

Employee Benefits & Executive Compensation Update

July 2020

DOL Proposes Broad New Fiduciary Investment Advice Exemption

On June 29, the Department of Labor (DOL) issued a Notice of Proposed Class Exemption and a Technical Amendment to the regulations formally reinstating the five-part test for determining investment advice fiduciary status in response to the vacatur of the DOL's prior rule by the U.S. Court of Appeals for the Fifth Circuit in June 2018. The proposed exemption, which DOL indicates is "aligned" with the Securities and Exchange Commission's (SEC's) approach in Regulation Best Interest as well as recent similar state regulatory and standards-setting activity, is far broader and more flexible than past prohibited transaction exemptions for investment advice fiduciaries and is intended to avoid the complexity associated with relying on multiple exemptions when providing investment advice. The Notice also sets forth DOL's interpretation of the five-part test and includes DOL's views on when advice to roll over assets to an individual retirement account or annuity (IRA) could be considered fiduciary investment advice.

Notice of Proposed Class Exemption

Investment advice fiduciaries are subject to duties and liability established in Title I and Title II of the Employee Retirement Income Security Act of 1974, as amended (ERISA), which require that a fiduciary act prudently and with undivided loyalty to employee benefit plans and their participants and beneficiaries. An individual is an investment advice fiduciary to the extent he or she renders investment advice for a fee or other compensation, whether direct or indirect, with respect to assets of a plan. As a result of the vacatur of the DOL's 2016 conflict of interest rule, the five-part test for determining whether advice constitutes "investment advice" was reinstated and

the Best Interest Contract Exemption was eliminated. However, in recognition of the fact that many financial institutions had developed practices in reliance on the Best Interest Contract Exemption, DOL issued a temporary non-enforcement policy and transition relief for investment advice fiduciaries. This new proposed prohibited transaction exemption (PTE) is intended to offer a more permanent solution that allows investment advice fiduciaries to build off compliance work and practices they have engaged in based on the former Best Interest Contract Exemption as reflected in the temporary transition relief.

The Five-Part Test

Under the DOL's five-part test, for advice to constitute "investment advice," an individual who is not otherwise a fiduciary under the plan must:

- Render advice to the 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 agreement, arrangement or understanding with the plan, plan fiduciary or IRA owner, that
- The advice will serve as a primary basis for investment decisions with respect to the plan or IRA assets, and that
- The advice will be individualized based on the particular needs of the plan or IRA.

Determination of whether all provisions have been met will be made by looking at all of the surrounding facts and circumstances. The first prong of the five-part test relates to rendering advice to a plan. This includes investment advice provided to a plan fiduciary in assisting with the selection of the investment portfolio offered under the plan. Further, the DOL has regularly interpreted “advice to a plan” to include advice to participants and beneficiaries.

The preamble demonstrates DOL’s particular concern with advice related to a retirement investor’s decision to roll over assets to an IRA. In focusing on whether recommendations occur on a “regular basis,” DOL notes that an isolated transaction regarding advice on whether to roll over the assets of a benefit plan to an IRA (or any other rollover type) may fail that test. However, if the advice is provided with the expectation of an anticipated ongoing advisory relationship, as is typical, the “regular basis” prong is met even if the advice is provided as part of an initial communication. As a result, it is important for a putative fiduciary to not only look at whether the test is met in the present, but also whether their actions will cause the test to be met at any point in the future. Further, DOL notes that parties typically should understand that advice serves as a primary basis for an investment decision when an investment professional makes a recommendation to an investor, particularly when subject to the best interest standard.

Proposed Class Exemption

Generally, ERISA prohibits investment advice fiduciaries from self-dealing and receiving compensation from third parties in connection with transactions involving employee benefit plans and IRAs. Individuals receiving otherwise prohibited compensation, whether direct or indirect, must rely on exemptions or other available relief. The proposed PTE would apply to registered investment advisers, broker-dealers, banks and insurance companies, and their employees, agents and representatives that are investment advice fiduciaries, and would allow these individuals to receive otherwise prohibited compensation for providing investment advice.

The proposed PTE requires investment advice to be provided in accordance with revised Impartial Conduct

Standards which have three essential components: (1) a best interest standard, (2) a reasonable compensation and best execution standard, and (3) a requirement to make no materially misleading statements about investment transactions or other relevant matters.

The best interest standard requires that investment advice reflects the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity 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. Further, the best interest standard requires an objective standard of care and undivided loyalty, consistent with the requirements of Section 404 of ERISA. The standard of care is an objective standard, requiring the investigation, evaluation and sound judgment that an impartial professional would provide. The standard is measured at the time the advice is provided and not in hindsight and is aligned with the conduct standards in the SEC’s Regulation Best Interest and the fiduciary duty of registered investment advisers under securities law. Focusing on advice related to rollovers, the preamble to the proposed exemption includes a description of the considerations that need to be documented in determining whether a recommendation to roll over assets is in the best interest of the retirement investor. Notably, these considerations align with past guidance issued by the Financial Industry Regulatory Authority (FINRA) and provisions of the vacated Best Interest Contract exemption that many investment professionals have adopted and continue to follow.

The second provision of the Impartial Conduct Standards includes a reasonable compensation requirement as well as a best execution requirement. The reasonable compensation standard has long been recognized under Section 408(b)(2) of ERISA and Section 4975(d)(2) of the Internal Revenue Code (Code). The reasonable compensation standard requires that compensation not be excessive, as measured by the market value of the particular services, rights and benefits an investment professional delivers to the investor. Payments in excess of such amounts may evidence self-dealing. The

reasonableness of fees will depend on the facts and circumstances present at the time of the recommendation and would include analysis of the market price of the services, the amount of the underlying assets, the scope of the monitoring and the complexity of the product, with no single factor being dispositive. The best execution standard requires the investment advice fiduciary to seek to obtain the best execution of the investment transaction reasonably available under the circumstances.

The final provision of the Impartial Conduct Standards requires that investment professionals not make any materially misleading statements at the time such statements are made. Relevant matters include statements regarding fees and compensation, material conflicts of interest and any other factor which could be reasonably expected to affect an investment decision.

In addition to the Impartial Conduct Standards, the proposed PTE requires an investment fiduciary to acknowledge in writing its status as a fiduciary under ERISA and the Code with respect to any fiduciary investment advice provided. Investment fiduciaries must also establish, maintain and enforce written policies and procedures designed to ensure that they comply with the Impartial Conduct Standards. These policies and procedures are required to mitigate conflicts of interest and avoid the misalignment of the interests of the fiduciaries and investors. A financial institution relying on the exemption will also be required to perform at least annual retrospective reviews, have its chief executive officer provide written certification of certain oversight activities, and retain and make available for review records related to the exemption for at least six years.

The proposed PTE is subject to a 30-day comment period that ends on August 6, 2020. There is likely to be a significant number of comments in response to the proposal and therefore changes to the PTE before it is finalized would not be surprising.

Technical Amendment to 29 CFR Parts 2509 and 2510

In addition to the Notice of Proposed Class Exemption, the DOL issued a technical amendment removing the Best

Interest Contract Exemption and the Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs and announced the return of six amended prohibited transaction exemptions to their pre-amendment form. The PTEs are as follows:

- PTE 75-1 permitting a fiduciary to cause a plan or IRA to purchase securities from a member of an underwriting syndicate other than the fiduciary when the fiduciary is also a member of the syndicate, and permitting a plan or IRA to purchase securities in a principal transaction from a fiduciary that is a market maker with respect to such securities;
- PTE 77-4 providing relief for a plan or IRA for the purchase or sale of open-end investment company shares where the investment adviser for the open-end investment company is also a fiduciary to the plan or IRA;
- PTE 80-83 providing relief for a fiduciary causing a plan or IRA to purchase a security when the proceeds of the securities issuance may be used by the issuer to retire or reduce indebtedness to the fiduciary or an affiliate;
- PTE 83-1 providing relief for the sale of certificates in an initial issuance of certificates, by the sponsor of a mortgage pool to a plan or IRA, when the sponsor, trustee or insurer of the mortgage pool is a fiduciary with respect to the plan or IRA assets invested in such certificates;
- PTE 84-24 providing relief for fiduciary advisers for the sale of insurance and annuity products to plans and IRAs; and
- PTE 86-128 providing for a fiduciary to receive commissions for engaging in and receiving commissions for certain transactions.

Lastly, the technical amendment reinstates CFR Interpretive Bulletin 96-1 (IB 96-1), which had been removed and incorporated into the text of the now vacated 2016 final rule. Generally, IB 96-1 describes the circumstances under which investment-related information provided to plan participants and beneficiaries will not constitute “investment advice” under ERISA.

FOR MORE INFORMATION

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