# Department of Labor Issues FAQs for Fiduciary Investment Advice Exemption

## A Practical Guidance® Article by Gary R. Polega, Chapman and Cutler LLP

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On April 13, 2021, the Department of Labor (DOL) released guidance on the prohibited transaction exemption pertaining to fiduciary investment advice for retirement investors, employee benefit plans and investment advice providers. See DOL, New Fiduciary Advice Exemption: PTE 2020-02 Improving Investment Advice for Workers & Retirees Frequently Asked Questions. The guidance follows the DOL confirmation on February 12, 2021 that PTE 2020-02, "Improving Investment Advice for Workers & Retirees," would go into effect as scheduled on February 16, 2021. See EBSA News Release, Feb. 12, 2021. The guidance comes in the form of two documents. One includes questions that a retirement investor can ask when interviewing potential advice providers. The other is a set of compliance-focused frequently asked questions (FAQs), which provides guidance for investment advice providers who are relying on the exemption. This article focuses on the latter document.

Under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (Code), parties who provide fiduciary investment advice to plan sponsors, plan participants, and IRA owners may not receive payments creating conflicts of interest, unless they comply with protective conditions in a prohibited transaction exemption. On December 18, 2020, the Department finalized PTE 2020-02. Investment advice fiduciaries who rely on the exemption must render advice that is in the plan and IRA customers' best interest to receive compensation that would otherwise be prohibited in the absence of an exemption, including commissions, 12b-1 fees, revenue sharing, and mark-ups and mark-downs in certain principal transactions.

The DOL's adoption of PTE 2020-02 followed various actions regarding the regulation of investment advice. In 2016, the DOL issued a controversial regulation that significantly changed a long-standing 1975 regulation which provided rules for determining who was an investment advice fiduciary. See 81 Fed. Reg. 20,945 (Apr. 8, 2016).

The DOL also issued new prohibited transaction class exemptions and amended certain existing exemptions, all in order to allow these fiduciaries who were newly created under the new fiduciary rule to be able to receive compensation if certain requirements set forth in the exemptions were satisfied. In 2018, after significant debate and comment, the U.S. Court of Appeals for the Fifth Circuit vacated the new fiduciary rule and the new and amended exemptions. See Chamber of Commerce of the United States v. United States Dep't of Labor, 885 F.3d 360 (5th Cir. 2018). On July 7, 2020, the DOL proposed PTE 2020-02 and restored the 1975 fiduciary advice regulation, which included a five-part test to determine who is an investment advice fiduciary. See 85 Fed. Reg. 40,589 (July 7, 2020).

Many financial institutions and investment professionals, who would have been investment advice fiduciaries under the 2016 rule, are not investment advice fiduciaries under the 1975 regulation because they do not satisfy all five parts of the test. Accordingly, in general, such financial institutions and investment professionals may not need

to satisfy the conditions of an exemption when receiving compensation on account of their investment advice that would otherwise be prohibited if they were deemed to be an investment advice fiduciary. PTE 2020-02 and its preamble does, however, provide additional rules and clarifications for financial institutions and investment professionals who may previously not have considered their recommendations with respect to rollovers from employee benefit plans to IRAs as being fiduciary actions.

Although some of the DOL FAQs provide some additional color with respect to the various requirements under the exemption, most of the FAQs simply reiterate parts of the exemption which have already been published. Maybe the most interesting statement by the DOL in the FAQs is that it intends to take further regulatory and sub-regulatory actions, including possibly amending the 1975 investment advice fiduciary regulation. This statement may be a precursor to another attempt by the DOL to broaden the definition of an investment advice fiduciary to include investment professionals and financial institutions who currently are not a fiduciary because they do not satisfy all five parts of the 1975 regulation.

The following are some of the highlights of the FAQs.

## Generally

- PTE 2020-02 allows investment advisers, broker-dealers, banks, and insurance companies and their employees, agents, and representatives to enter into a variety of transactions and receive compensation that may otherwise pose a conflict to the investment advice fiduciary. The exemption makes clear that the 1975 fiduciary regulation can extend to advice to roll assets out of a plan to an IRA as well as provides relief for prohibited transactions resulting from such advice.
- To satisfy the exemption, the financial institutions and investment professionals must:
    - Acknowledge their fiduciary status in writing
    - Disclose their services and material conflicts of interest
    - Adhere to "Impartial Conduct Standards"
    - Adopt policies and procedures designed to ensure compliance with the Impartial Conduct Standards and to mitigate conflicts of interest
    - Document and disclose specific reasons as to why any rollover recommendations are in the best interest of retirement investors –and–
    - Conduct an annual compliance review.

  In general, the Impartial Conduct Standards require an investment advice fiduciary to act prudently, with undivided loyalty to the retirement investors when making recommendations, charge no more than reasonable compensation and comply with federal securities laws regarding "best execution," and avoid misleading statements about the investment transactions.

## Rollover Recommendations

- The DOL provides that rollover recommendations, which it has previously indicated could result in a person being an investment advice fiduciary, is its primary concern. The DOL indicates that, among other conditions, for the exemption to provide relief from the rollover recommendation resulting in a prohibited transaction, the financial institutions must document and disclose the specific reasons that a rollover recommendation is in the retirement investor's best interest. Among other things, the financial institution should consider the retirement investor's alternatives to a rollover, such as leaving the money in an employer's plan and taking advantage of the investment options available in that plan. Accordingly, investment professionals are expected to make diligent and prudent efforts to obtain information about the existing employee benefit plan. Other factors that an investment investor should consider include (1) the fees and expenses associated with both the plan and the IRA, (2) whether the employer pays for some or all of the plan's administrative expenses, and (3) the different levels of services and investments available under the plan and IRA.
- The DOL recited the five-part test from the 1975 regulation for determining when recommendations will cause a financial institution or investment professional to be a fiduciary.
- One of the FAQs focused on the "**regular basis**" prong of the five-part test. In particular, with respect to rollover advice, the DOL indicated when rollover advice would meet the "regular basis" element of the five-part test. It indicated that a single, discreet instance of advice to roll over assets from a plan to an IRA would not meet the "regular basis" prong of the five-part test. If the advice, however, occurred as part of an ongoing relationship or at the beginning of an intended future relationship that an individual has with an investment advice provider, such advice to rollover may be considered to satisfy the "regular basis" prong of the test. The 1975 test extends to the entire advice relationship and does not exclude the first instance of advice, such as a rollover recommendation, in an ongoing advice relationship.

- Another FAQ provides that an investment advice provider cannot avoid the two prongs of the test that require a "mutual agreement, arrangement, or understanding" that the advice will serve as "a primary basis for investment decisions" simply by providing a written statement disclaiming a "mutual" understanding or forbidding a retirement investor to rely on the fact that the advice was the "primary basis" for the investment decision. The DOL indicated that such a statement will be considered but will not be determinative. The DOL will consider the reasonable understandings of the parties based on the totality of the circumstances, including reviewing the investment professional's oral communications, marketing materials, and interactions with retirement investors.

## Written Acknowledgement of Fiduciary Status

- The DOL indicated that the fiduciary acknowledgement requirement in the exemption was designed to ensure that the fiduciary nature of the relationship under ERISA and/or the Code is clear to both the financial institution/investment professional and the retirement investor. The DOL's view is that in order to take advantage of the relief in the exemption, the parties must make a conscious up-front determination that they are acting as fiduciaries, should tell the retirement investors that they are rendering advice as fiduciaries, and, based on their decision to act as fiduciaries, they will implement and follow the exemption's conditions. The DOL expects clear unambiguous statements about the financial institution and investment professional's fiduciary status. The preamble in PTE 2020-02, in fact, included model language that will satisfy the exemption's fiduciary status acknowledgement requirement.

## Conflict of Interest Disclosures and Mitigation

- Where a fiduciary acknowledgement is made then, in addition to the fiduciary acknowledgement, a fiduciary **must** give the retirement investor a written description of the financial institution's and investment professional's material conflicts of interest arising out of the services that it provides and any recommended investment transaction. The disclosure, among other things, must, for example, include conflicts associated with proprietary products, payments from third parties, and compensation arrangements for both the financial institution and individual investment professional. The disclosure should be designed to allow a reasonable person to assess the scope and severity of the financial institution's and investment professional's conflicts of interest.
- If relying on the exemption, financial institutions must carefully focus on the conflicts of interest associated with their business practices and must develop policies and procedures that place a retirement investor's interest ahead of their own interests. Such policies and procedures must be prudently designed to, among other things, protect retirement investors from recommendations or excessive trades, from buying investment products, annuities, or including riders that are not in the investor's best interest, or from allocating excessive amounts to illiquid or risky investments.
- Financial institutions must take special care in developing and monitoring compensation systems to ensure that their investment professionals satisfy the fundamental obligation to provide advice that is in the retirement investor's best interest. The financial institution cannot create a compensation structure that a reasonable person would view as creating incentives for investment professionals to place their interests ahead of the retirement investor. Accordingly, financial institutions cannot use quotas bonuses, prizes, or performance standards as incentives that a reasonable person would conclude are likely to encourage investment professionals to make recommendations that are not in the retirement investor's best interest. Financial institutions should work toward eliminating conflicts, not creating them.
- Financial institutions' policies and procedures must also include supervisory oversight of investment recommendations. For example, a financial institution's policies and procedures could provide for increased monitoring of investment professional recommendations that are 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 (*e.g.*, proprietary products and principal-traded assets). The DOL also stated that, in many circumstances, supervisory oversight is not a substitute for mitigation or elimination of dangerous compensation practices.

## Investigation and Compliance

- The DOL indicated that it will investigate for compliance with the exemption to enforce ERISA protections. The DOL also noted that participants, beneficiaries and plan fiduciaries have statutory causes of action under ERISA for fiduciary breaches and prohibited transactions. For non-ERISA-covered plans, such a IRAs, the DOL has authority to determine whether the exemption was

satisfied and may send the information to the IRS for enforcement of the prohibited transaction excise tax under the Code. If the DOL actually undertakes this approach of alerting the IRS, it would be viewed as somewhat of a departure from the DOL's current practice. The DOL noted that, unlike the 2016 rules, the exemption does not impose contract or warranty requirements on the financial institutions or investment professionals responsible for compliance with the exemption. Finally, the DOL also noted that the exemption also does not expand the retirement investors' ability to enforce their rights in court beyond the rights they have under ERISA and the Code.

As provided above, especially considering the DOL's comments in the FAQs, it will not be a surprise if the DOL provides further guidance for financial institutions and investment professionals with respect to who is an investment advice fiduciary and what conditions need to be satisfied in order for an investment advice fiduciary to receive certain compensation that would otherwise be prohibited under ERISA's prohibited transaction rules.

# Related Content

## Lexis

- DOL, New Fiduciary Advice Exemption: PTE 2020-02 Improving Investment Advice for Workers & Retirees Frequently Asked Questions (April 13, 2021)
- PTE 2020-02, 85 Fed. Reg. 82,798 (Dec. 18, 2020)
- 81 Fed. Reg. 20,945 (Apr. 8, 2016)
- Chamber of Commerce of the United States v. United States Dep't of Labor, 885 F.3d 360 (5th Cir. 2018)

## Practical Guidance

- ERISA Fiduciary Duties
- DOL Finalizes Fiduciary Investment Advice Guidance
- Unwinding the Department of Labor's Fiduciary Rule
- Prohibited Transactions
- Prohibited Transaction Exemptions

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