

DOL Releases FAQs on PTE 2020-02, Foreshadows Future Activity on Investment Advice

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On April 13, 2021, the Department of Labor (“DOL”) issued a [set of Frequently Asked Questions](#) (“FAQs”) on the DOL’s [new class exemption for the provision of investment advice](#), known as Prohibited Transaction Exemption (“PTE”) 2020-02. The FAQs also cover DOL’s interpretation of the five-part test under its 1975 regulation defining who is an investment advice fiduciary under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) and Section 4975 of the Internal Revenue Code (the “Code”). Alongside the FAQs, DOL released a [consumer-focused guide](#) (the “Guide”) to help retirement investors better understand their rights and the role of investment advisors.

In many respects, the FAQs restate the conditions of PTE 2020-02 or the interpretations of the five-part test the DOL previously advanced in the preamble to PTE 2020-02. However, the FAQs also include important new information on several important issues. For example, the FAQs make clear that DOL intends to make further changes to the existing regulatory framework for providing fiduciary advice in the future, which may include promulgating a new fiduciary rule and amending or revoking other exemptions financial institutions currently rely upon in providing services to the retirement industry. While DOL has recently addressed a variety of issues (e.g., cybersecurity and missing participants) through subregulatory guidance, changes to the existing fiduciary advice regulation or exemptions would be made through notice and comment rulemaking.

I. Rollover Recommendations

The FAQs affirm DOL’s position that a recommendation to roll over from an ERISA plan or IRA may be considered fiduciary investment advice if the five-

If you have any questions, please do not hesitate to contact your regular Groom attorney or the authors listed below:

Jennifer Eller
jeller@groom.com
(202) 861-6604

Allison Itami
aitami@groom.com
(202) 861-0159

Michael Kreps
mkreps@groom.com
(202) 861-5415

David Levine
dlevine@groom.com
(202) 861-5436

Scott Mayland
smayland@groom.com
(202) 861-6647

George Sepsakos
gsepsakos@groom.com
(202) 861-0182

Kevin Walsh
kwash@groom.com
(202) 861-6645

Jeanne Klinefelter Wilson
jwilson@groom.com
(202) 861-6613

part test is met. A number of the FAQs provide gloss suggesting that DOL would like for more rollover recommendations to be considered fiduciary investment advice.

FAQ 7 discusses when the prong of the five-part test requiring that advice be given on a “regular basis” may be met when rollover advice is given. In this respect, DOL stated:

- A single, discrete instance of rollover advice does not meet the regular basis prong.
- If an advisor has been giving advice to an individual about investing in, purchasing, or selling securities or other financial products through retirement accounts subject to ERISA or the Code and then provides rollover advice to the individual, the rollover advice is part of an existing ongoing advice relationship that satisfies the regular basis prong. DOL appears to be taking the position that advice to any and all of an individual’s retirement accounts (whether an ERISA plan account or IRA) are taken into account in determining whether advice meets the regular basis prong even though ERISA, the Code, and DOL’s 1975 regulation state that advice to a plan or IRA (as opposed to an individual) triggers fiduciary status.
- When an advisor has not previously provided advice but expects to regularly make investment recommendations with respect to the IRA as part of an ongoing relationship, the advice to roll assets out of an ERISA plan into an IRA would be the start of an advice relationship that satisfies the regular basis prong. Thus, DOL states that an initial recommendation without a prior relationship can satisfy the regular basis prong and therefore be considered fiduciary investment advice under the five-part test.

DOL suggests that a mutual understanding that the advice will serve as a “primary basis for investment decisions” is met where firms or investment professionals hold themselves out as making individualized recommendations that the investor can rely on, and where the investor relies on the recommendation in making an investment decision. For brokers subject to the Securities and Exchange Commission’s Regulation Best Interest, providing the Form CRS that states that the broker is required to act in the individual’s best interest may satisfy this prong notwithstanding that the broker does not seek to become a fiduciary under ERISA and the Code.

PTE 2020-02 requires the investment professional providing advice to document the specific reasons why rollover advice is in the best interest of the retirement investor receiving the advice. FAQ 15 discusses the factors that should be considered in determining whether a rollover from an ERISA plan to an IRA may be in the interest of the retirement investor. These 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. FAQ 15 provides that the analysis should include consideration of factors such as the long-term impact of any increased costs; why the rollover is appropriate notwithstanding any additional costs; and the impact of economically significant investment features such as surrender schedules and index annuity cap and participation rates.

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- 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. DOL states the investment professional should consider all of the investments in the plan's line-up, and not solely the investments held in the retirement investor's plan account.

DOL opined that an investment professional should make a "diligent and prudent effort" to obtain information (e.g., the plan's annual fee disclosure) regarding the retirement investor's existing plan by requesting it from the retirement investor and describing the significance of the information in doing so. If the information is not available, DOL states the investment professional can make assumptions of expenses, asset values, risk, and returns based on publicly available information (e.g., the most recent Form 5500 or reliable benchmarks on typical fees and expenses for the type and size of plan at issue), and explain the limitations of the assumptions to the retirement investor.

II. Written Acknowledgement of Fiduciary Status

PTE 2020-02 requires that the investment professional and its supervisory financial institution provide a written acknowledgment that they are fiduciaries under ERISA and the Code, as applicable, with respect to fiduciary investment advice provided to the retirement investor. DOL included this condition so that financial institutions will make an "up-front determination that they are acting as fiduciaries." FAQ 13 states that the fiduciary acknowledgment must be unambiguous. In addition, FAQ 13 includes a "model" fiduciary acknowledgement that DOL had previously provided in the preamble to PTE 2020-02. In the preamble to PTE 2020-02, DOL stated that the acknowledgement was not intended to create a private right of action. However, the model language goes far beyond a simple acknowledgement of fiduciary status and provides an affirmation that the financial institution will comply with the conditions of PTE 2020-02. The model would have a fiduciary state:

When we provide investment advice 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.*

The Guide also encourages retirement investors to ask advice providers to "represent" in writing whether they are acting as a fiduciary to their ERISA plan account or IRA. DOL appears to believe

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retirement investors should request this acknowledgement regardless of whether the advice provider relies on PTE 2020-02. The Guide also suggests that if the advice provider is not relying on PTE 2020-02, retirement investors should ask why.

III. Conflict Mitigation

PTE 2020-02 requires financial institutions to establish, maintain, and enforce policies and procedures that mitigate the investment professional's and financial institution's conflicts of interest to such an extent that a reasonable person would not view the financial institution's incentive practices as creating an incentive for the financial institution and investment professional to place their interests ahead of those of retirement investors. FAQs 16–17 discuss what DOL expects the financial institution's policies and procedures to cover for this purpose. These FAQs indicate that DOL is thinking about conflicts in much the same way as it did in 2016, under its prior investment advice rule and related exemptions.

FAQ 16 describes DOL's view that the financial institution's policies and procedures must be prudently designed to prevent its investment professionals from recommending excessive trades, buying investment products, annuities, or riders that are not in the retirement investor's best interest, or allocating excessive amounts to illiquid or risky investments. DOL stated that the financial institution must examine both investment-professional-level and firm-level conflicts and that, in evaluating whether a financial institutions have met this condition of PTE 2020-02, DOL will review the financial institution's conflict mitigation and supervisory oversight as a whole.

With respect to investment professionals' compensation, DOL stated that investment professionals should not be incentivized to put their interests ahead of the retirement investor. DOL explained that a financial institution's policies and procedures could include ensuring that investment professionals are paid level compensation within product categories (e.g., mutual funds, fixed annuities). Additionally, DOL cautioned against the use of quotas, bonuses, prizes, or performance standards as incentives to the extent they may cause investment professionals to make recommendations that are not in a retirement investor's best interest. DOL stated that financial institutions must exercise supervisory oversight over the investment professional, particularly in situations where there is a potential for differential compensation. Examples of circumstances where the financial institution could exercise heightened oversight of investment professions include where the investment professional is at or near compensation thresholds, recommendations at key liquidity events for investors (e.g., rollovers), and recommendations of investments that are particularly prone to conflicts of interest, such as proprietary products and principal-traded assets. However, DOL stated that supervisory oversight may not be a sufficient replacement for meaningful mitigation or elimination of "dangerous" compensation incentives. DOL did not explain what kind of incentive it would consider to be dangerous.

With respect to firm-level conflicts of interest, DOL stated that financial institutions should maintain a review process that will determine which investment products may or may not be recommended to retirement investors and that this process should include identifying the conflicts of interest associated with the products.

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FAQ 17 provides specific discussion of financial institutions' use of compensation grids that determine investment professionals' compensation based on overall revenue production or sales. This discussion mirrors in many respects DOL's previous guidance on compensation grids under the now-vacated Best Interest Contract ("BIC") Exemption, which also would have required that financial institutions maintain policies and procedures to mitigate compensation-related conflicts of interest. DOL indicates now that:

- Financial institutions must take care not to transfer the firm's conflict of interest in products to the investment professional. DOL stated that this may occur if the financial institution pays investment professionals a percentage of the commissions it receives from selling investment products, because the investment professional would have an incentive to recommend products that pay the greatest commission. We note that DOL had previously stated in connection with the BIC Exemption that compensation differentials must be justified by "neutral factors" independent of the amount of revenue the product generates for the financial institution, such as the investment professional's time and effort. Tellingly, DOL continues to describe categories of investments between which differentials might be appropriate broadly, such as "mutual funds" as a single category.
- Grids should generally provide a gradual increase in compensation. DOL did not specify what level of gradual and total increases would be permissible, but it emphasized that firms should avoid "disproportionate" increases that could misalign interests between the investment professional and retirement investor.
- Increases in compensation should not be retroactive. In DOL's view, retroactive grids that increase the percentage of compensation paid out on prior recommendations are likely to be considered disproportionate and to create "acute conflicts of interest." This means that grids that increase payout levels back to the beginning of the compensation year are likely out of step with PTE 2020-02.
- Financial institutions with escalating compensation grids should establish a system to monitor and supervise investment professional recommendations, both at or near compensation thresholds and overall.

IV. Insurance Companies

DOL has observed that insurance companies often contract with independent insurance agents who are licensed to distribute multiple insurance companies' products. FAQ 18 states that an insurance company may serve as the supervising financial institution under PTE 2020-02 for purposes of the agent's recommendation of that company's products. Since an independent agent may maintain relationships with multiple, unrelated insurance companies, this would mean that the agent would effectively be supervised by each of those multiple insurance companies, in each case, solely with respect to the agent's recommendation of that insurance company's own products. DOL took the same approach in connection with the Best Interest Contract Exemption that it issued in 2016 and vacated in 2018.

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However, FAQ 18 suggests that the insurance companies may need to acquire some level of knowledge about the competing products of other companies available for recommendation by the agent. In this regard, DOL notes that each supervising insurance company would need to “avoid improper incentives to preferentially push the products . . . that are most lucrative for the insurer.” A reasonable question to ask would be how an insurance company under this segmented approach might restrict the scope of its oversight to its own products while at the same time avoiding the provision of preferential compensation incentives to the agent.

DOL suggests that an alternative approach to complying with the exemption could be through contracting with an intermediary entity, such as an Independent Marketing Organization (“IMO”) to implement supervisory procedures on behalf of each of the insurance companies relying on the segmented approach to compliance with PTE 2020-02. In this respect, the DOL states that the IMO could review documentation generated by the agent in compliance with PTE 2020-02 and provide agents with third-party comparison tools to help them recommend products. DOL also opined that an IMO may be positioned to “eliminate compensation incentives across all the insurance companies that work with the insurance intermediary.”

As an alternative to compliance with PTE 2020-02, DOL noted that insurance companies and agents may continue to rely on PTE 84-24, which provides an exemption for sales of insurance contracts and annuities, and the payment of a commission by the insurance company to the agent. However, as described below, DOL stated its intent in FAQ 5 to amend or revoke existing class exemptions in the future, which could extend to PTE 84-24. DOL also noted that PTE 84-24 covers a “smaller range of compensation practices” than PTE 2020-02 but did not explain whether it views any compensation practices that are common in the insurance industry to be covered by PTE 2020-02 but not PTE 84-24.

V. DOL Enforcement of PTE 2020-02 Compliance

In FAQ 21, DOL stated that it intends to investigate and enforce compliance with PTE 2020-02 in connection with advice provided to ERISA plans. DOL explained that it has investigative and interpretive authority with respect to ERISA plans. By contrast, DOL explained that it has only “interpretive authority” with respect to IRAs and other accounts subject to section 4975 of the Code, such as health savings accounts. Nevertheless, DOL stated that its interpretive authority extends to determining whether the conditions of PTE 2020-02 have been met with respect to advice given to IRAs and other such accounts, and referring any violations to the Internal Revenue Service for enforcement. FAQ 21 does not provide examples of circumstances where DOL would be in a position to determine compliance with PTE 2020-02 without having first gathered information through an investigative process, but several of PTE 2020-02’s conditions contemplate or require reporting of certain information to DOL or the Treasury Department. It remains to be seen if DOL believes that its ability to request documents under ERISA Section 502 includes not only the ability to request documents in connection with an investigation but also in connection with an “interpretation”.

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VI. DOL's Future Plans

FAQ 5 states that DOL anticipates taking further action on investment advice, which may include issuing a new regulation defining investment advice for purposes of ERISA and the Code (i.e., a new fiduciary rule), amending PTE 2020-02, and amending or revoking other existing class exemptions. The announcement that DOL, under the new presidential administration, is considering a new fiduciary rule is not surprising, but it is significant news given the breadth and potential effects of the DOL's prior efforts to re-define fiduciary investment advice. With respect to PTE 2020-02, DOL suggested that it considers the exemption's impartial conduct standards (including the requirement to act in the retirement investor's best interest) and the conditions requiring policies and procedures to be "core concepts" that will remain but did not suggest it would refrain from adding in more conditions for compliance. Finally, DOL did not indicate which exemptions it would amend or revoke, but in connection with DOL's vacated 2016 regulatory package, DOL amended or revoked a number of exemptions commonly relied upon by financial institutions in connection with providing non-discretionary investment advice and discretionary investment management, including PTE 75-1, PTE 77-4, PTE 84-24, and PTE 86-128, among others.

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