respect.

Policies and Procedures

The Financial Institution must establish, maintain, and enforce written policies and procedures prudently designed to ensure that the Financial Institution and its Investment Professionals comply with the Impartial Conduct Standards. The policies and procedures should mitigate Conflicts of Interest to the extent that the policies and procedures, and the Financial Institution's incentive practices, when viewed as a whole, are prudently designed to avoid misalignment of the interests of the Financial Institution and Investment Professionals and the interests of Retirement Investors in connection with covered fiduciary advice and transactions.

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 Retirement Investor. A prudent rollover recommendation from an ERISA-covered plan to an IRA would necessarily include the alternatives to a rollover available to the Retirement Investor, including leaving the money in his or her employer's plan, if permitted, and selecting different investment options; the fees and expenses associated with both the plan and the IRA; whether the employer pays some or all of the plan's administrative expenses; and the different levels of services and investments under the plan and the IRA. A rollover from another IRA or changes in account structure from commission-based to fee-based compensation requires the consideration and documentation of services under the new account.

Furthermore, in evaluating a potential rollover from a plan to an IRA, the Financial Institution and Investment Professional should make diligent and prudent efforts to obtain information about the plan and the Retirement Investor's interests in it. If the participant is unwilling or unable to provide this information, then the Investment Professional should nonetheless make a reasonable estimate of expenses, asset values, risks and returns, and disclose those assumptions to the Retirement Investor.

Retrospective Compliance Review

The Financial Institution must conduct a retrospective review, at least annually, for the purpose of detecting and preventing violations. The DOL considered requiring outside auditors, but determined that self-review was a more cost-effective approach. The results of the retrospective review must be provided in a written report to the Financial Institution's chief executive officer and chief compliance officer (or equivalent officers).

The chief executive officer must then certify, no later than six months after the period being reviewed, that the policies and procedures are designed to comply with the conditions of the exemption; that there is a process in place to modify the procedures as business, regulatory, and legislative events dictate; and that there is a way to test, on a periodic basis, the effectiveness of the procedures in ensuring compliance. The certified audit must be retained for a six-year period.

Interpretive Bulletin 96-1 and FAB 2018-02

The Final Rule also reinstated DOL Interpretive Bulletin 96-1, distinguishing investment education from investment advice, which had been removed when it was incorporated into the 2016 Rule.

In connection with the decision to vacate the 2016 Rule, the DOL issued a temporary enforcement policy in the form of Field Assistance Bulleting 2018-02 ("FAB"), which recognized that financial institutions created and implemented compliance structures designed to comply with the Impartial Conduct Standards of the 2016 Rule, which we previously discussed here. The preamble to the Proposed Exemption indicated that the FAB "remains in place," but the DOL does not regard this policy as permanent.

We will be issuing more comprehensive Alerts on the specific components of the Proposed Exemption. In the interim, please let us know if we may of assistance.

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