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U.S. Department of Labor Proposes New (Simpler) Fiduciary Rule Exemption.

On June 29, the U.S. Department of Labor (DOL) again waded into the financial services standard of care waters, only this time, it is staying in the shallow end. The DOL's proposed prohibited transaction exemption (Proposed Exemption), if finalized, offers financial advisors, subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA), an opportunity to provide services to employee benefit plans (ERISA Plans), and individual retirement accounts (IRAs) that might otherwise be prohibited under the current regulatory scheme.

Introduction

Absent an exemption, a fiduciary may not deal with the income or assets of an ERISA Plan or IRA in his or her own interest or for his or her own account, and may not receive payments from any party dealing with an ERISA Plan or IRA in connection with a transaction involving assets of the ERISA Plan or IRA. Although existing DOL exemptions permit some related-party transactions, those exemptions are restrictive and have not kept up to date with current fee structures.

The Proposed Exemption would permit financial institutions, including broker-dealers and investment advisers, to receive a wide variety of fees that would otherwise violate existing prohibited transaction rules when providing investment advice to or facilitating securities transactions for fiduciaries, participants, and beneficiaries of ERISA Plans, and to owners and fiduciaries of IRAs. These fees include, but are not limited to, commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs, and revenue-sharing payments from investment providers or third parties. The Proposed Exemption will permit a financial institution fiduciary to receive fees resulting from investment advice to ERISA Plan participants in connection with a rollover from an ERISA Plan to an IRA and allow financial institutions to engage in principal transactions with ERISA Plans and IRAs in which the financial institution purchases or sells certain investments from its own account.

To qualify for the Proposed Exemption, a financial institution must be an "investment advice fiduciary." In general, an investment advice fiduciary is subject to the duties and liabilities under ERISA that require it to act prudently and with undivided loyalty to ERISA Plans, participants, and beneficiaries. The Proposed Exemption embraces the long-standing five-part test used by the DOL to determine whether an investment adviser is an investment advice fiduciary for purposes of ERISA and the Code. The reaffirmation of the five-part test is important because the now-vacated fiduciary rule (temporarily) discarded the test in favor of a much more expansive definition of who is a fiduciary.

Under the five-part test, a financial institution is considered an investment advice fiduciary if it: (i) renders advice 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, (ii) on a regular basis, (iii) pursuant to a mutual agreement, arrangement, or understanding with the ERISA Plan fiduciary or IRA owner that (iv) the advice will serve as a primary basis for investment decisions with respect to the ERISA Plan or IRA, and (v) the advice is individualized based on the particular needs of the ERISA Plan or IRA.

Proposed Exemption Requirements

To qualify for the Proposed Exemption, an investment advice fiduciary must:

1. Adhere to Impartial Conduct Standards (as described below).
2. Provide the retirement investor with a written description of the services to be provided and an acknowledgment that it and its investment professionals are acting as a fiduciary under ERISA and the Code, as applicable.
3. Establish, maintain, and enforce written supervisory procedures (WSPs) to comply with the exemption.
4. Create and maintain certain records.
5. Conduct an annual retrospective review of compliance with the exemption.

The Proposed Exemption is an attractive alternative to existing prohibited transaction exemptions, which are narrower and more restrictive. Also, investment advice fiduciaries are likely to find that the Proposed Exemption's litany of necessary qualifications is already met through existing regulatory obligations. The Proposed Exemption specifically excludes robo-advisers.

Impartial Conduct Standards Requirement

The Impartial Conduct Standards include: (i) a best interest standard, (ii) a reasonable compensation standard, and (iii) a no misleading statements standard. These standards largely replicate existing securities regulations and anti-fraud provisions.

1. *Best Interest Standard.* Financial services provided by investment advice fiduciaries are required to be in the best interest of retirement investors. To meet this standard, an investment advice fiduciary must (i) provide advice that reflects care, skill, and prudence based on the investment objectives, risk tolerance, and financial circumstances of the retirement investor, and (ii) put the interests of its retirement investors ahead of its own interests. For instance, an investment advice fiduciary must determine, and document (as discussed further below), that rolling over employee benefit assets to an IRA is in the best interest of the retirement investor.
2. *Reasonable Compensation Standard.* Investment advice fiduciaries are prohibited from receiving excessive compensation for providing financial services. No single factor is dispositive in determining the reasonableness of compensation received, and both direct and indirect compensation should be taken into account when making an assessment. The proposal specifies that, as required by federal securities laws, investment advice fiduciaries must seek to obtain the best execution of the investment transaction reasonably available under the circumstances, analyzing best execution and third-party compensation arrangements.
3. *No Misleading Statements Standard.* Statements made by investment advice fiduciaries to a retirement investor about a recommended transaction and other relevant matters must not, at the time statements are made, be materially misleading.

Written Disclosure

An investment advice fiduciary must provide a retirement investor, prior toproviding any financial services, with a written document: (i) explicitly stating that the firm is operating as a fiduciary, (ii) describing the services to be provided, and (iii) disclosing any conflicts of interest.

Written Supervisory Procedures

An investment advice fiduciary’s WSPs must be prudently designed to comply with the Impartial Conduct Standards. The WSPs must be designed to mitigate conflicts of interest and to avoid misalignment of the interests of the financial institution and its investment professionals and the interests of retirement investors, such as through incentive arrangements based on sales.

Documentation and Recordkeeping Requirements

Financial institution fiduciaries must create and maintain a record of their reasoning when recommending that a retirement investor rollover ERISA Plan or IRA assets. These records must be kept for six years.

Annual Retrospective Review

A financial institution fiduciary that is relying on the Proposed Exemption to provide financial services for retirement investors must review and test its compliance annually. This process is designed to detect and prevent violations of the Impartial Conduct Standards and to ensure the financial institution fiduciary complies with its policies and procedures. This review must be memorialized within six months of the review period’s completion and provided to the chief executive officer (CEO) and chief compliance officer (or equivalent officers) at the investment advice fiduciary. The CEO must certify: (i) that they reviewed the report, (ii) that the WSPs are prudently designed to achieve compliance with the exemption, and (iii) that the financial institution fiduciary has a prudent process in place to accommodate any business or regulatory changes that may arise during the following year.

Principal Transactions

The Proposed Exemption would permit certain transactions between an investment advice fiduciary and an ERISA Plan or IRA that could otherwise be prohibited, such as engaging in a purchase or sale of an investment with a retirement investor and receiving a mark-up or a mark-down or similar payment on the transaction. The Proposed Exemption would extend to both riskless principal transactions and covered principal transactions. A riskless principal transaction is a transaction in which a financial institution, after having received an order from a retirement investor to buy or sell an investment product, purchases or sells the same investment product for the financial institution’s own account to offset the contemporaneous transaction with the retirement investor.

Covered principal transactions are defined in the Proposed Exemption as:

1. For a sale to an ERISA Plan or IRA, a transaction that involves publicly traded equity or debt, Treasury bills, municipal securities, and certificates of deposit, and if the recommended investment is a debt security, the security is recommended pursuant to written policies and procedures adopted by the financial institution that are reasonably designed to ensure that the security, at the time of the recommendation, has no greater than moderate credit risk and has sufficient liquidity that it could be sold at or near carrying value within a reasonably short period of time;
2. For purchases from an ERISA Plan or IRA, a transaction that involves any securities or investment property.

Principal transactions that are not riskless and that do not fall within the definition of a covered principal transaction would not be covered by the Proposed Exemption.

Conclusion

The DOL stated in the Proposed Exemption that once the final form of the exemption is published in the Federal Register, following a comment period that ends on August 6, the exemption will be effective 60 days thereafter.

Overall, the Proposed Exemption seems a welcome modernization of the existing, narrow exemptions from the prohibited transaction rules available to financial institutions, ERISA Plans, and IRAs. Importantly, the proposal reaffirms the five-part test for determining fiduciary status, which many advisors will welcome. Private equity and hedge funds should also be relieved to see that the proposal does not resuscitate terms of the vacated fiduciary rule that purported to make fund managers ERISA fiduciaries with respect to many of their ERISA Plan and IRA investors.

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July 16 2020

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