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DOL Update

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Department of Labor Takes Another Look at Investment Advice

On June 29, 2020, the Department of Labor (DOL) proposed a prohibited transaction exemption called *Improving Investment Advice for Workers & Retirees* (Exemption), which could have a substantial impact on the compliance operations of financial firms and their representatives. Possibly, the most significant development can be found in the preamble to the Exemption. The DOL states that it will now interpret more broadly its long-standing regulation defining investment advice so that more recommendations to investors, particularly rollover distribution recommendations, will result in the provision of "investment advice" for purposes of Section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) and Section 4975(e)(3)(B) of the Internal Revenue Code of 1986, as amended (Code). Additionally, if finalized in its current form, a fiduciary will be able to receive "conflicted compensation" in connection with providing investment advice to retail investors pursuant to the conditions of the Exemption. The Exemption will also allow a fiduciary to provide investment advice in connection with the recommendation of certain principal transactions despite the inherent conflicts involved in such recommendations.

Background

The DOL in 1975 promulgated a regulation in which it defined the term "investment advice" for purposes of Section 3(21)(A)(ii) of ERISA. The Regulation states that a person provides "investment advice" if he or she: (1) renders advice to a 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 understanding; (4) that such advice will be a primary basis for investment decisions; and (5) that the advice will be individualized to the plan. This is known as the "five-part test." A regulation promulgated by the Department of the Treasury defines "investment advice" in the same manner for purposes of the Section 4075(e)(3)(B) of the Code. Therefore, if a person provides investment advice in connection with an ERISA-governed employee benefit plan (Plan) or a "plan" defined in Section 4975(e)(1) that is not subject to ERISA, such as an individual retirement account (IRA), he or she acts as a fiduciary in connection with the Plan or IRA.

In 2005, the DOL issued Advisory Opinion 2005-23A to Deseret Mutual Fund Administrators (Deseret Letter) in which the DOL provided its interpretation of when a person provides investment advice in connection with taking a distribution from

a Plan and rolling over the distribution proceeds to an IRA. The Department stated that an investment adviser who was not otherwise a fiduciary with regard to the Plan would not be deemed a fiduciary with respect to the Plan solely on the basis of making a rollover recommendation to a plan participant, even if the adviser gave specific advice as to how to invest the distributed funds. In reaching this conclusion, the DOL stated that such a recommendation did not meet prong one of the five-part test; that is, the recommendation is not a recommendation as to the advisability of investing in, purchasing, or selling securities. On the other hand, the DOL stated that where a Plan officer who is already a fiduciary to the plan responds to questions regarding a Plan distribution or the investment of amounts withdrawn from the Plan, such fiduciary would be exercising discretionary management over the Plan, thus resulting in fiduciary status.

Preamble to the Proposed Exemption

In the preamble to the Exemption, the DOL concluded that its prior reasoning in the Deseret Letter was incorrect and that a recommendation to liquidate securities held in a Plan account, take a distribution, and roll those assets over to an IRA involves a recommendation described in the first prong of the five-part test. In reaching its conclusion, the DOL stated that "[a] recommendation to roll assets out of a Plan is necessarily a recommendation to liquidate or transfer the Plan's property interest in the affected assets, the participant's associated property interest in the Plan investments, and the fiduciary oversight structure that applies to the assets. Typically, the assets, fees, asset management structure, investment options, and investment service options all change with the decision to roll money out of the Plan." The DOL also pointed to the fact that "…a distribution recommendation commonly involves either advice to change specific investments in the Plan or to change fees and services directly affecting the return on those investments…" Therefore, in its view, the firms and their representatives should apply the above-described five-part test. Notably, the factors to which the DOL pointed are strikingly similar to those which the Securities and Exchange Commission (SEC) pointed out when it concluded that account recommendations, which include recommendations to rollover from a Plan to an IRA, should be subject to the requirements of Regulation Best Interest (Reg BI).

In addition, the DOL in the preamble provides guidance on how it interpreted several parts of the five-part test. Traditionally, based on the language in the regulation, firms and their representatives could often reach the conclusion that one or more of the prongs of the five-part test would not be met. In applying the DOL's guidance, many financial services firms and their representatives concluded that even if they made recommendations to buy or sell securities or other property, they did not do so (1) on a regular basis (for example, the advice was provided on a one-time or sporadic basis), or (2) pursuant to a mutual understanding that the firm and representative provides investment advice (for example, the account agreement specifically states that no investment advice will be provided). Additionally, the firms and their representatives may take the position that any advice they provide is not the "primary basis" for the investment decisions made by the Plan participant or IRA owner. At bottom, the preamble to the Exemption provides language that suggests a firm and its representatives may have more difficulty taking those positions.

With regard to the "regular basis" part of the test, the DOL stated that while a recommendation to take a distribution and rollover to an IRA or another account may be a one-time transaction that does not give rise to recommendations on a "regular basis," such recommendations "…can occur as part of an ongoing relationship or an anticipated ongoing relationship that an individual enjoys with his or her advice provider." Thus, for example, if a person is a fiduciary to the Plan participant with regard to investing Plan account assets and then recommends

a rollover distribution, the person likely will provide advice in connection with that rollover recommendation. Furthermore, the DOL went on to state that

> …advice to roll assets out of the Plan into an IRA where the advice provider will be regularly giving financial advice regarding the IRA in the course of a more lengthy financial relationship would be the start of an advice relationship that satisfies the "regular basis" requirement.

In other words, if the rollover recommendation will begin a "regular basis" relationship, this initial recommendation will be investment advice so long as the other four prongs of the five-part test are met. Historically, most firms have not interpreted the five-part test in this manner.

The DOL also explained that whether there is a "mutual agreement" should be "based on the reasonable understanding of each of the parties, if no mutual agreement or arrangement is demonstrated." Therefore, in the view of the DOL, "[w]ritten statements disclaiming a mutual understanding or forbidding reliance on the advice as a primary basis for investment decisions are not determinative," although they may be informative. Therefore, firms and their representatives should not automatically assume a statement that they do not provide advice will work if the facts and circumstances otherwise reveal that a mutual understanding of an advice relationship exists.

Finally, with regard to the "primary basis" prong, the DOL expressed its view that the advice not be "…'the' primary basis of investment decisions…", but rather, the advice be "'a' primary basis" of the investment decision. Therefore, the DOL states that "[w]hen financial service professionals make recommendations to a Retirement Investor, particularly 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, the parties typically should reasonably understand that the advice will serve as at least a primary basis for the investment decision." Therefore, the DOL may in the case of a broker-dealer look to Reg BI (or other applicable law) to determine whether the "primary basis" and "individualized" prongs are met.

Apparently, based on the Exemption preamble, the DOL will be reading its investment advice regulation (and more specifically the five-part test) differently and more expansively. This is a different tact from the rulemaking in which it attempted to eliminate the five-part test and implement a new regulation that more broadly defined the term "investment advice." The Court of Appeals for the Fifth Circuit vacated that regulation in 2018 in *Chamber of Commerce of the U.S. v. U.S. Dept. of Labor*. Firms and their representatives are more likely to be fiduciaries based on the preamble language.

Proposed Exemption

An understanding of when a firm and its representatives provide investment advice and thus act as fiduciaries is important. In the case of a Plan, the fiduciary is subject to the fiduciary provisions of Section 404 of ERISA and the prohibited transaction provisions of Section 406 of ERISA and Section 4975(c)(1) of the Code. In the case of an IRA, the fiduciary is subject to the fiduciary provisions of Section 4975(c)(1) of the Code. At bottom, prohibited transactions are conflicts of interest that should be addressed through compliance with prohibited transaction exemptions found in Section 408(b) of ERISA or Section 4975(c) of the Code (known as statutory exemptions) or exemptions issued by the DOL (known as individual or class exemptions). To that end, the DOL proposed the Exemption, which is a class exemption, to allow fiduciaries to address prohibited transactions that arise when a fiduciary provides investment advice to Plan participants and IRA holders.

The first part of the Exemption focuses on conflicts that arise in connection with recommending the purchase or sale of securities and other property

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(including the recommendations to take or not take a rollover distribution) in agency transactions and riskless principal transactions. The focus of the exemption is conflicts that arise by reason of the fiduciary's or its affiliate's receipt of prohibited compensation that may vary in amount and timing by reason of the recommendations made (such as commissions and third party payments). Thus, for example, the exemption would apply to the recommendation to buy or sell equities, mutual fund shares, fixed income securities, and insurance contracts in connection with a Plan or IRA and any transaction-compensation paid in connection therewith. There are a number of exclusions including, but not limited to, prohibited transactions that arise in connection with recommendations made by certain robo-advisers and recommendations made in connection with pooled employer plans. Firms and representatives that are convicted of certain crimes (for example, fraud) are also excluded. The Exemption provides that the DOL may deem a firm or representative to be ineligible to rely on the exemption due to consistent violations of the Exemption. This latter point is interesting in that the DOL could effectively shut down or at least substantially limit a firm's qualified account business for non-compliance.

As a threshold matter, the Exemption would require that the fiduciary act in accordance with "impartial conduct standards," which require that the fiduciary comply with "best interest" and "best execution" standards and that the fiduciary not make any materially misleading statements. The impartial conduct standards in large part mirror the standards that many firms and their representatives applied prior to the vacatur of the aforementioned DOL investment advice regulation and prior to it becoming fully effective. However, one key difference is that the DOL's articulation of the "best interest" standard is closer to that found in Reg BI rather than the standard in the DOL's vacated rule. The Exemption also would require a firm and its representatives to disclose their fiduciary status, the services that will be provided and any conflicts of interest as defined in the Exemption. "Conflicts of interest" include "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." Notably, the written disclosure requirement does not give rise to a "private right of action" as did the DOL's now vacated Best Interest Contract Exemption. However, if a recommendation is made in connection with a Plan, ERISA provides for its own enforcement scheme including the right to bring a breach of fiduciary duty class action lawsuit in federal court.

The Exemption also requires that the firm establish policies and procedures pursuant to which the firm and its representatives will comply with the Exemption's requirements. In the preamble, the DOL focuses on four key, but non-exclusive, areas of compliance including (1) rollover recommendations, (2) commission-based compensation arrangements, (3) proprietary products, and (4) limited menus of investment products. Additionally, the exemption requires an annual, retroactive review by the firm to assure compliance with the policies and procedures. That review must be documented in a report, which is certified by the firm's chief executive officer.

In addition to exempting the above-described prohibited transactions, the Exemption would be available for a limited number of principal transactions called "Covered Principal Transactions." In a purchase transaction, where the firm purchases the security from the Plan or IRA, any security would be part of a Covered Principal Transaction. On the other hand, when the Firm sells a security from its own inventory, the security is limited to:

- a US dollar denominated debt security issued by a US corporation and offered pursuant to a registration statement under the Securities Act of 1933;
- a US Treasury Security;

- a debt security issued or guaranteed by a US federal government agency other than the US 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 certain unit investment trusts.

The Exemption requires compliance with the above-discussed conditions. Additionally, with regard to the sale of debt securities, policies and procedures should be implemented to assess whether the security 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, the DOL discussed that firms and representatives should pay special care to the reasons for advising Plans and IRAs, which are tax exempt, to invest in municipal bonds and suggested that firms and their representatives document the reason for making such recommendations. Importantly, sales of equity securities are not covered if sold in a principal transaction.

Conclusion

The Exemption is another significant development in the DOL's quest to exercise greater influence over firms and their representatives to assure that they make recommendations that are in the best interest of Plan participants and IRA holders. Many firms may have come to the realization when attempting to comply with the DOL's now vacated investment advice regulation that they were acting as fiduciaries even under the five-part test. Additionally, some firms that are broker-dealers may have concluded that compliance with Reg BI will result in fiduciary status under the five-part test. To them, the Exemption may prove helpful because it will allow the receipt of transaction-based compensation in connection with fiduciary recommendations and the recommendation of certain principal transactions. However, many firms will view the Exemption, particularly the preamble language, as a renewed attempt by the DOL to assure that more firms and their representatives are fiduciaries who must comply with the Exemption or another exemption for purposes of dealing with conflicts of interest.

Whether a final Exemption in substantially the same form will be issued is unclear. The DOL received over one hundred written comments from the public on the Exemption. Additionally, the DOL conducted a public hearing on September 3, 2020 at which it heard from a number of witnesses and constituencies. The written and verbal comments range from allegations that the DOL once again overstepped its authority, particularly with regard to its interpretation in the preamble of the five-part test, to the DOL did not do enough to protect US workers and retirees. Thus, we will see how the DOL will react. However, broker-dealers, banks, insurance companies, advisers, and other financial institutions should prepare for the possibility that a final exemption will be issued. In addition, regardless of whether it issues a final exemption, the DOL may simply take the position that its interpretation of the five-part test and the reversal of its analysis in the Deseret Letter apply today.

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