Do You Have Questions About How to Comply with the New DOL fiduciary "Investment Advice" Prohibited Transaction Exemption?

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On December 15, 2020, the Department of Labor (DOL) issued class exemption 2020-02 (the PTE or Exemption) which provides conditional relief to fiduciaries who render investment advice to employee benefit plans, plan participants, and owners of individual retirement accounts (IRAs) from the prohibited transaction rules under Title I of ERISA and the Internal Revenue Code. The PTE is designed to replace the class exemptions issued with the DOL's 2016 fiduciary rule, which, along with the rule itself, were invalidated in 2018 by the Fifth Circuit Court of Appeals.

In July 2020, the DOL had issued this PTE as a proposal in conjunction with officially vacating the DOL's 2016 fiduciary rule nationwide and reinstating the DOL's 1975 fiduciary rule (commonly known as the five-part definition of fiduciary or "five-part test"). In addition to providing exemptive relief, this final publication of the PTE in its preamble adopts and amplifies the guidance in the proposed PTE on the five-part test for determining who is a fiduciary. We will discuss the implications for the five-part test in more detail at another time, but briefly, if an individual or entity that is a fiduciary under the five-part test renders investment advice to a plan or plan participant, and receives direct or indirect compensation, that person or entity is considered to be a fiduciary to whom the exemption is addressed.

The final PTE follows the proposed PTE but makes some changes, primarily to the disclosure and recordkeeping requirements. In general, the PTE's emphasis is on transactions for which the fiduciary's compensation varies based on the investment advice or is received from third parties, and on transactional fees received in conjunction with the advice. On the other hand, the PTE preamble's emphasis is on the DOL's new understanding of the five-part test, particularly as that definition is applied to advice on a participant's asset rollover from a qualified plan to an IRA.

Reading PTE 2020-02 together with the new interpretations of the five-part test, an organized approach unfolds. All seem to agree that more advisers are now deemed to be fiduciaries. Except in the rollover context, assuming most advisers are fiduciaries, as we explain below, the PTE then assumes that most investment advice is at least potentially conflicted, but provides disclosure, self-monitoring and mitigation rules for advice fiduciaries and their financial institutions. This system in effect passes the responsibility to the investing plan or plan participant to determine whether the disclosed and mitigated potential conflict does or does not create an incentive for the advice fiduciary, whether an individual or an institution, to place its own interest ahead of the interest of the investor.

Compliance

Currently, the final PTE will be in effect on February 16, 2021, 60 days after the date of publication. On January 20th, the Biden Administration instructed its acting or designated agency heads to consider postponing such effective date for 60 days for the purpose of reviewing any questions of fact, law, and policy the rule may raise.

The agencies are further encouraged to consider, where appropriate, opening a 30-day comment period to allow interested parties to provide comments or petitions for reconsideration involving such rules, or to consider further delaying, or publishing for notice and comment proposed rules further delaying such rules beyond the 60-day period.

The Department of Labor has not yet announced whether PTE 2020-02 will be among those rules with a future effective date that will be under review, and there is no indication whether Congress will use the Congressional Review Act to exercise its discretion to review the last 60 days of rules issued during the previous Congress, or to disapprove of a federal agency's final rule by introducing a special joint resolution.

Assuming at least one of these actions might occur with PTE 2020-02, calling into question its continued validity, the DOL has provided alternatives:

1. The DOL PTE Fact Sheet announces that financial institutions that created and implemented compliance structures designed to ensure satisfaction of the Impartial Conduct Standards under the exemptions issued in 2016 will be able to continue those approaches under the new prohibited transaction class exemption.

2. The PTE preamble also provides that until December 18, 2021, fiduciaries will be able to continue relying on the DOL nonenforcement policy in FAB 2018-02 which provides that the DOL will not pursue prohibited transactions claims against investment advice fiduciaries who work diligently and in good faith to comply with "Impartial Conduct Standards" for transactions that would have been exempted in the now invalidated 2016 exemptions. According to the PTE preamble, the Impartial Conduct Standards' three components — a best interest standard, a reasonable compensation standard, and a bar on misleading statements to plan investors about investment transactions — are similar to the requirements in the PTE. We understand that the IRS will follow a similar nonenforcement policy, but the non-enforcement policy does not prevent actions by private parties.

3. There is a special grace period in the PTE preamble for advice relating to IRA rollovers and for fiduciaries who relied on the DOL's prior guidance on rollovers taken before the PTE was proposed in July 2020. The preamble of the proposed PTE explicitly overruled an earlier DOL advisory opinion (the Deseret Letter) which held that certain rollover advice was not a fiduciary function. The final PTE preamble states that, "the Department will not pursue claims for breach of fiduciary duty or prohibited transactions against any party, or treat any party as violating the applicable prohibited transaction rules, for the period between 2005, when the Deseret Letter was issued, and [the PTE's effective date], based on a rollover recommendation that would have been considered non-fiduciary conduct under the reasoning in the Deseret Letter."

4. According to the final PTE preamble, fiduciaries may also rely on the new DOL interpretive guidance on the five-part test for who is a fiduciary under the 1975 regulation. The preamble to the proposed PTE, as adopted and clarified in the preamble to the final PTE, provides new articulations of several elements of the test for when a person is a fiduciary rendering investment advice, i.e., the advice: 1. is as to the value of, or a recommendation for purchasing or selling, securities or other property, 2. is on a regular basis, 3. is pursuant to a mutual agreement, arrangement, or understanding with a plan, plan fiduciary, or IRA owner, 4. will serve as a primary basis for investment decisions with respect to Plan or IRA assets, and 5. is individualized based on the particular needs of the Plan or IRA.

At this time, we understand that fiduciaries and fiduciary institutions may not necessarily want to begin to adjust their systems to follow the requirements of the new PTE, given the time, expense and overhanging uncertainty. The DOL or Congress will likely give themselves at least 60 days to reconsider both the substance of the PTE and its interpretation of the definition of fiduciary, and there may be questions on the last administration's position that its PTE and its reinterpretation of the five-part fiduciary test had to be consistent with the 2018 judicial decision.

It is also possible there will be review of all of the steps taken by the DOL since the 5th Circuit ruling in 2018, including the DOL's 2020 republication of the 1975 fiduciary rule. For instance, there was much discussion in 2018 as to whether the 5th Circuit's ruling automatically applied nationwide, or, if not, whether DOL appropriately decided to apply the 5th Circuit decision nationwide. And we expect to see some public debate, at least, on whether the DOL took the proper steps under the Administrative Procedure Act (APA) to rescind the 2016 fiduciary rule, when, in July 2020, it took what it described as a "ministerial action," instructing the Federal Register, as a "technical amendment," to remove the 2016 fiduciary rule from the Code of Federal Regulations (CFR) and reinsert the 1975 fiduciary rule. However, it appears that the DOL (and hopefully courts as well) will be understanding when it comes to enforcement if a fiduciary follows any reasonable interpretation of the current or past DOL guidance. And, assuming that the PTE and its preambles could remain intact, either in whole or in part, here is a description for purposes of current compliance.

Summary of the Exemption

The PTE defines investment advice fiduciaries as both individual fiduciaries who are "investment professionals" and as "financial institutions"— entities like registered investment advisers and registered broker-dealers that employ investment professionals. In this Alert, we generally refer to the two together as "advice fiduciaries," although many of the conditions of the PTE are, for compliance purposes, the responsibility of the financial institutions. The PTE provides conditions under which advice fiduciaries may receive reasonable compensation for fiduciary advice and related transactions from "Retirement Investors", defined as plan or IRA fiduciaries, participants in self-directed plans, and beneficial owners of IRAs (referred to here as "investors"), including advice to roll over assets to an IRA, another plan, or a different type of account, and other incidental services, even when there is a conflict of interest involved in the transaction or service which would otherwise be a prohibited transaction.

Who Is a fiduciary

In order to apply the PTE, the preambles apply the newly republished 1975 five-part test (29 C.F.R. 2510.3-21(c)(1)) to determine who is a fiduciary, with additional interpretation of the applicable facts and circumstances. To determine which advisers are fiduciaries, the preambles emphasize that the investment advice need only be a primary basis, but need not be the primary basis for an investment decision, and suggests that, in addition to being part of an existing regular ongoing relationship, the advice may be assumed to be the beginning of and in anticipation of an ongoing regular fiduciary advice relationship. The preambles further note that the requirement for mutual understanding is appropriately based on the reasonable understanding of each of the parties, if no mutual agreement or arrangement is demonstrated. The preambles also note that written statements disclaiming a mutual understanding or forbidding reliance on the advice as a primary basis for investment decisions are not determinative, although such statements are appropriately considered in determining whether a mutual understanding exists. The final preamble also states that the DOL "...intends to consider marketing materials in which Financial Institutions and Investment Professionals hold themselves out as trusted advisers, in evaluating the parties' reasonable understandings with respect to the relationship."

The PTE preamble, except perhaps in the IRA rollover context, appears to have a broad interpretation of the definition of who is a fiduciary. There is an indication that DOL will consider that exercising discretion on available investment products on a platform is investment advice with a potential for conflicts, and perhaps even that a bundled service provider may share advice fiduciary status with affiliates and subcontractors.

Special Treatment for IRA Rollover Recommendations

The DOL appears to limit the definition of fiduciary for purposes of one type of rollover — from a qualified plan to an IRA. Although the particularized guidance is for these rollovers, it is not clear whether the preamble interpretation is designed to cover investment advice in general, thus altering the general rules for all advice stated elsewhere in the preamble. In the meantime, although the future status of this guidance is unknown, it may currently be of some use, at least for these rollovers. An unanswered question that will be of more importance to the IRA owner is how to enforce the terms of the PTE. In the event of an alleged fiduciary breach, may the IRA owner, as a former plan participant, still sue the advice fiduciary or financial institution? It appears the IRA owner would have to allege, and prove, that the rollover adviser is, or was at the time of the rollover advice, an advice fiduciary under Title I of ERISA. If unsuccessful, the PTE preamble states that the PTE does not create an additional private right of action, and that the sole remedy is the Code's excise tax.

- *Where There is No Pre-existing Relationship*

  If the rollover advice is not part of an ongoing relationship, it would appear easier for an adviser to avoid fiduciary status than in other circumstances. The preamble states that ". . .Rollover advice to take a distribution from a workplace retirement plan and roll over the assets to an IRA may be an isolated and independent transaction that would fail to meet the 'regular basis' prong of the five-part test. "While the application of this prong is, in general, a "facts and circumstances" test, with rollovers, the DOL PTE Fact Sheet is apparently unequivocal: "The Department acknowledges that a single instance of advice to take a distribution from a Title I Plan and roll over the assets would fail to meet the regular basis prong such that the adviser would not be considered a fiduciary for the advice and transactions involved."

  Despite the adherence to the general principle that the relationship between the adviser and a plan participant after the participant leaves a plan may be used to satisfy the "regular basis" requirement with respect to IRA rollovers from qualified plans, the DOL provides a different spin – "... sporadic interactions...are generally insufficient..." to create fiduciary status. The PTE preamble unequivocally states that a single instance of advice to take a distribution from a Title I plan and roll over the assets would fail to meet the "regular basis" prong, even if, "the investor subsequently sought the professional's advice in connection with another transaction long after receiving the rollover assistance."

- *Disclaimers*

  Also, according to the PTE preamble and the DOL Fact Sheet, an adviser making a rollover recommendation may disclaim fiduciary status unequivocally even though, in general, disclaimers about fiduciary status are not necessarily determinative. In the rollover context, the preamble states that ". . . Additionally, parties can make clear in their communications that they do not intend to enter into an ongoing relationship to provide investment advice, and avoid fiduciary status, if they act in conformity with that communication. . ."

General PTE Provisions

The PTE requires the advice fiduciaries to comply with impartial conduct standards, including a best interest standard. Under the PTE, investment advice must be, at the time it is provided, in the best interest of the retirement investor. Such advice:

1. 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 objectives, risk tolerance, financial circumstances, and needs of the retirement investor, and

2. does not place the financial or other interests of the advice fiduciary, or any affiliate, related entity, or other party ahead of the interests of the investor or subordinate the investor's interests to their own.

The PTE further requires that the compensation received, directly or indirectly, for both the advice and for all related transactions, does not exceed reasonable compensation within the meaning of ERISA and the Code, and, as required by the federal securities law, the advice fiduciary seeks to obtain the best execution of the investment transaction reasonably available under the circumstances.

The PTE includes conditions designed to support compliance with the impartial conduct standards:

- Advice fiduciaries must make certain disclosures to retirement investors in advance of interaction, including a written acknowledgment that the advice fiduciary is a fiduciary as well as a written description of the services to be provided and any material conflicts of interest.
- The advice fiduciary must provide prior documentation of the specific reasons why a rollover recommendation is in the best interest of the investor, whether the transfer is plan to plan, plan to IRA, or from one type of account to another(g., commission-based to fee-based account).
- Advice fiduciaries must not make any statements about recommended investment transactions and other relevant matters that are materially misleading at the time they are made. An example given as misleading is to include any exculpatory clauses or indemnification provisions in an agreement with a retirement investor that are precluded by applicable law.
- The advice fiduciaries must maintain written policies and procedures for compliance with the impartial conduct standards, including having policies that ". . . mitigate Conflicts of Interest to the extent that a reasonable person reviewing the policies and procedures and incentive practices as a whole would conclude that they do not create an incentive for the [advice fiduciaries] to place their interests ahead of the Retirement Investor."
- The advice fiduciaries must conduct, and report on, an annual retrospective review designed to detect any violations of the impartial conduct standards or of the advice fiduciaries' own policies and procedures. A responsible fiduciary must certify the report within six months. The report and certification and supporting data must be held for six years and made available to the DOL within ten days' notice of a request. The advice fiduciary is also required to maintain for six years records generally demonstrating compliance to be available to authorized employees of the DOL and the Department of the Treasury.
- There is a conditional bar on using the PTE by persons and entities who have engaged in criminal conduct or other egregious conduct regarding compliance with the exemption.

The Exemption covers:

- certain riskless "principal transactions" in which an advice fiduciary sells or purchases certain securities and other investments from their own inventories to or from plans and IRAs, and conditionally, certain other principal transactions.
- certain advice by insurance companies that sell insurance products and fixed (including indexed) annuities through their employees as well as independent agents.
- advice involving an Archer medical savings account, a health savings account, or a Coverdell education savings account (except for rollover advice).

Exclusions from Use of the Exemption:

- The exemption is not available for plans for which the advice fiduciary, or an affiliate, is (a) the employer of employees covered by the plan or (b) a named fiduciary or plan administrator selected by a fiduciary that is not independent of the investment advice fiduciary.

- Nor is it available for investment advice that is generated solely by an interactive website in which computer models or applications provide investment advice based on information supplied by the investor, unless the computer-generated advice is in connection with additional personal interaction with an investment professional (i.e., robo advice).
- Discretionary fiduciary investment arrangements.

The Final Exemption Generally Follows the Proposed Exemption with the Following Exceptions:

- Adds a self-correction program for non-exempt prohibited transactions due to a violation of the PTE's conditions with respect to a transaction. The PTE provides that there is no prohibited transaction if, among other conditions, there is no investment loss, or the investor is made whole, and the advice fiduciary corrects the violation within 90 days and notifies the DOL within 30 days of the correction.
- Adds a requirement that, prior to engaging in any of the types of rollovers described in the PTE recommended pursuant to the exemption, the fiduciary provide in advance a specific written explanation to the investor for its recommendations relating to the rollover.
- Streamlines the required retrospective annual report delivery to just one plan functionary before certification and transmittal to the DOL.
- Removes a requirement that the advice fiduciary make the fiduciary's annual reports available to plans and participants, and also limits access to the advice fiduciaries' compliance data to only authorized employees of the DOL and the Treasury Department.
- Adds definitions for important terms such as "independent," "affiliate," "related entity."
- Rewrites the mitigation policy requirement concerning "misalignment of interests" between adviser and investor to provide a reasonable person standard to evaluate whether the adviser or institution has placed their interest ahead of the interest of the investor.

Conflicts of Interest

The PTE has a broad and subjective definition of "conflict of interest," i.e., "....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." The purpose seems to be to encourage advice fiduciaries to assume there might be conflicts of interest, and therefore a need for mitigation, for any possible interest, especially for every IRA rollover, plan to plan transfer or transfer to a different type of compensation scheme, and likely as well, for any type of variable compensation, revenue sharing or other indirect compensation, use of proprietary products, use of limited investment product options, and transactional costs related to the advice.

However, the PTE preamble explains, such apparently conflicted advice and transactions are not per se prohibited. The PTE puts the burden on the advice fiduciary to identify and mitigate any possible conflict of interest. As we have described, the mitigation appears to be largely a matter of self-policing — disclosure, written policies, monitoring by the advice fiduciary institution of both advice and related transactions, written justification for some specific conflicts of interest, retrospective certifications as to compliance by the financial institution, and recordkeeping.

Conclusion

The PTE appears to suggest that it is safest to assume that the five-part test sweeps in most investment advisers, and to assume that all investment advice is potentially imprudent, disloyal, a prohibited transaction, or otherwise problematic. But the PTE in effect passes the responsibility to the investor, whether a plan, plan participant, or IRA owner, to understand, and determine, under the reasonable person standard in the PTE, whether the disclosed potential conflict does or does not create an incentive for the advice fiduciary, either individual or institution, to place its interest ahead of the interest of the investor.

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