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The DOL's New Proposal to Regulate Investment Advice

Few aspects of retirement plan governance have been as controversial as regulating investment advice. Exactly what obligation—if any—does an investment professional have to provide impartial, conflict-free advice to savers and retirees? When do financial professionals step over the boundary that can make them a fiduciary, with the ethical and legal obligations that come with this duty?

The answers have been inconsistent, stretching over many years. Department of Labor (DOL) fiduciary investment advice regulations date back to the 1970s. Those regulations needed revision in order to better align with today's investment products and participant-directed retirement plans. Changes were proposed in 2010, withdrawn in response to public comments, revised again in 2015, and made final in 2016.

The DOL delayed implementing the 2016 final investment fiduciary regulations and accompanying guidance. These regulations were ultimately struck down in 2018 as "regulatory overreach" by the United States Court of Appeals for the Fifth Circuit.

The DOL later issued **Field Assistance Bulletin (FAB) 2018-02**, which states that the DOL will not pursue prohibited transaction claims against fiduciaries who make good-faith efforts to comply with the Impartial Conduct Standards (discussed later). FAB 2018-02 remains in effect.

The DOL has again issued investment advice guidance, this time to replace the guidance struck down by the appellate court. This latest guidance package includes a proposed prohibited transaction class exemption entitled **Improving Investment Advice for Workers and Retirees**, and a **technical amendment** to DOL Regulations (Regs.) 2509 and 2510 that implements the appellate court's order by

- reinstating the original version of DOL. Reg. 2510.3-21 (including the five-part test);
- removing prohibited transaction exemptions (PTEs) 2016-01 (the Best Interest Contract Exemption) and 2016-02 (the Class Exemption for Principal Transactions);
- returning PTEs **75-1**, **77-4**, 80-83, 83-1, 84-24, and **86-128** to their original form; and
- reinstating **Interpretive Bulletin (IB) 96-1**, which is intended to help investment providers, financial institutions, and retirement investors determine the difference between investment education and investment advice. Investment providers and financial institutions may rely on the safe harbors in IB-96-1 in order to avoid providing information that could be construed as investment advice.

The technical amendment became effective on July 7, 2020.

What is the five-part test?

The original version of DOL Reg. 2510.3-21 (which the technical amendment reinstates) contains a five-part test that is used to determine fiduciary status for investment advice purposes. Under the test, an investment provider or a financial institution that receives a fee or other compensation is considered a fiduciary if it meets all of the following standards (i.e., prongs) of the test.

- The provider or institution gives advice on investing in, purchasing, or selling securities, or other property.
- The provider or institution gives investment advice to the retirement investor on a regular basis.
- Investment advice is given pursuant to a mutual agreement or understanding with a retirement plan or its fiduciaries.
- The retirement investor uses the advice as a primary basis for investment decisions.
- The provider or institution provides individualized advice, taking into account the plan's demographics, needs, goals, etc.

Has the DOL's opinion changed on rollover recommendations?

In the preamble of the proposed PTE, the DOL clarified that it no longer agrees with the guidance originally provided in **Advisory Opinion 2005-23A** (better known as the Deseret Letter). In the Deseret Letter, the DOL indicated that a recommendation to distribute and roll over retirement plan assets would not generally constitute investment advice because it would not meet the first prong of the five-part test. But because it is common for the investments, fees, and services to change when the decision to roll over assets is made, the DOL now believes that a recommendation to distribute assets from an IRA or an ERISA-covered plan would be considered investment advice with respect to the first prong of the five-part test.

The DOL acknowledges that advice encouraging an individual to roll over retirement plan assets may be an isolated and independent transaction that would fail to meet the second "regular basis" prong. But determining whether advice to roll over assets meets the "regular basis" prong depends on the facts and circumstances. So the DOL could view a rollover recommendation that begins an ongoing advisory relationship as meeting the "regular basis" prong.

As discussed above, the proposed PTE would allow investment professionals to receive compensation for advising a retirement investor to take a distribution from a retirement plan or to roll over the assets to an IRA. The investment professional could also receive compensation for providing advice on other similar transactions, such as conducting rollovers between different retirement plans, between different IRAs, or between different types of accounts (e.g., from a commission-based account to a fee-based account).

Under the proposed PTE, financial institutions would need to document why the rollover advice was in the retirement investor's best interest. Documentation would need to

- explain whether there were other alternatives available (e.g., to leave the assets in the plan or IRA and select different investment options);
- describe any applicable fees and expenses;
- indicate whether the employer paid for some or all of the plan's administrative expenses; and
- show the different levels of services and investments available.

In addition, investment providers or financial institutions that recommend rolling over assets from another IRA or changing account types should consider and document the services that would be provided under the new arrangement.

Who is covered under the proposed PTE?

The proposed PTE would apply to registered investment advisers, broker-dealers, banks, and insurance companies (financial institutions), and their employees, agents, and representatives (investment professionals) that provide fiduciary investment advice to retirement investors. The proposed PTE would also apply to any affiliates or related entitites.

"Retirement investors" include

- IRA and plan fiduciaries (regardless of plan size),
- IRA owners or beneficiaries, and
- plan participants or beneficiaries with authority to direct their accounts or take distributions.

The proposed PTE defines a “plan” as including 401(a) plans (e.g., 401(k) plans), 403(a) plans, 403(b) plans, defined benefit plans, owner-only plans, simplified employee pension (SEP) plans, and savings incentive match plan for employees of small employers (SIMPLE) plans. The proposed PTE would also apply to employee welfare benefit plans that have established a trust (e.g., VEBAs).

The proposed PTE, defines an “IRA” as an individual retirement account, an individual retirement annuity, a health savings account (HSA), an Archer medical savings account (MSA), and a Coverdell education savings account (ESA).

What protection does the proposed PTE offer?

The Internal Revenue Code and ERISA generally prohibit fiduciaries from receiving compensation from third parties and compensation that varies based on investment advice provided to retirement plans and IRAs. Fiduciaries are also prohibited from selling or purchasing their own products to retirement plans and IRAs (known as principal transactions).

Under the proposed PTE, financial institutions and investment professionals providing fiduciary investment advice could receive payments (e.g., commissions, 12b-1 fees, and revenue sharing payments) that would otherwise violate the prohibited transaction rules mentioned above. For example, the exemption would provide relief from prohibited transactions that could occur if a financial institution or investment professional

- advises a client to take a distribution or roll over assets to an IRA or retirement plan;
- provides recommendations to acquire, hold, dispose of, or exchange securities or other investments; or
- recommends using a particular investment manager or investment advice provider.

In addition, the proposed PTE would cover riskless principal transactions (e.g., when a broker-dealer purchases a security for their own account knowing that it will be sold to a retirement investor at a certain price) as well as principal transactions involving certain specific types of investments (e.g., municipal bonds).

The following transactions would not be covered by the PTE.

- Transactions where advice is provided solely through a computer model without any personal interaction (i.e., robo-advice arrangements).
- Transactions in which the investment professional is acting in a fiduciary capacity other than as an investment advice fiduciary under the five-part test, as described below (e.g., a 3(38) investment manager with authority to make discretionary investment decisions).
- Transactions involving investment providers, financial institutions, and their affiliates if they are the employer of employees covered by the plan; or are a named fiduciary, plan administrator, or affiliate who was chosen to provide advice by a fiduciary who is not independent of the investment professional, financial institution, or their affiliates.

Certain individuals and institutions (and all members within the institution’s controlled group) would be ineligible to rely on the exemption—including those who have been convicted of a crime associated with providing investment advice to a retirement investor, or those who have a history of failing to comply with the exemption. The period of ineligibility would generally be 10 years, but a financial institution with a conviction may petition the DOL for continued reliance on the exemption.

What does the proposed PTE require?

To take advantage of the relief provided under the proposed PTE, investment professionals and financial institutions must provide advice in accordance with the Impartial Conduct Standards. The Impartial Conduct Standards contain three components—a reasonable compensation standard, a best interest standard, and a requirement that prohibits investment providers or financial institutions from giving misleading statements about investment transactions or other related matters. The Impartial Conduct Standards also requires financial professionals and financial institutions to provide the best execution possible when completing security transactions (e.g., completing the transaction timely).

Under the best interest standard, investment professionals and financial institutions are not required to identify the best investment for the retirement investor, but any investment advice given must put the retirement investor’s interests ahead of the interests of the investment professional, financial institution, or their affiliates. This is consistent with the SEC’s **Regulation Best Interest**.

Investment providers and financial institutions cannot waive or disclaim compliance with any of the proposed PTE's conditions. Likewise, retirement investors cannot agree to waive any of the conditions. In addition, the proposed PTE would require a financial institution to

- provide the retirement investor—*before* the transaction takes place—with an acknowledgment of the institution's fiduciary status in writing, and a written description of the service to be provided and any material conflicts of interest;
- adopt and enforce policies and procedures designed to discourage incentives that are not in the retirement investor's best interests and to ensure compliance with the Impartial Conduct Standards;
- maintain records that prove compliance with the PTE for six years; and
- conduct a review at least annually to determine whether the institution complied with the Impartial Conduct Standards and the policies and procedures created to ensure compliance with the exemption. Although an independent party does not need to conduct the review, the financial institution's chief executive officer (or the most senior executive) must certify the review.

Note that the proposed PTE would not give retirement investors new legal claims (e.g., through contract or warranty provisions) but rather would affect the DOL's enforcement approach.

Next Steps

Many investment advisers, broker-dealers, banks, and insurance companies that will be affected by the proposed PTE currently operate under similar standards found in various state laws and in the SEC's Regulation Best Interest. The DOL's temporary enforcement policy discussed in FAB 2018-02 also remains in effect, as do other more narrowly tailored PTEs.

Each type of investment provider and financial institution is likely affected differently, whether in steps to comply or costs involved. Financial institutions and investment providers may want to review the proposed PTE and start taking steps to comply with it. This may involve creating and maintaining any policies and procedures they don't already have in place as a result of state law or the Regulation Best Interest.

In the meantime, a 30-day comment period for the proposed PTE starts on July 7, 2020. Comments may be submitted at **www.regulations.gov.** The Docket ID number is EBSA-2020-0003.