The ERISA Fiduciary Advice Exemption

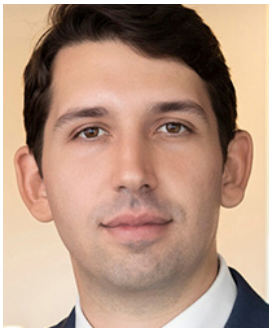
By Jennifer Eller and Jacob Eigner, Groom Law Group, Chartered*

Investment advisers act as fiduciaries to clients based on a recognition that an adviser's relationship with clients is one of trust and confidence. When an adviser deals with retirement clients, such as plan fiduciaries or participants in plans governed by the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), the relationship is subject to an overlay of additional duties of care and loyalty.

An adviser that breaches ERISA's duties can be liable for losses suffered by the retirement client. ERISA and the Internal Revenue Code of 1986, as amended (the "Code") prohibit certain transactions between a retirement plan (including an IRA) and certain other parties. These rules also prohibit a plan fiduciary from using its fiduciary authority to benefit itself or an affiliate. A prohibited transaction involving a retirement plan cannot be cured through disclosures, and violations can lead to the potential for excise tax liability. Importantly, when an adviser deals with IRA clients, ERISA's fiduciary duties do not apply, but the prohibited transaction and excise tax provisions of the Code do.

Here, we discuss DOL-Prohibited Transaction Class Exemption 2020-02 ("PTE 2020-02"), which is a continuation of the DOL's efforts to further regulate interactions between financial professionals and retirement clients. The first section, below, describes the DOL's current guidance on when a person is deemed a fiduciary for purposes of ERISA and the Code. Importantly, whether a person is a fiduciary for these purposes is determined by whether the person functions as a fiduciary, not whether they have a particular title or role. The second section describes the transactions that are and are not covered by PTE 2020-02 and outlines the conditions of the exemption. While PTE 2020-02 has been available to investment advice fiduciaries since February of 2021, the DOL provided a transition period during which not all of the conditions of the exemption had to be met right away. However, the final phase of the transition relief ended as of June 30, 2022.

Jennifer Eller



Jacob Eigner

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I. When Is an Investment Adviser an ERISA/Code Fiduciary?

Determining whether a person is a fiduciary (and at what point that status arises) is critical in determining whether ERISA's duties and/or the Code's prohibited transaction provisions apply to adviser behavior.

A. ERISA and Code Definition of Fiduciary Investment Advice

Existing DOL regulations include a five-part test under which a person is an "investment advice" fiduciary for purposes of ERISA and the Code if, for a fee, they:

- Render advice to a plan as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing, or selling securities or other property;
- On a regular basis;
- Pursuant to a mutual understanding;
- That such advice will be a primary basis for investment decisions; and that
- The advice will be individualized to the needs of the plan.

This definition is critical because the ERISA duties apply *only to the extent that* a person is acting as a fiduciary and the prohibited transaction provisions of

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ERISA and the Code apply only to fiduciary conduct. This means that changes to the DOL's interpretation of the five-part test can have an enormous impact on the potential liability of investment advisers dealing with retirement clients. For example, investment advisers have long accepted ERISA and Code fiduciary status *once the adviser has been hired by a retirement client,* but under the DOL's current interpretation of the five-part test, an adviser may become a fiduciary under ERISA and the Code *before being hired as an adviser*.

B. The Deseret Letter

In DOL Advisory Opinion No. 2005-23A (the "Deseret Letter"), the DOL opined that a recommendation to a plan participant to take a rollover distribution is not a fiduciary act if undertaken by a person without an existing fiduciary relationship to the plan – even if the person making the recommendation stands to benefit financially if it is followed. In the preamble to PTE 2020-02, the DOL withdrew this opinion and stated that the analysis in the Deseret Letter no longer reflects its views regarding fiduciary status in the context of rollover recommendations. Rather, the DOL now believes that a recommendation to roll assets out of an ERISA plan likely *is* fiduciary advice. Since each prong of the five-part test would need to be satisfied, the DOL acknowledged in the preamble that not every rollover recommendation will necessarily constitute fiduciary investment advice. The withdrawal of the Deseret Letter is significant for advisers because, based on Deseret, many adviser compliance programs assume the adviser will not be a fiduciary when recommending a rollover.

C. PTE 2020-02 Preamble and DOL Frequently Asked Questions

The DOL expanded on its position regarding rollover advice when it issued its April 2021 Frequently Asked Questions ("FAQs"). The FAQs affirm the DOL's position that a recommendation to roll over from an ERISA plan or IRA may be considered fiduciary investment advice if the five-part test is met. FAQ #7 discusses the "regular basis" prong, stating that a single, discrete instance of rollover advice does not meet the regular basis prong. However:

- If an adviser 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.

- When an adviser 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.

The DOL further suggests that a mutual understanding that the advice will serve as a primary basis for a retirement investor's investment decisions occurs 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.

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II. Complying with PTE 2020-02

An adviser that is an investment advice fiduciary for purposes of ERISA and/or the Code may not give advice that results in the adviser or its affiliates receiving an additional fee or compensation. For example, if a fiduciary adviser recommends an IRA rollover and the adviser will receive a fee (even a flat, asset-based fee for managing the IRA) as a result of that advice, then the adviser must comply with the conditions of an exemption or be in violation of the prohibited transaction rules. Other examples include fiduciary advice to an ERISA plan to invest in a separate account managed by the adviser, or advice to an IRA holder to transition from one type of IRA to another (*e.g.,* commission-based to advisory).

Very few DOL exemptions are available in these situations. PTE 2020-02 is the exemption that is most likely to be available. We note that the exemption also permits a fiduciary to engage in riskless principal transactions and certain other principal transactions, however a discussion of these aspects of the exemption is beyond the scope of this article.

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A. Covered Recipients of Advice

PTE 2020-02 applies to investment advice given to "Retirement Investors," which include (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 (in either case, a "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, and (iii) a fiduciary with respect to a Plan or IRA (no matter the size of the Plan). Despite the use of the term "Retirement Investor," the DOL confirms in PTE 2020-02's preamble that advice to fiduciaries, participants, and beneficiaries with respect to ERISA welfare plans with an investment component is covered.

B. Covered Providers of Advice

Investment advice fiduciaries – individual "Investment Professionals" and the "Financial Institutions" that employ or contract with them – and their affiliates and related entities – are eligible for relief under PTE 2020-02.

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 covered investment advice under PTE 2020-02 and satisfies applicable law and licensing requirements with respect to receipt of 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.

C. Exclusions

PTE 2020-02 is not available where:

- The Investment Professional, Financial Institution, or affiliate is the employer of employees covered by the ERISA-covered Plan, meaning that investment advisory firms are not able to use the exemption for plans covering their own employees.

- The Investment Professional or Financial Institution is a named fiduciary, plan administrator, or an affiliate of an ERISA-covered Plan, unless the Investment Professional or Financial Institution was selected to provide advice by an independent fiduciary. While commenters asked the DOL to clarify that an affiliate of a pooled employer plan (PEP) would be permitted to provide advice in reliance on the PTE, the DOL declined to address PEPs.

- The Investment Professional exercises discretion with respect to the transaction.

- The transaction involves only "robo-advice". The PTE would cover "hybrid" robo-advice arrangements where an Investment Professional is personally involved.

- Investment Professionals and Financial Institutions are ineligible to rely on PTE 2020-02 in certain circumstances, including by reason of a criminal conviction or a finding by the DOL of: a systematic pattern or practice of violating the conditions of the exemption; an intentional violation of the exemption; or that an adviser provided materially misleading representations to the DOL in connection with the exemption.

D. PTE 2020-02 Conditions

Brief summaries of the conditions that Investment Professionals and Financial Institutions must comply with to obtain relief under PTE 2020-02 are below.

1. **Impartial Conduct Standards**

The Investment Professional and Financial Institution must satisfy Impartial Conduct Standards, including:

- The "Best Interest" Standard, generally prohibiting placing the interests of the investment advice fiduciaries or any other party ahead of the advice recipient. The "Best Interest" Standard is where plan fiduciaries must act prudently and generally prohibits placing the interests of the investment advice fiduciaries or any other party ahead of the advice recipient.

- The "Reasonable Compensation and Best Execution" Standard, requiring that no more than reasonable compensation be received for this advice and that the Financial Institution and Investment Professional must also seek to obtain best execution of the investment transaction reasonably available under the circumstances.

- The "No Materially Misleading Statements" Standard, requiring that the Financial Institution and Investment Professional must not make statements about the recommended transaction and other relevant matters that are materially misleading. The DOL also stated that it would consider it materially misleading for a Financial Institution or Investment Professional to include any exculpatory clauses or indemnification provisions in an arrangement with a Retirement Investor that are prohibited by applicable law (including state law).

2. **Disclosure**

A Financial Institution must provide the following written disclosures to the Retirement Investor prior to a covered investment recommendation:

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- A written acknowledgment that the Financial Institution and its Investment Professionals are fiduciaries under ERISA and the Code, with respect to fiduciary investment advice provided to the Retirement Investor.

- An accurate written description of the Financial Institution's and Investment Professional's services and material conflicts of interest.

- With respect to rollover recommendations only, documentation of the specific reasons why the rollover recommendation is in the Best Interest of the Retirement Investor.

In addition, for a rollover from an ERISA-covered Plan to an IRA, the DOL expects that Investment Professionals and Financial Institutions will make diligent and prudent efforts to obtain information including:

- The Retirement Investor's alternatives to a rollover, including leaving the money in his or her current employer's plan and selecting different investment options;
- Fees and expenses associated with both the Plan and the IRA;
- Whether the employer pays for the Plan's administrative expenses; and
- Different levels of services and investments available under the Plan and the IRA.

3. **Policies and Procedures**

PTE 2020-02 requires Financial Institutions to establish, maintain, and enforce policies and procedures that (1) are prudently designed to ensure compliance with the Impartial Conduct Standards and (2) 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 to create an incentive for the Financial Institution and Investment Professional to place their interests ahead of those of Retirement Investors.

4. **Annual Retrospective Compliance Review**

PTE 2020-02 requires Financial Institutions to 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 a Senior Executive Officer (defined to include the CCO, CEO, CFO, president, or one of the three most senior officers) of the Financial Institution, 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 PTE 2020-02; 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, in a way reasonably designed to ensure continuing compliance with the conditions of PTE 2020-02.

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

5. **Self-Correction**

Generally, if an Investment Professional or Financial Institution provides fiduciary investment advice resulting in compensation but fails to comply with a condition of PTE 2020-02, a non-exempt prohibited transaction will occur. However, PTE 2020-02 permits Financial Institutions to self-correct violations, meaning a non-exempt prohibited transaction will not occur. To self-correct a violation of PTE 2020-02, a Financial Institution must:

- Correct the violation within 90 days of the date the Financial Institution learns or should have learned of the violation;
- Make the Retirement Investor whole for any investment losses;
- Notify DOL within 30 days of the correction; and
- Report the correction in the Financial Institution's annual retrospective compliance review.

6. **Recordkeeping**

Financial Institutions that rely on PTE 2020-02 must maintain compliance records for a period of six years. Under PTE 2020-02, only DOL and the Treasury Department may request these records.

**Jennifer Eller is a Principal with Groom Law Group, Chartered, and the co-head of the firm's Retirement Services and Fiduciary Practice. She advises asset managers on all aspects of ERISA compliance. She may be reached at jeller@groom.com. Jake Eigner is an Associate at Groom who specializes in ERISA's application to financial institutions. He may be reached at jeigner@groom.com.*

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