Chapman and Cutler LLP

Chapman Client Alert

July 2, 2020

Current Issues Relevant to Our Clients

Department of Labor Proposes New Fiduciary Rule

The Department of Labor proposed a new investment advice fiduciary rule, which generally reinstates the DOL's longstanding investment advice fiduciary test and provides a new prohibited transaction exemption for such fiduciaries.

Overview

On June 29, 2020, the Department of Labor (the *"DOL"*) proposed a new investment advice fiduciary rule under the Employee Retirement Income Security Act (*"ERISA"*) and the Internal Revenue Code. The DOL's proposed rule fills the void that was created when the United States Court of Appeals for the Fifth Circuit in 2018 vacated the DOL's previous 2016 fiduciary rule. The proposed rule aligns the conduct standards for fiduciaries who provide investment advice to retirement plans with the conduct standards provided by other regulators, such as the Securities and Exchange Commission. In general, the new rule, by reinstating the DOL's longstanding five-part investment advice fiduciary test, defines "fiduciary" much more narrowly than the vacated 2016 rule and provides a new exemption for fiduciaries who provide investment advice to or engage in principal transactions with retirement plans.

Under ERISA, a person is a fiduciary to the extent he or she renders investment advice for a fee or other compensation, direct or indirect, with respect to a plan. Whether a person is providing investment advice is based on the DOL's long-standing five-part test. Under ERISA and the Internal Revenue Code, fiduciaries are prohibited from self-dealing with the assets of an employee benefit plan and individual retirement account and annuity (*"IRA"*). If a person is an investment advice fiduciary, provided that certain requirements are satisfied, under the proposed rule, such person will be exempt from ERISA's self-dealing prohibited transaction rules which otherwise would prevent the fiduciary from providing investment advice that would enable it to receive additional compensation. Such exemption would be available to registered investment advisers, broker-dealers, insurance companies, banks, and individual investment professionals who are employees or agents of such entities.

Reinstatement of the Five-Part Investment Advice Fiduciary Test

Under the proposed rule, the DOL reverts back to its 1975 five-part test to determine whether a person is providing investment advice. Under the test, based on the facts and circumstances, a person will be considered to be providing investment advice if he or she:

(1) Renders advice to a retirement 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 agreement, arrangement, or understanding with the plan, plan fiduciary or IRA owner, that

(4) The advice will serve as a primary basis for investment decisions with respect to plan or IRA assets, and that

(5) The advice will be individualized based on the particular needs of the plan or IRA.

Although the proposed rule makes no changes to the text of the 1975 five-part test, the Preamble to the rule provides some color regarding the DOL's current thinking about the five-part test. For example, with respect to the "mutual agreement" prong, the Preamble to the rule provides that whether there is a mutual agreement, arrangement, or understanding that the advice will serve as a primary basis for investment decisions is appropriately based on a reasonable understanding of each of the parties if no mutual agreement or arrangement is demonstrated. The

DOL specifically cautioned that written statements disclaiming a mutual understanding or forbidding reliance on the advice as a primary basis for investment decisions are not determinative, although such statements may be considered in determining whether a mutual understanding exists.

The DOL also emphasized that the five-part test does not look at whether the advice serves as “the” primary basis for the investment decision, but whether it is “a” primary basis. The DOL indicated, by contrast, a one-time sales transaction generally does not by itself confer fiduciary status under ERISA or the Internal Revenue Code, even if accompanied by a recommendation that the product is well-suited to the investor and would be a valuable purchase. The DOL also indicated that in applying the five-part test, all of the facts and circumstances must be considered.

After indicating that in applying the five-part test, all of the facts and circumstances must be considered, the DOL focuses on how the five-part test applies to rollovers. Specifically, it provides that it would no longer follow the position it took in a 2005 Advisory Opinion in which it indicated that the advice to roll assets out of a plan did not constitute investment advice. Under the proposed rule, the DOL will apply the five-part test, considering all of the facts and circumstances, to determine whether advice to roll assets out of a plan causes the person providing the advice to be a fiduciary.

New Exemption from Prohibited Transaction Rules

The prohibited transaction provisions of ERISA and the Internal Revenue Code generally prohibit fiduciaries with respect to employee benefit plans and IRAs from engaging in self-dealing and receiving compensation from third parties in connection with transactions involving such plans and IRAs. Such compensation may include commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs, and revenue sharing payments from investment providers or third parties. The self-dealing provisions also prohibit purchasing and selling investments with plans and IRAs when the fiduciaries are acting on behalf of their own accounts (*i.e.,* principal transactions). The exemption would extend to both riskless principal transactions and Covered Principal Transactions (as defined below). Riskless principal transactions are transactions in which the financial institution, after having received an order from a retirement investor to buy or sell a product, purchases or sells the same investment product in a contemporaneous transaction for the financial institution’s own account to offset the transaction with the retirement investor. Covered Principal Transactions are defined in the proposed rule as non-riskless principal transactions involving certain types of investments. For purchases from a plan or IRA, any types of securities or property would be included. For sales to a plan or IRA, the proposed rule provides a list of securities that would be covered. The list includes registered corporate debt, municipal bonds, certificates of deposit and interests in Unit Investment Trusts. The proposed rule provides an exemption from the self-dealing provisions that would allow investment advice fiduciaries under both ERISA and the Code to receive compensation and to engage in principal transactions that would otherwise violate such prohibited transaction provisions of ERISA and the Code as long as certain requirements are satisfied. The exemption requirements are meant to provide protections to safeguard the interests of the plans, participants, beneficiaries and IRA owners.

In order for compensation and certain principal transactions to be exempt under the proposed rule, fiduciary investment advice must be provided by the fiduciary in accordance with “Impartial Conduct Standards,” which include three components: a best interest standard, a reasonable compensation standard, and a requirement to make no materially misleading statements about recommended investment transactions. In addition, the proposed rule would require financial institutions to acknowledge in writing their investment professionals’ fiduciary status under ERISA and the Internal Revenue Code and to describe the services to be provided and any material conflicts of interest. Finally, in addition to certain other rules, financial institutions would be required to adopt policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards and to conduct a retrospective review of compliance.

The best interest standard is based on ERISA’s longstanding prudence and loyalty fiduciary standards. In general, the best interest standard would require that a fiduciary investigate and evaluate investments, provide advice, and exercise sound judgment in the same way that a knowledgeable, impartial and prudent investment professional would. The rule provides that the financial institution and investment professional has a duty to not place their financial or other interest ahead of the retirement investor or subordinate the retirement investor's interest to their own. Accordingly, a financial institution and investment professional may provide investment advice despite having a financial or other interest in the transaction so long as they do not place the interests ahead of the interests or the retirement investor or subordinate the retirement investor's interest to their own.

In general, the reasonableness of fees will depend on all the particular facts and circumstances at the time of the recommendation, including the market price of the services provided and/or the underlying assets, the scope of monitoring, and the complexity of the product. The fiduciary is not required to recommend the investment or transaction that is the lowest cost or that generates the lowest fees without regard to other relevant factors.

Notably, the DOL indicated that it does not intend that the fiduciary acknowledgment or any of the disclosure obligations to create a private right of action as between a financial institution or investment professional and a retirement investor.

For More Information

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