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DOL Proposes a New Fiduciary Investment Advice Exemption

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On June 29, the U.S. Department of Labor ("DOL") proposed a new exemption from the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") in connection with the provision of investment advice (the "Proposed Exemption"). The Proposed Exemption is the DOL's response to the vacatur of its prior fiduciary rule and reflects its desire to harmonize its approach with that of the Securities and Exchange Commission. In response to the vacatur, the DOL confirmed that its 1975 regulation defining investment advice by virtue of a five-part test remains in effect and directed that it be re-codified in the Code of Federal Regulations. [i]

Aligning with the SEC's Regulation Best Interest, the Proposed Exemption is an extraordinary development in the form of a class exemption allowing financial institutions to give fiduciary investment advice to participants, plans and IRAs and to receive compensation resulting from that advice. Because of its breadth, the Proposed Exemption might be viewed as a "one stop shop" for providers of many types of fiduciary investment advice. Comments are due 30 days from publication in the Federal Register.

Because of our engagement with our clients, we at Groom Law Group have long recognized the need for fiduciary harmonization in a practical and workable framework. As part of our focus on this framework, we have engaged with the DOL in recent years providing input on this exemption. There are some major wins in the Proposed Exemption, which does not include a contract requirement, an arbitration ban, prescriptive conflict mitigation procedures or large disclosure system builds. Other positive developments include a best interest formulation mirroring that of recent SEC guidance, and broad relief for advice to a broad range of investors. However, as with any proposal, there are some surprises, particularly in the preamble, and plenty of room for constructive comments that could make the Proposed Exemption even more workable. We are already working with a number of clients to address these potential additional improvements.

This alert provides important background on the Proposed Exemption, an overview of its coverage and conditions, and a discussion of its implications for existing business strategies.

I. History and Rationale for Exemption

In 2016, the DOL made available its final regulation on the definition of "fiduciary" under ERISA (the "2016 Fiduciary Rule"). The 2016 Fiduciary Rule greatly expanded those who would be considered a fiduciary to an ERISA plan or IRA by reason of providing investment advice, replacing a 1975 regulation providing that a non-discretionary investment advisor could become a fiduciary subject to ERISA's fiduciary and prohibited transaction rules only if the adviser met each prong of a five-part test.

In the absence of an exemption, receipt by a fiduciary advisor of compensation paid by the plan, participant or beneficiary, or IRA, or its receipt of commissions, sales loads, 12b-1 fees, revenue sharing, or other payments from third parties that provide investment products would violate the prohibited transaction provisions of ERISA sections 406(a)(1)(D) and 406(b) because the amount of the fiduciary's compensation (or the compensation paid to a party in which the fiduciary has an interest) would be affected by the investment advice it provides. DOL views prohibited compensation as the receipt of compensation by a fiduciary (or party in which the fiduciary has an interest) that varies based upon the investment advice given by the fiduciary and the receipt of compensation by fiduciaries from third parties in connection with the advice. To facilitate the continued provision of advice following the issuance of the 2016 Fiduciary Rule, the DOL finalized a Best Interest Contract Exemption, which purported to exempt prohibited transactions that may have arisen by reason of the payment of prohibited compensation in connection with the provision of investment advice. However, the conditions of the Best Interest Contract Exemption included substantial limitations, contract and disclosure requirements.

On March 15, 2018, the United States Court of Appeals for the Fifth Circuit issued an opinion concluding that the 2016 Fiduciary Rule should be vacated in total. 2[ii]

As a result of the decision, the 2016 Fiduciary Rule was removed, and the DOL's 1975 regulation was reinstated. Further, the Best Interest Contract Exemption was removed. However, many financial institutions developed investment advice programs in reliance on the broad exemptive relief provided by the Best Interest Contract Exemption. Groom Law Group pressed the DOL to recognize that under some circumstances, the pre-existing prohibited transaction exemptions available prior to the 2016 Fiduciary Rule would not provide relief to investment advice fiduciaries comparable to the relief that would have been provided under the Best Interest Contract Exemption.

As a result, the DOL issued Field Assistance Bulletin 2018-02 on May 7, 2018, which provides temporary non-enforcement of the prohibited transaction exemptions for investment advice fiduciaries who work "diligently and in good faith" to comply with certain conditions of the Best Interest Contract Exemption. Field Assistance Bulletin 2018-02 is transition relief that will continue only "until after regulations or exemptions or other administrative guidance has been issued" governing investment advice arrangements. The DOL indicated that Field Assistance Bulletin 2018-02 will continue to be available for now, but cautioned that it does not envision it to be a permanent compliance approach.

II. Overview of Proposed Exemption

A. Covered Transactions and Relief Provided

The Proposed Exemption would provide relief from the restrictions of ERISA sections 406(a)(1)(A),(D), and 406(b) and Internal Revenue Code of 1986, as amended ("Code") sections 4975(c)(1)(A),(D), (E), and (F) for the receipt of prohibited compensation in connection with the provision of non-discretionary investment advice. The Proposed Exemption would be available to exempt prohibited transactions that arise by reason of the payment of otherwise prohibited compensation in connection the recommendation of any security or investment product, and fiduciary rollover recommendations, as well as recommendations of investment managers and investment advice providers. Moreover, the Proposed Exemption would apply to a Financial Institution's recommendation of its proprietary investment products, or investment products that generate payments from third parties. Finally, the Proposed Exemption would cover, in addition to recommendations to engage in agency transactions and rollovers, recommendations to engage in riskless principal transactions and principal transactions involving certain types of covered securities, described below.

B. Covered Recipient of Advice

The Proposed Exemption would apply to investment advice given to "Retirement Investors," defined as (i) a participant or beneficiary of a plan subject to Title I of ERISA, or a plan described in section 4975(e)(1)(A) of the Code but not subject to Title I of ERISA [iii] ("Plan") with authority to direct the investment of assets in his or her Plan account or to take a distribution,(ii) the beneficial owner of an IRA acting on behalf of the IRA, [iv] or (iii) a fiduciary with respect to an Plan or IRA. Unlike the Best Interest Contract Exemption, the Proposed Exemption would apply when providing investment advice to the fiduciaries of Plans no matter the size of the Plan.

C. Covered Providers of Advice

Investment advice fiduciaries – both individual "Investment Professionals" and the "Financial Institutions" that employ or otherwise contract with them – and their affiliates and related entities would be able to obtain relief under the Proposed Exemption.

- An "Investment Professional" is an employee, independent contractor, agent, or registered representative of a "Financial Institution" who acts as a fiduciary of a Plan or IRA when providing investment advice in connection with a transaction sought to be covered under the Proposed Exemption and satisfies applicable law and licensing with respect to the receipt of the compensation.

- A "Financial Institution" is a registered investment adviser, bank, insurance company, or registered broker-dealer that employs an Investment Professional or otherwise retains the Investment Professional as an independent contractor, agent, or registered representative. This definition does not cover independent marketing organizations, field marketing organizations, or brokerage general agencies who may supervise independent insurance agents. However, the DOL stated that such organizations could apply to amend the exemption to gain coverage as Financial Institutions.

Unlike the Best Interest Contract Exemption, the Proposed Exemption does not contain a definition of "affiliates" and "related entities." However, in the preamble, the DOL indicated the term "affiliate" would refer to (1) any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the Investment Professional or Financial Institution, (2) any officer, director, partner, employee, or relative (as defined in ERISA section 3(15)), of the Investment Professional or Financial Institution; and (3) any corporation or partnership of which the Investment Professional or Financial Institution is an officer, director, or partner. The DOL indicated the term "related entity" would refer to entities that are not affiliates, but in which the Investment Professional or Financial Institution has an interest that may affect the exercise of its best judgment as a fiduciary.

D. Exclusions

The Proposed Exemption would not cover the receipt of prohibited compensation in the following circumstances:

- If the Investment Professional, Financial Institution, or Affiliate is the employer of employees covered by the ERISA-covered Plan.
- If the Investment Professional or Financial Institution is a named fiduciary or plan administrator (or an affiliate thereof) with respect to an ERISA-covered Plan, unless the Investment Professional or Financial Institution was selected to provide advice by an independent fiduciary.
- The Investment Professional exercises discretion with respect to the transaction.
- The transaction is a result of investment advice generated solely by an interactive web site in which computer software-based models or applications provide investment advice based on personal information each investor supplies through the website, without any personal interaction or advice with an Investment Professional (i.e., robo-advice). However the DOL indicated in the preamble that the Proposed Exemption would cover "hybrid" robo-advice arrangements where an Investment Professional is personally involved.
- The Investment Professional and Financial Institution would be excluded from reliance on the proposed exemption for 10 years following their, or with respect to a Financial Institution, an entity within its control group's: (1) conviction of a crime arising out of the provision of investment advice to Retirement Investor described in section 411 of ERISA,[v] or (2) receipt of a finding by the DOL Office of Exemption Determinations regarding noncompliance with the

Proposed Exemption. A Financial Institution convicted, or whose control group member, was convicted of such a crime may seek dispensation from the DOL Office of Exemption Determinations allowing it to continue to rely on the Proposed Exemption. Further, the specific DOL findings that may render an Investment Professional and Financial Institution ineligible to rely on the Proposed Exemption include (1) engaging in a systematic pattern or practice of violating the conditions of this exemption in connection with otherwise non-exempt prohibited transactions; (2) intentionally violating the conditions of this exemption in connection with otherwise non-exempt prohibited transactions; or (3) providing materially misleading information to the DOL in connection with the Financial Institution's conduct under the exemption. The Proposed Exemption provides that the DOL would issue a warning and opportunity to be heard prior to making such findings. Finally, the Proposed Exemption permits Financial Institutions a one year winding down period to continue to rely on the exemption after becoming ineligible.

E. Conditions of Relief

In order to avail itself of the relief provided by the Proposed Exemption, Investment Professionals and Financial Institutions would be required to comply with all of the following conditions.

1. Impartial Conduct Standards

The Investment Professional and Investment Professional would be required to adhere to certain Impartial Conduct Standards:

- **Best Interest Standard.** Measured at the time the investment advice is provided, the advice must meet a "Best Interest" standard meaning it "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, and 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 their own." The Proposed Exemption's Best Interest standard is a departure from the Best Interest Contract Exemption in that it does not require that advice be provided "without regard to" the interests of the Investment Professional and Financial Institution. Instead, the DOL explained in the preamble that the language restricting placement of the interests of the investment advice fiduciaries "ahead" of the advice recipient and restricting "subordinat[ion]" of the advice recipient's interest was intended to harmonize with the Best Interest standard set forth in the Securities and Exchange Commission's ("SEC") Regulation Best Interest.
- **Reasonable Compensation Standard**. The recommended transaction may not cause the Financial Institution, Investment Professional or their affiliates, or related entities to receive, directly or indirectly, compensation for their services that is in excess of reasonable

compensation, within the meaning of ERISA section 408(b)(2) and Code section 4975(d)(2). DOL confirmed in the preamble that an Investment Professional and Financial Institution do *not* necessarily have to recommend a transaction that is the lowest cost or that generates the lowest fees, and that selection of an investment solely because it offers the lowest cost may violate the Best Interest standard.

- **Best Execution Standard**. The Financial Institution and Investment Professional must seek to obtain the best execution of the investment transaction reasonably available under the circumstances. The DOL explained in the preamble that it intends for the best execution standard to encompass best execution requirements already applicable to certain Financial Institutions under the securities laws, including under FINRA, Municipal Securities Rulemaking Board, and Investment Advisers Act rules, or in other words that compliance with these rules for Financial Institutions that are required to comply would satisfy the best execution standard.
- **No Materially Misleading Statements Standard**. The Financial Institution and Investment Professional must make statements about the recommended transaction and other relevant matters that are not, at the time statements are made, materially misleading. The DOL indicated in the preamble that it may read this requirement broadly. For example, it stated that an indemnification or exculpatory clause in a contract that violates ERISA may constitute such a misleading statement.

2. Disclosure

Under the Proposed Exemption, a Financial Institution must provide the following written disclosures to the Retirement Investor prior to the recommended transaction

- A written acknowledgment that the Financial Institution and its Investment Professionals are fiduciaries under ERISA and the Code, as applicable, with respect to any fiduciary investment advice provided by the Financial Institution or Investment Professional to the Retirement Investor; and
- A written description of the services to be provided and the Financial Institution's and Investment Professional's material Conflicts of Interest that is accurate and not misleading in all material respects. A "Conflict of Interest" is defined as "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 DOL explained in the preamble that the disclosures must be written in "plain English," but can be satisfied through any disclosure, or combination of disclosures, including in disclosures required to be provided by other regulators of the Financial Institution. Moreover, as distinct from the Best Interest Contract Exemption, the DOL stated that it did not intend for the disclosures to create a binding contract between the Financial Institution and Retirement Investor that would create the possibility for a private right of action in favor of the Retirement Investor.

3. Policies and Procedures

The Proposed Exemption would require that Financial Institutions establish, maintain, and enforce certain policies and procedures. The policies and procedures would be required to be prudently designed to ensure compliance with the Impartial Conduct Standards of the exemption. In addition, the policies and procedures would be required to mitigate Conflicts of Interest to the extent that the policies and procedures, and the Financial Institution's incentive practices, when viewed as a whole, become prudently designed to avoid misalignment of the Financial Institution and Investment Professionals with the interests of Retirement Investors. Finally, the Proposed Exemption would require Financial Institutions to document the rationale for any rollover recommendations that are made, including recommendations to rollover from one type of account to another (e.g., from a commission-based account to a fee-based account).

The preamble to the Proposed Exemption adds the Department's views on certain aspects of the Proposed Exemption. These preamble statements may inform the regulated company how the DOL believes the conditions of the Proposed Exemption should be applied and how the regulation setting forth the five-part test should be interpreted. We discuss them below. In the preamble, the DOL notes that a Financial Institution's policies and procedures would need to focus on the potential Conflicts of Interest that may arise from its business model. The preamble describes conflicts that may arise from rollover recommendations, commission-based compensation arrangements, and from the recommendations of the proprietary products or recommendations of products from a limited menu, as focus areas.

a. Rollover Recommendations

With respect to rollover recommendations, the preamble to the Proposed Exemption describes that the considerations that would need to be documented in determining whether the recommendation is in the best interest of the Retirement Investor would include:

- the Retirement Investor's alternatives to a rollover, including leaving the money in his or her current employer's Plan, if permitted, and selecting different investment options;
- the fees and expenses associated with both the Plan and the IRA;
- whether the employer pays for some or all of the Plan's administrative expenses;
- the different levels of services and investments available under the Plan and the IRA; and
- for rollovers from another IRA or changes from a commission-based account to a fee-based arrangement, a prudent recommendation would include consideration and documentation of the services that would be provided under the new arrangement.

The DOL stated in the preamble that Investment Professional and Financial Institution should make diligent and prudent efforts to obtain this information, but if it is not obtainable, the Investment Professional should make a reasonable estimation of expenses, asset values, risk, and returns based on publicly available information and explain the assumptions used and their limitations to the Retirement Investor.

b. Commission-based Compensation Arrangements

Where Investment Professionals are compensated through transaction-based payments and incentives, the preamble to the Proposed Exemption states that Financial Institutions' policies and procedures would need to focus on the financial incentives and oversight of investment advice. The DOL opined that options for conflict mitigation in connection with financial incentives that were identified by the Securities and Exchange Commission may be adopted by Financial Institutions:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimizing compensation incentives for employees to favor one type of account over another; or to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis, for example, by establishing differential compensation based on neutral factors;
- Eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
- Implementing supervisory procedures to monitor recommendations that are: near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the rollover or transfer of assets from one type of account to another or from one product class to another;
- Adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and
- Limiting the types of retail customer to whom a product, transaction or strategy may be recommended.

Much like Regulation Best Interest, the DOL also stated in the preamble to the Proposed Exemption that sales contests and similar incentives such as sales quotas, bonuses, and non-cash compensation that are based on sales of certain investments within a limited period of time create incentives to recommend products that are not in a Retirement Investor's best interest that cannot be effectively mitigated. As noted by the DOL, this approach is consistent with the SEC's Regulation Best Interest and NAIC guidance.

c. Proprietary Products and Limited Menus of Investment Products

The preamble to the Proposed Exemption states that Financial Institutions and Investment Professionals should give complete and accurate disclosure of their material conflicts of interest in connection with such proprietary products, products that generate third-party payments to the Financial Institution or its affiliates and related entities, or limited investment menus. The DOL stated that Financial Institution's policies and procedures should address circumstances where as a result of limitations in the universe of available investments to recommend, it is not possible to make a recommendation compliant with the Impartial Conduct Standards. Moreover, the DOL stated that a limited menu cannot justify making a recommendation that is not compliant. However, the DOL acknowledged that the Proposed Exemption does not prohibit recommendation of proprietary products, products that generate third-party payments, and recommendation of products from a limited menu, and that such limitations can serve a useful purpose by allowing an Investment Professional to become more familiar with the products he or she can recommend.

4. Annual Retrospective Compliance Review

The Proposed Exemption would require that Financial Institutions conduct an annual retrospective review reasonably designed to assist in detecting and preventing violations of the Impartial Conduct Standards and the Financial Institution's policies and procedures. The methodology and results of the review must be set forth in a written report submitted to the Chief Executive Officer of the Financial Institution (or an equivalent officer), who must certify, within six months of the end of the annual review period that:

- The officer reviewed the report;
- The Financial Institution has in place policies and procedures prudently designed to achieve compliance with the conditions of the Proposed Exemption; and
- The Financial Institution has in place a prudent process to modify such policies and procedures as business, regulatory and legislative changes and events dictate, and to test the effectiveness of such policies and procedures on a periodic basis, the timing and extent of which is reasonably designed to ensure continuing compliance with the conditions of the Proposed Exemption.

The Financial Institution must retain the report, certification, and supporting data for a period of six years, and should the DOL request such materials from the Financial Institution, they must be made available to the DOL within 10 business days of the request.

In the preamble to the Proposed Exemption, the DOL stated that it envisioned the annual review process would involve a sample of recommended transactions. Additionally, the DOL stated that a Financial Institution's chief executive office could consult with compliance professionals in making the required certifications.

5. Principal Transactions

The Proposed Exemption would be available only in connection with a "Covered Principal Transaction." For principal transactions by which the Financial Institution would purchase securities from a Plan or IRA the Proposed Exemption any principal transaction would constitute a Covered Principal Transaction. However, for principal transactions involving sales from the Financial Institution, the security would need to be either:

- a U.S. dollar denominated debt security issued by a U.S. corporation and offered pursuant to a registration statement under the Securities Act of 1933;

- a U.S. Treasury Security;
- a debt security issued or guaranteed by a U.S. federal government agency other than the U.S. Department of Treasury;
- a debt security issued or guaranteed by a government-sponsored enterprise;
- a municipal security;
- a certificate of deposit; or
- an interest in a Unit Investment Trust.

In addition, for sales of debt securities, the Financial Institution would be required to adopt policies and procedures reasonably designed to ensure that the security, at the time of the recommendation, has no greater than moderate credit risk and sufficient liquidity that it could be sold at or near carrying value within a reasonably short period of time. In the preamble to the Proposed Exemption, the DOL stated that Financial Institution should pay special care to the reasons for advising Retirement Investors to invest in municipal bonds and may wish to document the reason for making such recommendations.

6. Recordkeeping

A Financial Institution using the Proposed Exemption would be required to comply with certain recordkeeping requirements to demonstrate that they complied with the Proposed Exemption's requirements and would be required to provide DOL and others with access to the Financial Institution's records. For parties other than the DOL, exceptions are available for records that do not concern the Retirement Investors, privileged trade secrets or privileged commercial or financial information of the Financial Institution, or information identifying other individuals.

III. Rollover Recommendations

In 2005, the DOL issued an advisory opinion that generally provided that a party with no prior relationship to an ERISA Plan would not become a fiduciary by reason of provide a rollover recommendation to a participant. In this respect, the DOL had opined that a rollover recommendation would not meet one of the prongs of the five-part test defining fiduciary investment advice – that the advice must concern purchasing or selling securities or other property. The DOL withdrew this advisory opinion in connection with issuing the 2016 Fiduciary Rule, but its status was unclear following the Fifth Circuit decision vacating the 2016 Fiduciary Rule.

In the preamble to the Proposed Exemption, the DOL made it clear that it no longer agrees with its 2005 analysis, and now believes that a rollover recommendation would involve a sale and purchase of securities or other property, thereby meeting the prong of the five-part test. The DOL stated that recommendations to rollover would still need to meet the other prongs of the five-part test in order to be considered fiduciary investment advice, including that advice must be provided on a regular basis. However, in the preamble, the DOL indicated that it intended to interpret the five-part test broadly, stating:

- A recommendation that *begins* an ongoing advice relationship may meet the regular basis prong;
- Advice that is made pursuant to a best interest standard such as the one in the SEC's Regulation Best Interest, or another requirement to provide advice based on the individualized needs of the Retirement Investor may meet the "primary basis" prong of the five-part test; and
- A disclaimer of fiduciary status would not be determinative under the five-part test.

These statements amplify the importance of the Proposed Exemption's coverage of rollover recommendations. There is no other prohibited transaction exemption covering rollovers.

IV. Effect on Strategies Currently In Place

The Proposed Exemption does not alter the five-part test defining the status of providers of investment advisors as fiduciaries, although the preamble provides significant new color on how DOL interprets its longstanding five-part test.

Additionally, unlike the 2016 Fiduciary Rule, the Proposed Exemption would not amend or remove other prohibited transaction exemptions currently in place. The Proposed Exemption would create flexibility by adding a new strategy for Investment Professionals and Financial Institutions to deliver investment advice to Retirement Investors and receive a broad array of compensation. But Investment Professionals and Financial Institutions may instead to choose to continue to rely on the exemptions that are currently in place.

V. Conclusion

The Proposed Exemption incorporates broad relief for advice to a broad range of Retirement Investors. That said, there are still some opportunities for continued improvement to create an even more workable solution for plan fiduciaries, plan sponsors, and service providers. Service providers in particular should carefully review the Proposed Exemption for potential opportunities and challenges and consider submitting comments to the DOL by 30 days from publication in the Federal Register.

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[i] The DOL also directed that Interpretive Bulletin 96-1, defining the safe harbor from fiduciary investment advice applicable to investment education, be re-codified. Interpretive Bulletin 96-1 had been withdrawn in connection with the 2016 Fiduciary Rule because most of its provisions were incorporated within the text of the 2016 Fiduciary Rule.

[ii] *Chamber of Commerce of United States of Am. v. United States Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018).

[iii] A Plan described in section 4975(e)(1)(A) of the Code but not subject to ERISA may include plans for self-employed individuals and their spouses such as a Keogh Plan or solo 401(k) Plan. *See* 29 C.F.R. § 2510.3-3.

[iv] IRAs are defined to include Health Savings Accounts, Archer Medical Savings Accounts, and Coverdell Education Savings Accounts.

[v] Section 411 of ERISA restricts individuals convicted of certain crimes from serving in certain positions with respect to an ERISA plan, including as a fiduciary.