

Employee Benefits Update

November 2023

DOL Again Enters the Investment Advice Fray With Proposed Retirement Security Rule

Major Expansion of Existing Investment Adviser Rules

The following groups, among others, *could* be impacted by the Proposed Rule and related PTE amendments:

- Pension consultants
- Robo-advisers
- Insurance agents and brokers
- Investment company principal underwriters
- Insurance companies
- Registered investment advisers
- Banks and credit unions
- Mutual funds

Investment fiduciaries must meet ERISA's standards when providing advice to retirement plan investors.

On October 31, the U.S. Department of Labor (DOL) issued the proposed Retirement Security Rule (Proposed Rule), which would amend the existing rule that defines when a person is an investment advice fiduciary under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (Code). The DOL simultaneously issued proposed amendments to various class prohibited transaction exemptions (Exemptions), which are intended to narrow and harmonize the exemptions available to address conflicts of interest with respect to investment advice.

As discussed in this bulletin, the Proposed Rule and amendments to Exemptions – if finalized as drafted – would significantly expand which parties may be considered investment advice fiduciaries under ERISA and the Code and impose new and expanded requirements on investment firms

and professionals that rely on Exemptions in their work with retirement investors. The following is a high-level summary of the more than 500-page Proposed Rule and amendments; we expect to provide additional insight in the future.

Background

ERISA imposes significant fiduciary obligations on individuals responsible for the operation and management of workplace employee benefit plans, including retirement plans (e.g., 401(k) and defined benefit plans). Among other obligations, ERISA fiduciaries must act for the exclusive benefit of plan participants and beneficiaries, act in accordance with a prudent expert standard, follow the governing plan documents unless contrary to ERISA, and diversify plan assets to minimize the risk of large losses unless it is clearly prudent not to do so. The consequences of breaching those fiduciary duties can be significant, including disgorgement of profits and restoration of plan losses.

ERISA broadly defines the term “fiduciary” and applies a functional test: a person is a fiduciary to *the extent* he or she engages in certain conduct (or has the authority to do so), including a person who provides investment advice for a fee, direct or indirect, with respect to a plan's monies or property. In 1975, the DOL adopted a rule defining when a person is a fiduciary as a result of providing investment advice to a plan (Five-Part Test). Under the Five-Part Test, a person is considered to provide investment advice if that person:

- Renders advice to the 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;
- On a regular basis;

- Pursuant to a mutual agreement, arrangement, or understanding with the plan or plan fiduciary;
- For which the advice will serve as a primary basis for investment decisions with respect to the plan; and
- For which the advice will be individualized based on the particular needs of the plan.

If adopted, the Proposed Rule would replace the Five-Part Test. In the preamble to the Proposed Rule (Preamble), the DOL describes the need for a new test to reflect the current retirement landscape – namely, the move away from defined benefit plans to defined contribution plans such as IRA and 401(k) plans. The DOL first sought to replace the Five-Part Test based on a similar rationale in 2010, specifically that in its view, the Five-Part Test no longer adequately protects retirement investors. The DOL further notes in the Preamble that similar rule changes have been adopted by the SEC (for broker-dealers and their registered representatives) and many states in accordance with an NAIC model regulation (for insurance agents). The Proposed Rule and proposed amendments to the Exemptions are the latest chapter in what to date has been a 13-year process.

The Proposed Rule

The Proposed Rule replaces the Five-Part Test with a two-part test designed to impose fiduciary status in circumstances in which investors “can and should reasonably place trust and confidence in the financial services provider.”

Under the Proposed Rule, a person is an investment advice fiduciary if, for a fee or other compensation:

- The person makes a recommendation of any securities transaction or other investment transaction or any investment strategy involving securities or other investment property to a retirement investor; *and*
- The person provides the advice or recommendation in one of the following contexts:
 - The person has discretionary authority or control, whether or not pursuant to an agreement, arrangement, or understanding, with respect to purchasing or selling securities or other investment property for the retirement investor;
 - The person makes investment recommendations to investors on a regular basis as part of their business, and the recommendation is provided under circumstances indicating that the

recommendation is based on the retirement investor’s particular needs or individual circumstances and may be relied upon by the retirement investor as a basis for investment decisions that are in the retirement investor’s best interest; *or*

- The person making the recommendation represents or acknowledges that they are acting as a fiduciary when making investment recommendations.

Key Definitions

Retirement investor. Defined in the Proposed Rule to include the plan, plan fiduciary, plan participant or beneficiary, IRA (including, among others, HSAs), IRA owners or beneficiary, or IRA fiduciary.

Recommendation. While not explicitly defined in the Proposed Rule, the DOL views a recommendation as “a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the retirement investor engage or refrain from taking a particular course of action.” Whether a communication is a recommendation depends on the facts and circumstances of a particular situation.

For a fee or other compensation, direct or indirect. If the person (or any affiliate) receives any explicit fee or compensation, from any source, for the advice or the person (or any affiliate) receives any other fee or compensation, from any source, in connection with or as a result of the recommended purchase, sale, or holding of a security or other investment property or the provision of investment advice, including, but not limited to, commissions, loads, finder’s fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, mark-ups or mark-downs, underwriting compensation, payments to brokerage firms in return for shelf space, recruitment compensation paid in connection with transfers of accounts to a registered representative’s new B-D firm, expense reimbursements, gifts and gratuities, or other non-cash compensation.

What’s Changed?

In expanding the types of recommendations covered, the Proposed Rule significantly alters certain requirements of the Five-Part Test that, in the DOL’s view, have resulted in investment professionals avoiding fiduciary status in situations in which retirement investors would reasonably expect them to act in their best interests.

Divergence From the Five-Part Test

The regular basis prong. Under the Five-Part Test, recommendations must be made on a regular basis to be considered investment advice. As such, many providers take the position that one-time advice to an investor – regardless of the nature of the advice – does not constitute investment advice. It's worth noting that the DOL itself previously interpreted the Five-Part Test consistent with that position in an opinion letter issued in 2005, which was subsequently withdrawn during 2020 with an explanation that its interpretation of the test had changed.

The Proposed Rule eliminates the regular basis requirement as currently formulated and instead focuses on whether the person provides recommendations to investors on a regular basis as part of his or her business. Rather than evaluating the specific nature of the relationship between the person and an individual retirement investor, the Proposed Rule would evaluate more broadly whether the person is in the business of providing investment recommendations to investors generally. As a result, one-time advice to a specific investor would not escape coverage under the Proposed Rule simply because it was provided once or for the first time to an individual investor.

The mutual agreement and primary basis prongs. Under the Five-Part Test, advice must be rendered pursuant to a mutual agreement that the advice will serve as a primary basis for the investor's investment decisions. These requirements permit investment professionals to potentially defeat fiduciary status by disclaiming fiduciary status in their written agreements with investors or to argue that if an investor consulted with various professionals, the professional's advice was not a "primary basis" for the investor's decisions.

The Proposed Rule eliminates these formal requirements and instead focuses on the reasonable understanding of the nature of the relationship. Important to this analysis is how investment providers market themselves and describe their services. In the Preamble, the DOL notes that the use of certain titles (e.g., financial consultant, financial planner, or wealth manager) "routinely involves [service providers] holding themselves out as making investment recommendations that will be based on the particular needs

or individual circumstances of the retirement investor and may be relied upon as a basis for investment decisions that are in the retirement investor's best interest."

The Proposed Rule also specifically rejects the utility of disclaimers under certain circumstances, noting that disclaimers "will not control to the extent they are inconsistent with the person's oral communications, marketing materials, applicable State or Federal law, or other interactions with the retirement investor." In other words, an investment professional cannot engage in conduct that the DOL believes would lead an investor to believe that the professional is acting in a fiduciary capacity and at the same time disclaim such status.

Familiar Expansion to Rollover Advice

One major consequence of the departure from the Five-Part Test is the expansion of the rule to cover rollover recommendations. Specifically, the Proposed Rule applies both to recommendations regarding the decision to rollover and to recommendations on how securities or other investment property should be invested immediately after rollover, transfer, or distribution. This expansion is unsurprising, as the DOL has attempted to regulate rollover recommendations in the past. According to the DOL, this expansion is warranted because rollover decisions are among the most important decisions a retirement investor may make in his or her lifetime. Additionally, advice concerning the initial investment of assets post-rollover implicitly requires an investment adviser to consider the alternative of leaving the retirement investor's assets in the current plan or account.

The Proposed Rule also covers recommendations of others to provide investment advice or management services and advice regarding account arrangements such as whether to hold assets in a brokerage or advisory account.

Lessons Learned From Vacatur of 2016 Rule

In an attempt to address concerns raised by the Fifth Circuit in its 2018 decision vacating a similar DOL rule issued in 2016, the DOL clarified that, while broad, the definition of investment advice is not intended to capture all interactions with retirement investors. For example, a person would not

become a fiduciary solely by engaging in their own general marketing activities to a retirement investor unless the marketing efforts include specific investment recommendations that, standing alone, would constitute investment advice under the Proposed Rule. The Preamble also discusses certain other circumstances, such as wholesaling activities and the application of the Proposed Rule to platform providers and pooled employer plans. While these activities and the typical functions of these service providers often do not involve communications that would rise to the level of investment advice, the determination would depend on the specific facts and circumstances involved. The DOL also notes in the Preamble that valuation services are not covered by the Proposed Rule.

Proposed Amendments to Class Prohibited Transaction Exemptions

Along with the Proposed Rule, the DOL issued proposed amendments to various Exemptions. At a high level, these amendments are intended to harmonize, when appropriate, the requirements for prohibited transaction relief for investment advice fiduciaries, regardless of the investment product or service involved. Based on the amendments, investment advice fiduciaries must now rely on one of two exemptions to address conflicted advice: PTE 2020-02 and PTE 84-24.

PTE 2020-02

PTE 2020-02 permits investment advice professionals to receive compensation for advice that would otherwise run afoul of ERISA's and the Code's prohibited transaction provisions if certain requirements are satisfied. In general, financial institutions and their financial professionals relying on the exemption must:

- Acknowledge fiduciary status in writing;
- Disclose their services and material conflicts;
- Meet the Impartial Conduct Standards (prudence and loyalty requirements, receipt of no more than reasonable compensation, and avoid making misleading statements about transactions or related matters);
- Adopt policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards and mitigate conflicts of interest that could otherwise cause violations of those standards;

- Document and disclose the specific reasons that any rollover recommendations are in the retirement investor's best interest; and
- Conduct an annual retrospective review.

The proposed amendment expands the availability of the Exemption to certain providers (including pooled plan providers and robo-advisers) and clarifies and expands on a variety of current requirements, including the obligation to provide additional disclosures (automatic and upon request), the disqualifying provisions, and the winding down requirements.

PTE 84-24

PTE 84-24 currently permits certain purchases of insurance or annuity contracts or investment company securities and permits insurance agents or brokers, pension consultants, and principal underwriters to receive compensation as a result of those purchases.

The proposed amendment eliminates reliance on the Exemption for investment advice transactions (which would be subject to PTE 2020-02 for relief), except for those involving the receipt of commissions or fees in connection with recommendations by independent producers involving annuities or other insurance products not regulated by the SEC. PTE 84-24 provides relief in those narrow circumstances, subject to requirements similar to those of PTE 2020-02.

PTEs 75-1, 77-4, 80-83, 83-1, and 86-128

The proposed amendment to PTEs 75-1, 77-4, 80-83, 83-1, and 86-128 would eliminate reliance on those Exemptions for conflicts arising from the provision of investment advice:

Exception. No relief from the restrictions of ERISA section 406(b) and the taxes imposed by Code section 4975(a) and (b) by reason of Code sections 4975(c)(1)(E) and (F) is available for fiduciaries providing investment advice within the meaning of ERISA section 3(21)(A)(ii) or Code section 4975(e)(3)(B) and regulations thereunder.

Discussion and Effective Date

The Proposed Rule and proposed Exemption amendments would, as proposed, significantly expand ERISA fiduciary

status in a variety of circumstances and limit the relief available to resolve conflicted advice. Plan fiduciaries and potentially impacted investment professionals should carefully review the proposals and monitor further developments. We anticipate that there will be a large number of comments submitted to the DOL regarding the Proposed Rule and that, if adopted, the resulting final rule will face legal challenges.

The Proposed Rule and Exemption amendments provide that they will be effective 60 days after publication of a *final rule* or *final amendments* in the Federal Register, though the DOL has requested comments on the proposed timeline and whether additional time may be needed before the rule and amendments become effective.

FOR MORE INFORMATION

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