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Department of Labor Proposes New Guidance for Fiduciaries: Paul Hastings

On June 29, 2020, the U.S. Department of Labor (the "DOL") issued a regulation reinstating its old rule defining when an investment advisor will be deemed to be a "fiduciary" under ERISA, and proposed a broad new prohibited transaction class exemption (the "Proposed Exemption") for financial institutions and investment professionals that are plan fiduciaries by virtue of providing investment advice for compensation to employee benefit plans and IRAs. The new regulation and the Proposed Exemption are intended to replace the so-called "fiduciary rule" that was issued by the DOL in 2016 (the "2016 Rule"), which was vacated by the Fifth Circuit Court of Appeals in 2018.

Key Take-Aways

- *Reinstatement of the Five-Part Test* – The "new" fiduciary regulation actually reinstates the old ERISA regulation defining who is an "investment advice fiduciary" (the "Five-Part Test") which had been revoked with the 2016 Rule, and also reinstates various class exemptions and Interpretive Bulletins (PTEs 75-1, 77-4, 80-83, 83-1, 84-24, and 86-128 and Interpretive Bulletin 96-1 (relating to the provision of investment education to participants and beneficiaries in participant-directed individual account plans)) that had long been in effect prior to the adoption of the now-defunct 2016 Rule. The DOL also removed prohibited transaction exemptions issued contemporaneously with the 2016 Rule, including the controversial Best Interest Contract Exemption (the "BIC Exemption").
- *Broad Relief* – The Proposed Exemption is intended to provide relief from ERISA's prohibited transaction restrictions that is broader and more flexible than existing exemptions and will allow "Investment Advice Fiduciaries" (as defined below) to rely on one exemption, rather than several exemptions that cover specific types of transactions. The Proposed Exemption generally covers any advice to acquire, hold, dispose of, or exchange securities, as well as certain principal transactions and advice to plan participants to rollover assets from an ERISA plan to an IRA.
- *Alignment with Regulation Best Interest* – Reliance on the Proposed Exemption is conditioned on compliance with the "Impartial Conduct Standards," and certain disclosure and compliance requirements. The Proposed Exemption is generally designed to align with rules issued under federal securities law and state regulations, including the SEC's "Regulation Best Interest" and the fiduciary standards applicable to registered investment advisers so as to promote compliance efficiencies.
- *Extension of FAB 2018-02* – The DOL formally extended FAB 2018-02 (the "FAB"), which provides relief for fiduciaries that have complied with the impartial conduct standards set forth in the BIC Exemption. Accordingly, financial institutions that have implemented systems to comply with the FAB may continue to do so, subject to the other conditions of the Proposed Exemption.
- *No Private Right of Action* – The Proposed Exemption does not create any private right of action or expand legal claims beyond those provided under ERISA. However, entities relying on the FAB will continue to be subject to a private right of action as described under the FAB.

Five-Part Test

Under the Five-Part Test in the fiduciary regulation, a person will be considered to be a fiduciary to the extent that such person: (1) renders advice to a retirement plan as to the value of securities or other property, or makes recommendations 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, arrangement, or understanding with the plan, plan fiduciary, or IRA owner, that; (4) the advice will serve as a primary basis for investment decisions with respect to plan or IRA assets, and that; (5) the advice will be individualized based on the particular needs of the plan or IRA. This is the same five-part test that had been in effect since 1976. In reinstating the old regulation, the DOL has done away with the most controversial aspects of the 2016 Rule that would have made any person who makes a sales or marketing presentation to a plan an ERISA "fiduciary" subject to the fiduciary responsibility and prohibited transaction restrictions of ERISA.

The Five-Part Test is a facts-and-circumstances test. In the Preamble to the Proposed Exemption, the DOL elaborates on the application of the Five-Part Test in the rollover to IRA context.

- *Regular Basis* – Among other things, if the provider's relationship to the Retirement Investor is limited to advice regarding the rollover, the provider may not be a fiduciary because it is not providing advice to the Retirement Investor on a regular basis. However, if the parties anticipate that the provider will provide investment management services to the Retirement Investor on an ongoing basis after the rollover, the provider may satisfy the regular basis prong and, therefore, may be a fiduciary.
- *Mutual Understanding* – Whether an agreement, arrangement, or understanding that the investment advice will serve as a primary basis for investment decisions exists will be based on the reasonable understanding of the parties if no mutual agreement or arrangement is demonstrated. Written statements disclaiming such a mutual understanding may be considered, but are not determinative.
- *Primary Basis* – The advice need not serve as "the" primary basis for an investment decision; rather, the relevant inquiry is whether the advice is "a" primary basis.

Finally, whether such advice is rendered "for a fee" as required under ERISA should be interpreted broadly and should include incident fees and compensation received from transactions involving rollover assets.

The Proposed Exemption

The Proposed Exemption generally covers prohibited transactions resulting from any advice to acquire, hold, dispose of, or exchange securities that is rendered by Investment Advice Fiduciaries (i.e., SEC or state registered investment advisers ("RIAs"), broker-dealers, banks, and insurance companies ("Financial Institutions") and their individual employees, agents, and representatives) to ERISA plan fiduciaries, participants and beneficiaries, and IRA owners and fiduciaries (collectively, "Retirement Investors").

The Proposed Exemption also covers "Riskless Principal Transactions" and "Covered Principal Transactions." A "Riskless Principal Transaction" occurs when a Financial Institution receives an order from a Retirement Investor to buy or sell an investment product and subsequently purchases or sells the same investment product for the Financial Institution's own account (or an account of certain of its affiliates) to offset the contemporaneous transaction with the Retirement Investor. A "Covered Principal Transaction" is the purchase of any securities or other investment property from a plan or IRA, or a sale to a plan or IRA of corporate debt securities offered pursuant to a registration statement under the Securities Act of 1933, U.S. Treasury securities, debt securities issued or guaranteed by a U.S. federal government agency other than the U.S. Department of Treasury, debt securities issued or guaranteed by a government-sponsored enterprise, municipal bonds, certificates of deposits, and interests in Unit Investment Trusts.

Investment Advice Fiduciaries that comply with the Proposed Exemption may receive a wide array of compensation that might otherwise be prohibited under existing exemptions, including, without limitation, commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs and revenue sharing payments, provided the compensation is "reasonable compensation," as described in further detail below. In addition, Investment Advice Fiduciaries would be permitted to receive compensation relating to investment advice on proprietary products or investments that generate third-party payments.

Investment Advice Fiduciaries could choose to rely solely on the Proposed Exemption, existing class, statutory and administrative exemptions, or a combination thereof, depending on business needs. In order to rely on the Proposed Exemption, the Investment Advice Fiduciary must comply with the Impartial Conduct Standards, as well as certain other disclosure and compliance requirements.

Impartial Conduct Standards

Under the Impartial Conduct Standards, the Investment Advice Fiduciary (i) must provide advice that is in the "Best Interest" of the Retirement Investor, (ii) may receive no more than "reasonable compensation", and (iii) may not make misleading statements to the Retirement Investor.

Best Interest Standard

The Best Interest Standard requires that such advice reflect 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." The Best Interest Standard is intended to be an objective, principles-based standard, applied at the time the advice is provided.

Moreover, consistent with the SEC's Regulation Best Interest and the fiduciary standards applicable to RIAs, the needs of the Retirement Investor must be paramount—any financial or other interests of the Investment Advice Fiduciary must be subordinate to those of the Retirement Investor. However, an Investment Advice Fiduciary is not required to seek out the single "best" option for the Retirement Investor and is not precluded from receiving fees from proprietary products or investments that generate third-party payments.

Reasonable Compensation

Any compensation received by the Investment Advice Fiduciary may not exceed "reasonable compensation," and the Investment Advice Fiduciary is obligated to seek the best execution of the investment transaction reasonably available under the circumstances. Whether fees are reasonable is determined at the time of the transaction and is based on facts and circumstances. The essential question is whether the charges are reasonable in terms of what the investor receives, and, while no single factor is dispositive, relevant factors may include the market price of the service to be provided, the scope of monitoring, and the complexity of the product. The application of the "best execution" standards is intended to be applied in a manner consistent with similar requirements under federal securities laws.

No Misleading Statements

An Investment Advice Fiduciary may not make any "materially misleading" statements regarding the recommended transaction or other relevant matters (determined at the time such statements are made), including statements regarding fees and compensation, material conflicts of interest, and any other fact that could reasonably be expected to affect the Retirement Investor's investment decisions.

Disclosures

Prior to engaging in the transaction, an Investment Advice Fiduciary must acknowledge its fiduciary status in writing and provide a written description of the services to be provided and material conflicts of interest that are accurate and not misleading in all material respects. The disclosures must be in plain English and take into account the Retirement Investors' level of expertise. The disclosures may be provided in one or a series of documents, including through disclosures required by other applicable regulators.

Compliance Requirements

An Investment Advice Fiduciary must maintain and enforce written policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards. Such policies and procedures must mitigate any conflicts of interest so that the Investment Advice Fiduciary's incentive practices as a whole avoid misalignment of interests between the Investment Advice Fiduciary and the Retirement Investors.

Under the Proposed Exemption, a conflict of interest is "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." For example, a Financial Institution's policies and procedures must be prudently designed to protect against recommendations to make excessive trades or buy investment products, annuities, or riders that are not in the best interest of the investor or that allocate excessive amounts to illiquid or risky investments.

A Financial Institution must perform an annual retrospective review that is designed to detect and prevent violations of the Impartial Conduct Standards and other relevant policies and procedures. The review must be documented in a written report to the Financial Institution's chief executive officer or chief compliance officer. The Financial Institution would also be required to maintain, and make available, records demonstrating compliance with the exemption for six years.

Exclusions

Transactions with an ERISA plan where the Investment Advice Fiduciary or one of its affiliates is either the employer of employees covered under the plan, or a named fiduciary or plan administrator, or an affiliate thereof, who was selected to provide advice to the plan by a fiduciary who is not independent of the Investment Advice Fiduciary or affiliate, are not eligible for relief under the Proposed Exemption.

In addition, the Proposed Exemption would not apply to pure "robo-advice" arrangements that do not involve interactions with an investment professional, as these arrangements are covered by statutory exemptions.

Finally, certain Financial Institutions and other investment professionals that have engaged in certain criminal conduct may be ineligible from coverage under the Proposed Exemption. The DOL may also find certain persons that have engaged in systematic violations of the exemption or provided materially misleading statements ineligible for relief under the exemption.

Effective Date

The reinstatement of the Five-Part Test and the exemptions listed herein is effective immediately upon publication in the Federal Register. The Proposed Exemption is currently open for comments.

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