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DOL Finalizes New Prohibited Transaction Exemption for "Investment Advice", With Statement That Fiduciary Standard May Apply to IRA Rollover Guidance

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On December 18, 2020, the U.S. Department of Labor (the "DOL") published in the Federal Register a final prohibited transaction class exemption (the "Exemption") that allows "investment advice" fiduciaries to provide advice that affects their compensation and to engage in otherwise prohibited "principal transactions." Importantly, the preamble to the Exemption (the "Preamble") includes the DOL's final interpretation of the "five-part test" for purposes of determining when IRA rollover advice constitutes fiduciary "investment advice."

The Exemption (PTE 2020-02) is set to become effective on February 16, 2021. At this time, it is not yet clear whether the Biden administration will delay or revoke the Exemption.

By way of background, on July 7, 2020, the DOL issued a guidance package (summarized here) that included the proposed Exemption and formally reinstated the "five-part test" from 1975 to determine what constitutes fiduciary "investment advice" under ERISA and Section 4975 of the U.S. Internal Revenue Code (the "Code"). The reinstatement of the "five-part test" followed the direction of the U.S. Court of Appeals for the Fifth Circuit on March 15, 2018 to vacate the Obama administration's 2016 fiduciary rule, and was final when published in July 2020. Accordingly, any changes to the "five-part test" will require a new proposed rule and comment period.

Below we describe in more detail the DOL's views on application of the "five-part test" to IRA rollover advice and the Exemption.

Advice to Roll Over Can Be Investment Advice Under the "Five-Part Test"

Under the “five-part test”, a person is considered to be providing “investment advice” only if the person: (i) renders advice as to the value of securities or other property, or makes recommendations as to investing in, purchasing or selling securities or other property, (ii) on a regular basis, (iii) pursuant to a mutual agreement, arrangement, or understanding with the plan, the plan fiduciary or IRA owner that, (iv) the advice will serve as a primary basis for investment decisions with respect to plan or IRA assets, and (v) the advice will be individualized based on the particular needs of the plan or IRA. A person who meets all five prongs of the test ***and*** receives direct or indirect compensation will be considered an “investment advice” fiduciary with respect to the applicable plan or IRA.

Historically, service providers have often taken the position that advice on whether to leave money in a plan or to roll over to an IRA was not provided on a “regular basis” and/or was not provided pursuant to a “mutual” agreement, arrangement or understanding that the advice would serve as a “primary basis” for the decision. Further, in Advisory Opinion 2005-23A (the “Deseret Letter”), the DOL stated that advice to roll assets from a plan to an IRA was not “investment advice,” because it was not advice with respect to assets of a plan.

In the Preamble, however, the DOL disclaimed its guidance in the Deseret Letter as an “incorrect analysis.” The DOL now says that the “better view” is that IRA rollover advice is a recommendation to liquidate or transfer the plan’s property to effectuate the rollover. This means that advice on whether to take a distribution from a retirement plan and roll it over to an IRA (or to roll over from one plan to another plan, or one IRA to another IRA) may be covered by the “five-part test,” if the advice is either part of an ongoing relationship or the start of an ongoing relationship.

In this regard, the DOL has withdrawn the Deseret Letter and stated the following:

- The full “five-part test” applies for determining whether a service provider is an “investment advice” fiduciary. Whether or not the prongs of the test are satisfied “will be informed by all the surrounding facts and circumstances”;
- IRA rollover advice may be an isolated and independent transaction that would fail to meet the “regular basis” prong, but the analysis will depend on the surrounding facts and circumstances:

    - In circumstances where an advice provider has been giving financial advice to an individual about investing in, purchasing, or selling securities or other financial instruments through a retirement vehicle subject to Title I of ERISA or the Code, any rollover advice provided to the individual would be considered part of an ongoing advice relationship that would satisfy the "regular basis" requirement;
    - Similarly, where a rollover advice provider will be regularly giving financial advice with respect to the IRA ***following*** the rollover (even if it has not otherwise provided ***any*** advice before the rollover), the rollover advice would be the start of an advice relationship that would satisfy the "regular basis" requirement; and
    - When the parties reasonably expect an ongoing advice relationship at the time of the rollover recommendation, the "regular basis" prong is satisfied;
- The determination of whether there is a "mutual" agreement, arrangement, or understanding that the investment advice will serve as a "primary basis" for investment decisions will be based on the ***reasonable*** understanding of each of the parties:
- To be subject to the fiduciary standard, the advice does not need to serve as "***the***" primary basis of investment decisions: it need only serve as "***a***" primary basis;
- Written statements disclaiming a mutual understanding may be considered as part of the analysis, but are not determinative;
- In evaluating the reasonable understanding of the parties, the DOL intends to consider marketing materials where the advice provider holds itself out as a trusted adviser (or, in the alternative, clearly disclaims any fiduciary relationship or position of trust and confidence); and
- When a financial service professional makes recommendations that are based on the individualized needs of the recipient or made in accordance with a best interest standard such as the Securities and Exchange Commission's ("SEC") best interest standard, the parties "typically should reasonably understand that the advice will serve as at least a primary basis for the investment decision"; and
- "Hire me" marketing communications generally will not be treated as "investment advice" if not accompanied by an investment recommendation.

Recognizing that some advisers have relied on the Deseret Letter, the DOL says it will not pursue claims for breach of fiduciary duty or prohibited transactions based on rollover recommendations made before the effective date of the Exemption, if the recommendations would not have been considered fiduciary “investment advice” under the Deseret Letter.

The Exemption

The final Exemption is largely consistent with the proposed Exemption. It allows an “investment advice” fiduciary to provide advice that affects its compensation if the fiduciary complies with “impartial conduct” standards and satisfies certain other requirements. As described below, the “impartial conduct” standards incorporate ERISA’s principles of prudence and loyalty, and are intended to be aligned with the standards of conduct for investment advice professionals established and considered by other U.S. Federal and State regulators – in particular, the SEC and its Regulation Best Interest. Notably, the Exemption is available only for eligible fiduciaries who give *advice*—not for fiduciaries who retain discretion with respect to the plan or IRA.

The Exemption is available for an “investment advice” fiduciary who is a registered investment adviser, broker-dealer, bank, or insurance company, or an employee, agent, or representative of an eligible entity. Under the Exemption, an eligible investment advice fiduciary could receive direct compensation (such as management fees from a recommended investment) as well as indirect compensation such as 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs, and revenue sharing payments from investment providers or third parties.

The Exemption also permits qualifying “investment advice” fiduciaries to enter into and receive compensation with respect to “riskless” and certain other “principal transactions” with a Retirement Investor (i.e., an ERISA plan participant or beneficiary, IRA owner, or fiduciary of an ERISA plan or IRA) where the fiduciary either purchases certain investments from a Retirement Investor for its own account or sells certain investments out of its own inventory to the Retirement Investor.

The Exemption's critical protective condition is that the adviser must comply with "impartial conduct" standards – namely, the best interest standard described above (which includes prudence and not placing the fiduciary's financial or other interests (including interests of the financial institution) ahead of the Retirement Investor's interests); a reasonable compensation standard; and a requirement to make no materially misleading statements. The Exemption also requires that the "investment advice" fiduciary:

- Disclose both the financial institution's and the investment professional's status as an "investment advice" fiduciary, and provide an accurate description of the services to be provided and material conflicts of interest;
- If the advice involves a rollover recommendation, document and disclose the reasons that the rollover recommendation is in the Retirement Investor's best interest (this requirement was not in the proposed Exemption);
- Establish, maintain and enforce policies and procedures prudently designed to ensure compliance with the "impartial conduct standards"; and
- Conduct an annual review to ensure compliance with (and detect and prevent violations of) the conditions of the Exemption.

The Exemption is similar in substance to the "Best Interest Contract Exemption" that was vacated along with the Obama Administration's fiduciary rule, except that it does not give Retirement Investors a separate right of action.

An "investment advice" fiduciary could lose the ability to rely on the Exemption for a period of 10 years for certain criminal convictions, providing misleading statements to the DOL in connection with relying on the exemption, or engaging in an intentional violation or systematic pattern of violating the conditions of the exemption.

The Exemption includes a "self-correction" mechanism for certain violations. The self-correction mechanism was not included in the proposed Exemption and is available for violations that do not result in any losses to the Retirement Investor (or where the Retirement Investor is made whole by the financial institution for such losses), if (i) the violation is corrected within 90 days after the financial institution learned (or reasonably should have learned) of the violation, (ii) the DOL is notified within 30 days of correction, and (iii) the violation and correction is documented in the annual compliance review.

The Exemption does not cover advice arrangements that rely solely on "robo-advice" without interaction with an investment professional. Those advice arrangements are covered by the statutory exemption in Sections 408(b)(14) and 408(g) of ERISA and Sections 4975(d)(17) and 4975(f)(8) of the Code and the regulations thereunder.

To facilitate transition, the DOL's current non-enforcement policy for investment advice professionals that have established policies to comply with the "impartial conduct" standards under the vacated best Interest Contract Exemption and Class Exemptions for Principal Transactions (announced in Field Assistance Bulletin 2018-02) will remain in effect until December 20, 2021.

Proskauer Perspective

The withdrawal of the Deseret Letter is consistent with views the DOL has been stating publicly for some time now. With a new administration coming into office, we do not think the reinstatement of the "five-part test" or the final Exemption will be the final word from the DOL on this topic. Stay tuned.

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