DOL's New Fiduciary Regulation and Exemptions

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BACKGROUND – STATUTE

ERISA § 3(21)(A) – Who is a Fiduciary?

A person who "renders investment advice for a fee or other compensation, direct or indirect, with respect to ERISA-covered assets, or has any authority or responsibility to do so," is a fiduciary.

ERISA § 406 – Why does it Matter for Investment Professionals?

An investment advice fiduciary's receipt of compensation in connection with a transaction involving a plan is a prohibited transaction unless otherwise exempt.

BACKGROUND – REGULATION

1975 Test for Investment Advice Fiduciary (the "Five Part Test"):

Regulation previously defined investment advice fiduciary by a five part test limiting an investment-advice fiduciary to one who:

(1) "renders advice…or makes recommendation[s] 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…between such person and the plan;"
(4) the advice "serve[s] as a primary basis for investment decisions with respect to plan assets;" and
(5) the advice is "individualized . . . based on the particular needs of the plan."

BACKGROUND - 2016 RULE

In 2016 DOL promulgated a new rule to replace the 1975 rule as well as prohibited transaction class exemptions (the “2016 Fiduciary Rule”)

- challenged unsuccessfully in District of Columbia.
- challenged in part unsuccessfully in Tenth Circuit
- challenged **successfully** in Fifth Circuit and vacated Chamber of Commerce v. U.S. DOL, 885 F.3d 360 (5^{th} Cir. 2018).

Rather than appeal Fifth Circuit decision, DOL went back to the drawing board.

2024 INVESTMENT ADVICE FIDUCIARY RULE PACKAGE

April 25, 2024 - DOL published fiduciary investment advice rule and amended prohibited transaction class exemptions (PTCEs):

- Definition of "Investment Advice Fiduciary" – 29 CFR § 2510-3(21)(c)
- PTCE 2020-02 - exemptive relief for eligible investment advice fiduciaries
- PTCE 84-24 - exemptive relief for certain transactions involving insurance agents and brokers, pension consultants, insurance companies and investment company principal underwriters "Retirement Security Rule"
- PTCEs 77-4, 75-1, 80-83, 83-1 and 86-128 exemptive relief for other types of transactions

2024 INVESTMENT ADVICE FIDUCIARY RULE – DOL RATIONALE

DOL argues 1975 definition is outdated because employee benefit world has changed:

- 1975
  - Most retirement savings held in defined benefit plans
  - Small amount of retirement savings managed by individual retirement investors
- Today
  - Most retirement savings held in defined contribution plans such as 401(k)s or as roll over amounts from those plans in Individual Retirement Accounts (IRAs).
  - Most retirement savings managed by individuals

2024 INVESTMENT ADVICE FIDUCIARY RULE – DOL RATIONALE

DOL believes 1975 definition is outdated resulting in participants being harmed without recourse:

- Individual retirement savers lose billions of dollars in retirement savings because of the conflicted investment advice they receive
- 1975 definition of an investment advisor fiduciary is too restrictive to protect them.

2024 INVESTMENT ADVICE FIDUCIARY DEFINITION – TWO TESTS:

(a) The person/fiduciary directly or indirectly (e.g. through or with any affiliate) makes professional recommendations to investors on a regular basis as part of their business and the particular recommendation at issue is made under circumstances that would indicate to a reasonable investor in like circumstances that the recommendation:

i. Is based on a review of the retirement investor's needs or individual circumstances,
ii. Reflects the application of professional judgment to those needs or circumstances, and
iii. May be relied on by the retirement investor as intended to advance the retirement investor's best interest.

or

(b) The person/fiduciary represents or acknowledges that they are acting as a fiduciary with respect to the recommendation.

2024 INVESTMENT ADVICE FIDUCIARY RULE
DEFINITION OF A "RECOMMENDATION"

Includes recommendations as to:

(i) The advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, investment strategy, or how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA;

(ii) The management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (*e.g.*, account types such as brokerage versus advisory) or voting of proxies appurtenant to securities; and

(iii) Rolling over, transferring, or distributing assets from a plan or IRA, including recommendations as to whether to engage in the transaction, the amount, the form, and the destination of such a rollover, transfer, or distribution.

2024 INVESTMENT ADVICE FIDUCIARY RULE DEFNITION OF FEES OR OTHER COMPENSATION

[A]ny explicit fee or compensation, from any source, for the investment advice or the person (or any affiliate) receives any other fee or other compensation, from any source, in connection with or as a result of the recommended purchase, sale, or holding of a security or other investment property or the provision of investment advice, including, though not limited to, commissions, loads, finder's fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, mark ups or mark downs, underwriting compensation, payments to brokerage firms in return for shelf space, recruitment compensation paid in connection with transfers of accounts to a registered representative's new broker-dealer firm, expense reimbursements, gifts and gratuities, or other non-cash compensation

2024 INVESTMENT ADVICE FIDUCIARY RULE ADDITIONAL NOTES:

- Written disclaimers of fiduciary status will not control to the extent they are inconsistent with oral or written communications or other interactions with a retirement investor.

- Investment property” excludes “health insurance policies, disability insurance policies, term life insurance policies, or other property to the extent the policies or property do not contain an investment component.”

- “Retirement investor” includes

  - Plans and Plan Fiduciaries,
  - Participant or beneficiary,
  - IRA,
  - IRA owner or beneficiary or Fiduciary

- “Relative” defined to include (in the definition of “affiliate”) all of the relatives found at ERISA § 3(15) plus a fiduciary’s siblings and spouses of siblings (but not a sibling’s lineal descendants).

AMENDED EXEMPTION – PTCE 2020-02

PTCE 2020-02

Permits Financial Institutions and Investment Professionals, and their Affiliates and Related Entities, to engage in the following transactions, including as part of a rollover from a Plan to an IRA as defined in Code section 4975(e)(1)(B) or (C), as a result of the provision of investment advice within the meaning of ERISA section 3(21)(A)(ii) and Code section 4975(e)(3)(B):

(1) The receipt of reasonable compensation; and

(2) The purchase or sale of an asset in a riskless principal transaction or a Covered Principal Transaction, and the receipt of a mark-up, mark-down, or other payment.

PTCE 2020-02 (cont.)

DOL's goal is to create a "catch-all" provision establishing a common set of exemptive standards for all investment advice fiduciaries:

> To ensure that there is a common standard that Retirement Investors can rely on for all products and for all tax-advantaged retirement accounts, the Department is broadening this exemption to make it available for recommendations of all types of products by all fiduciary investment advice providers as defined in ERISA, the Code, and the final Regulation that the Department is issuing today.

PTCE 2020-02 does this by

- Expanding the type of providers who can utilize 2020-02 (includes pooled plan providers and robo-advisers).
- Making exemption applicable to all transactions as to which an investment advice fiduciary provides investment advice, including transactions that are executed on a principal or agent basis.

PTCE 2020-02 (cont.)

Exemption now requires covered individuals and entities to:

- Acknowledge their fiduciary status in writing to Retirement Investors;
- Disclose their services and material conflicts of interest to Retirement Investors;
- Adhere to Impartial Conduct Standards requiring them to:
  - Investigate and evaluate investments, provide advice, and exercise sound judgment in the same way that knowledgeable and impartial professionals would in similar circumstances (the Care Obligation);
  - Never place their own interests ahead of the Retirement Investor's interest, or subordinate the Retirement Investor's interests to their own (the Loyalty Obligation);
  - Charge no more than reasonable compensation and, if applicable, comply with Federal securities laws regarding "best execution"; and
  - Avoid making misleading statements about investment transactions and other relevant matters;

PTCE 2020-02 (cont.)

Exemption also now requires covered individuals and entities to:

- Adopt firm-level policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards and mitigate conflicts of interest that could otherwise cause violations of those standards;

- Document and disclose the specific reasons for any rollover recommendations; and

- Conduct an annual retrospective compliance review.

PTCE 2020-02 (cont.)

Impartial Conduct Standards:

DOL had originally proposed a "best interest standard" applicable to all covered transactions. Replaced that stand with an "impartial conduct standard" made up of a "Care Obligation" and a "Loyalty Obligation".

Care Obligation:

Advice meets the "Care Obligation" if, with respect to the Retirement Investor, such 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.

PTCE 2020-02 (cont.)

Loyalty Obligation:

Advice meets the "Loyalty Obligation" if, with respect to the Retirement Investor, such advice 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 those of the Investment Professional, Financial Institution or any Affiliate, Related Entity, or other party

PTCE 2020-02 (cont.)

Pre-Transaction Written Disclosures include:

- Acknowledgment of fiduciary status,
- Statement of the Care and Loyalty Obligations
- "All material facts" relating to the scope and terms of the relationship with the Retirement Investor such as:
  - Fees,
  - Costs,
  - Type of services provided to the Retirement Investor (including any material limitations)
- Conflicts of Interest associated with the recommendation.
- "Rollover disclosures" (where appropriate) including
  - available alternatives (such as leaving money in the Plan),
  - fees and expenses,
  - Identity of pays the Plan's administrative expenses.

PTCE 2020-02 (cont.)

Policies and Procedures:

Financial Institution must establish, maintain and enforce written policies and procedures designed to

- Ensure compliance with the Impartial Conduct Standards and
- Mitigate conflicts of interest

Financial Institutions may not use quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other similar actions or incentives in a manner that is intended, or that a reasonable person would conclude are likely, to result in recommendations that do not meet the Care Obligation or Loyalty Obligation.

PTCE 2020-02 (cont.)

Annual "Retrospective Review" and Report

Financial Institution must conduct, at least annually, a retrospective review designed to detect and prevent violations of the exemption.

Retrospective review must result in

- a written report that is provided to, reviewed and certified by a Senior Executive Officer, and
- other specified activities where appropriate (such as filing a Form 5330 reporting any non-exempt prohibited transactions discovered in the process).

PTCE 2020-02 (cont.)

“Self-Correction”

Exemption provides for “Self-Correction” where:

- Violation did not result in investment losses OR Financial Institution made the Retirement Investor whole,
- Financial Institution corrected violation no later than 90 days after learning of the violation or after it reasonably should have learned of the violation, and
- Financial Institution timely notifies retrospective reviewers AND violation and correction are set forth in retrospective review written report.

PTCE 2020-02 (cont.)

Disqualification Provision Broadened

Similar to recent amendments to PTCE 84-14 for “qualified professional asset managers” (QPAMs), PTCE 2020-02 also broadens the disqualification provisions to include convictions of certain affiliated entities and foreign convictions.

Phase-In Period:

Although amended PTCE 2020-02 becomes effective September 23, 2024. it provides a one year “Phase-In Period” providing relief for transactions that comply with both the Impartial Conduct Standards and the fiduciary acknowledgement requirement.

PTCE 84-24

Highlights:

- Tailored to investment recommendations by independent insurance agents who recommend annuities issued by more than one insurance company.
- Conditions similar to those in PTE 2020-02.
- Independent insurance agent required to
  - acknowledge its fiduciary status,
- Insurance Company whose product is sold required to:
  - Exercise supervisory authority over the independent agent with regard to an agent's recommendation of the insurance company's own products.
  - Not required to acknowledge fiduciary status
  - Not treated as a fiduciary merely because it exercised oversight responsibilities over independent agents.

PTCE 84-24 (cont.)

Notable changes:

- Remove transactions involving proprietary mutual fund recommendations from the ambit of PTCE 84-24 (so that those transactions must now satisfy the provisions of amended PTCE 2020-02 to be exempt).
- Eliminate exemptive relief for recommendations of annuity and insurance products by insurance companies (and their employees)
- Eliminate exemptive relief for recommendations of variable annuities and other insurance products that are considered to be securities.

PTCE 84-24 (cont.)

Allowed Compensation – Consistent With 2020-02

DOL initially proposed to limit an independent producer compensation to an “Insurance Sales Commission” (a term defined in detail in the initial proposal).

Pushback:

- Proposal was inconsistent with NAIC Model Regulations,
- Proposal would reduce investor choice,
- Proposal would create an unlevel playing field where those who sold other products could be compensated in ways that independent insurance agents could not.

As a result, DOL expanded the scope of allowable compensation to be consistent with that permitted by PTCE 2020-02.

PTCE 84-24 (cont.)

New conditions - Written disclosures to be provided at or prior to any covered transaction that include:

(a) Acknowledgement that the Independent Producer is a fiduciary;
(b) Statement setting forth the Impartial Conduct Standards (similar to PTCE 2020-02);
(c) All material facts about the scope and terms of the relationship with the retirement investor including (i) fees and costs that apply to the retirement investor's transactions, holdings and accounts, (ii) notice of a right to additional information regarding cash compensation including the ability to get an estimate of the compensation that will be paid and the terms relating to its payment (e.g., whether it is one-time, or through multiple payments); and (iii) any limits on the recommendations that the Independent Producer could make;
(d) All material facts relating to Conflicts of Interest; and
(e) Documentation demonstrating the basis for the product recommended.

PTCE 84-24 (cont.)

Additional Requirements:

- Rollover disclosures (similar to those in PTCE 2020-02).
- Insurer must establish, maintain and enforce written policies and procedures for the review of each recommendation before an annuity is issued to a Retirement Investor.
- Policies and procedures are to be designed to:
  - Ensure compliance with the Impartial Conduct Standards,
  - Mitigate conflicts of interest,
  - Provide for compliance with other exemption conditions,
  - Determine whether to authorize an Independent Producer to sell the Insurer's annuity contracts to Retirement Investors, and
  - Take action to protect Retirement Investors when there has been a failure to comply with the Impartial Conduct Standards.

PTCE 84-24 (cont.)

Other Requirements for Insurer:

- Must document the bases for its initial determination that it can rely on the Independent Producer to adhere to the Impartial Conduct Standards, and
- Must review reliance determination at least annually as part of the retrospective review required by the exemption.
- With regard to any non-exempt transactions identified by the retrospective review, Insurer is required to direct the Independent Producer to, among other things,

  (a) correct the transaction,
  (b) file a Form 5330, and
  (c) pay any resulting excise taxes.

Like PTCE 2020-02, 84-24 requires the conduct of a retrospective review resulting in a written report provided to, and reviewed and certified by, a Senior Executive Officer of the Insurer.

PTCE 84-24 (cont.)

2024 amendments to 84-24 also (similar to 2020-02):

Broaden the disqualification provisions to include convictions of certain affiliated entities and foreign convictions and

Provide a one year Phase-In Period beginning September 23, 2024 during which the exemption is satisfied if the Independent Producer complies with the Impartial Conduct Standards and fiduciary acknowledgement requirements.

PTCEs 75-1, 77-4, 80-83, 83-1, and 86-128

DOL amended five other exemptions in order to remove relief from those exemptions for certain transactions with the intention that relief relating to compensation for those transactions will now be available under amended PTCE 2020-02 or PTCE 84-24.

PTCE 86-128 was not implemented as proposed, in that it does not eliminate the exclusion from the current exemption conditions of PTCE 86-128 for covered transactions engaged in on behalf of IRAs.

Response to Retirement Security Rule

Legislation introduced in House and Senate under Congressional Review Act

- If enacted, would make Retirement Security Rule null and void
  DOL couldn’t adopt substantially similar legislation in absence of specific legislation authorizing it

One reason that DOL might have rushed to issue final regulations when it did was to avoid having the 60-day period within which Congress can issue a joint resolution under the Congressional Review Act was to avoid the possibility of review by a Republican administration

Political theatre

- Even if the resolution was approved by both houses, it would be vetoed by President Biden

Court Challenges

Two lawsuits challenging the Retirement Security Rule have been brought in District Courts in Texas

- Federation of Americans for Consumer Choice v. DOL, May 2, in Eastern District of Texas
- American Council of Life Insurance v. DOL, May 24, Northern District Texas

Texas District Courts are in the Fifth Circuit, and must follow the Chamber of Commerce precedent

District Courts in other Circuits are not required to follow Chamber of Commerce

DOL advised ABA it is confident it met Fifth Circuit objections

Court Challenges

The Federation of Americans for Consumer Choice has filed a motion for preliminary injunction to prevent the DOL from implementing Retirement Security Rule

- If motion granted, not clear if it would outside of the Fifth Circuit

Plaintiffs are alleging

- 2024 rule conflicts with the text of ERISA
- Unlike the 5-part test, the new criteria adopted by DOL do not capture the essence of a fiduciary relationship under common law
- The Retirement Security Rule impermissibly equates sales commissions with a fee for providing investment advice
- The Retirement Security Rule and PTE 84-24 impermissibly conflate Title I Plans and IRAs

Court Challenges

Major Questions Doctrine applies

- DOL lacks clear Congressional authorization for its assertion of vast new regulatory authority

2024 rule and amended PTE 84-24 are unreasonable

DOL acted arbitrarily and capriciously in amending PTE 84-24

- Supreme Court decisions on Chevron doctrine this term could affect outcome of challenge under Administrative Procedures Act

Court Challenges

American Council of Life Insurance claims

- Retirement Security Rule suffers from same legal defects as 2016 rule
- Exceeds the DOL's authority under federal law
- Arbitrary and capricious

Ignores recently enacted federal (SEC) and state (NAIC) standards for financial professionals

Will limit retirement advice to individuals with fewer assets who cannot afford long-term financial advisors

Likely Outcome?

Practitioners divided on likely outcome

Difficult to predict the outcome of individual case

Many practitioners were surprised by the Fifth Circuit Chamber of Commerce decision

- Was a split 2-1 decision
- Had DC Circuit heard case, likely would have been a Circuit split
- 10th Circuit decision would not have created a sufficient conflict
- DOL could have asked that decision be reviewed en banc, but declined to do so
- DOL could have filed a writ of certiorari with the Supreme Court, but declined to do so

If Trump elected President, one possible scenario is that history will repeat itself

Actions to Take In Interim

There is a cost to complying with an invalidated regulation

That is one of the bases on which a preliminary injunction is being sought in District Court

Decision on preliminary injunction motion will provide early indication

- Can be granted only if plaintiff likely to proceed on the merits

At a minimum, clients should continue to comply with PTE 2020-02


QUESTIONS

APPENDIX - PTCE 2020-02 Model Disclosure for Financial Institutions and Investment Professionals:

DOL model language that will satisfy 2020-02 Section II(b)(1), (2), and (4).

> When we make investment recommendations to you regarding your retirement plan account or individual retirement account, we are fiduciaries within the meaning of Title I of the Employee Retirement Income Security Act and/or the Internal Revenue Code, as applicable, which are laws governing retirement accounts. The way we make money creates some conflicts with your interests, so we operate under a special rule that requires us to act in your best interest and not put our interest ahead of yours. Under this special rule's provisions, we must:
>
> - Meet a professional standard of care when making investment recommendations (give prudent advice);
> - Never put our financial interests ahead of yours when making recommendations (give loyal advice);
> - Avoid misleading statements about conflicts of interest, fees, and investments;
> - Follow policies and procedures designed to ensure that we give advice that is in your best interest;
> - Charge no more than is reasonable for our services; and
> - Give you basic information about conflicts of interest.

APPENDIX - PTCE 84-24 Model Disclosure for Independent Producers:

DOL model language for Independent Producers that will satisfy 84-24 Section VII(b)(1) and (2):

> We are making investment recommendations to you regarding your retirement plan account or individual retirement account as fiduciaries within the meaning of Title I of the Employee Retirement Income Security Act and/or the Internal Revenue Code, as applicable, which are laws governing retirement accounts. The way we make money or otherwise are compensated creates some conflicts with your financial interests, so we operate under a special rule that requires us to act in your best interest and not put our interest ahead of yours.
>
> Under this special rule's provisions, we must:
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> - Meet a professional standard of care when making investment recommendations (give prudent advice) to you;
> - Never put our financial interests ahead of yours when making recommendations (give loyal advice);
> - Avoid misleading statements to you about conflicts of interest, fees, and investments;
> - Follow policies and procedures designed to ensure that we give advice that is in your best interest;
> - Charge you no more than what is reasonable for our services; and
> - Give you basic information about our conflicts of interest.