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The Next Chapter in the DOL's Fiduciary Rule Saga: Relief for Investment Advice Fiduciaries

Attorneys
Peter N. Rosenberg
William D. Jewett
Joshua A. Lichtenstein
Sabrina C. Glaser

On June 29, 2020, the U.S. Department of Labor (DOL) returned to its long-running fiduciary rule project for the first time since 2018, proposing a new framework to address the receipt by an investment advice fiduciary to retirement plan investors of otherwise prohibited compensation (such as commissions, trailing fees or revenue sharing) and to permit certain principal transactions with fiduciaries. The latest proposal replaces the DOL's 2016 final regulation (2016 Fiduciary Rule) and related exemptions, which the U.S. Court of Appeals for the Fifth Circuit vacated on June 21, 2018. Unlike the 2016 Fiduciary Rule, the new approach by the DOL does not expand the definition of fiduciary beyond the 1975 regulation and its five-part test[1] for defining an investment advice fiduciary. Instead, the DOL has created a new, permissive exemption, which existing investment advice fiduciaries and financial institutions can use to simplify compliance with ERISA. We expect further developments in the coming months, and we will monitor these developments closely.

The DOL's pronouncement consists of (i) a newly proposed prohibited transaction class exemption (Proposed Exemption) that would be available for investment advice fiduciaries and (ii) a technical amendment to reinstate the text of the DOL's 1975 investment advice regulation, which would eliminate any doubt regarding the removal of the 2016 Fiduciary Rule following the Fifth Circuit's order.

The remainder of this alert summarizes the conditions of the Proposed Exemption and includes a high-level comparison of the proposal against the 2016 Fiduciary Rule. Further discussion of the implications and next steps for asset managers will be provided in a subsequent alert.

Overview of the Proposed Exemption

The Proposed Exemption allows investment advice fiduciaries to receive compensation (including commissions, trailing fees, 12b-1 fees and revenue sharing) as a result of providing fiduciary investment advice, including advice to roll over a participant's account from an employee benefit plan to an IRA or from one IRA to another. The Proposed Exemption also offers broad relief for certain principal transactions where the financial institution sells or purchases securities and investments from its own inventory.

The Proposed Exemption includes conditions intended to protect retirement investors from the intrinsic conflicts of interest that could arise from these transactions. While a financial institution could choose to rely on the Proposed Exemption and comply with the conditions set forth below, it is not required to do so. Managers would have to consider whether it would be more advantageous instead to continue to use existing exemptions based on the relative compliance burdens and alignment with their business models.

Much like Regulation Best Interest (Regulation BI), which the U.S. Securities and Exchange Commission adopted in June 2019, the Proposed Exemption brings requirements of disclosure, care, conflict mitigation, and compliance, but

[1] Under the DOL's five-part test, for advice to constitute "investment advice," a financial institution or investment professional who is not a fiduciary under another provision of the statute must (1) 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, (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.

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there are differences between the rules in each category. Financial institutions that have already developed Regulation BI compliance procedures will likely need to adopt new or varied policies to comply with the Proposed Exemption, but the variations required should not be so significant as to require the same amount of compliance ramp-up time as Regulation BI or the 2016 Fiduciary Rule.

I. Impartial Conduct Standards

The Proposed Exemption requires fiduciary investment advice to be provided in accordance with the following "impartial conduct standards": (1) a best interest standard, (2) a reasonable compensation standard, (3) a best execution duty, and (4) a requirement to make no materially misleading statements about recommended investment transactions and other relevant matters.

- **Best Interest** – Under this standard, the advice must reflect the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and 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, and must not place the financial or other interests of the financial institution or investment professional or any affiliate, related entity, or other party ahead of the interests of the retirement investor, or subordinate the retirement investor's interests to their own.

- **Reasonable Compensation** – Any compensation received, directly or indirectly, by the financial institution, the investment professional, and their affiliates for their services would not be permitted to exceed reasonable compensation within the meaning of section 408(b)(2) of ERISA and section 4975(d)(2) of the Internal Revenue Code of 1986 (Code). These sections require that compensation not be excessive, as measured by the market value of the particular services, rights, and benefits the investment professional and financial institution are delivering to the retirement investor.

  - According to the DOL, while the reasonableness of fees will depend on the particular facts and circumstances at the time of the recommendation, some factors that would inform whether compensation is reasonable include the market price of service(s) provided and/or the underlying asset(s), the scope of monitoring, and the complexity of the product.

  - No single factor is dispositive in determining the reasonableness of compensation. The essential question is whether the charges are reasonable in relation to what the investor receives.

- **Best Execution** – The Impartial Conduct Standards would further require the financial institution and investment professional to seek to obtain the best execution of the investment transaction reasonably available under the circumstances, as required by the federal securities laws.

- **Not Materially Misleading** – Any statements made by the financial institution and its investment professionals to the retirement investor about the recommended transaction and other relevant matters must not be materially misleading at the time they are made. Other relevant matters would include fees and compensation, material conflicts of interest, and any other fact that could reasonably be expected to affect the retirement investor's investment decisions.

II. Disclosure

- Prior to engaging in a transaction in reliance on the Proposed Exemption, a financial institution would have to make the following disclosures to the retirement investor:

- **Written Acknowledgement of Fiduciary Status** – A written acknowledgment from the financial institution that it and its investment professionals are fiduciaries under ERISA and the Code, as applicable, with respect to any fiduciary investment advice it provides to the retirement investor.

- **Written Description of the Scope of Services and Any Material Conflicts of Interest** – A written description of the services to be provided and the financial institution's and investment professional's material conflicts of interest that is in all material respects accurate and not misleading.

III. Policies and Procedures

- **Written Policies and Procedures** – The Proposed Exemption would require the financial institution to establish, maintain and enforce written policies and procedures prudently designed to ensure that the financial institution and its investment professionals comply with the impartial conduct standards in connection with covered fiduciary advice and transactions.

- **Prudent Design of Written Policies; Alignment of Interests** – Moreover, the policies and procedures, and the financial institution's incentive practices, when viewed as a whole, would have to be prudently designed to avoid misalignment of the interests of the financial institution and its investment professionals with the interests of the retirement investors in connection with covered fiduciary advice and transactions.

- **Rollover Transactions** – For rollover transactions, the financial institution would have to document the specific reasons why a recommendation to roll over assets from a retirement plan to another plan or IRA, from an IRA to a plan, from an IRA to another IRA, or from one type of account to another (e.g., from a commission-based account to a fee-based account) would be in the best interest of the retirement investor.

IV. Retrospective Review

- **Annual Review** – The financial institution would have to conduct a retrospective review, at least annually, that is reasonably designed to assist it in detecting and preventing violations of, and achieving compliance with, the impartial conduct standards and the policies and procedures governing compliance with the Proposed Exemption.

- **Written Report** – The methodology and results of the retrospective review would have to be conveyed in a written report provided to the financial institution's CEO (or equivalent officer) and chief compliance officer (or equivalent officer).

- **CEO Certification** – The CEO (or equivalent officer) would then have to certify annually:

  - The officer has reviewed the report of the retrospective review;

  - The financial institution has in place policies and procedures prudently designed to achieve compliance with the conditions of the Proposed Exemption; and

  - The financial institution has a prudent process in place to modify such policies and procedures as business, regulatory and legislative changes and events dictate, and to test the effectiveness of such policies and procedures on a periodic basis, the timing and extent of which are reasonably designed to ensure continuing compliance with the conditions of this exemption.

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- **Six-Month Deadline** – The review, report and certification would have to be completed no later than six months following the end of the period covered by the review.

V. Eligibility

- **Types of Financial Institutions Covered** – The Proposed Exemption would apply to registered investment advisers, broker-dealers, banks, insurance companies, and their employees, agents, and representatives that are investment advice fiduciaries.

- **10-Year Bar for Certain Criminal Convictions** – Investment advice fiduciaries could lose access to the Proposed Exemption for a period of ten years for certain criminal convictions in connection with the provision of investment advice. The Proposed Exemption would create an opportunity for fiduciaries to request a waiver from the DOL.

VI. Recordkeeping

- **Six-Year Recordkeeping Obligation** – The financial institution would have to maintain, for a period of six years, records demonstrating compliance with the Proposed Exemption and make such records available (to the extent permitted by law), to:
    - any authorized DOL employee;
    - any fiduciary of a retirement plan that engaged in an investment transaction pursuant to the Proposed Exemption;
    - any contributing employer and any employee organization whose members are covered by a retirement plan that engaged in an investment transaction pursuant to the Proposed Exemption; or
    - any participant or beneficiary of a retirement plan, or IRA owner that engaged in an investment transaction pursuant to the Proposed Exemption.

Certain Principal Transactions

The Proposed Exemption would also allow financial institutions to enter into certain principal transactions with retirement investors where the institution purchases or sells certain investments from its own account. The exemption would extend to both riskless principal transactions and Covered Principal Transactions, as defined in the Proposed Exemption. Principal transactions that do not fall into one of these categories would not be covered by the Proposed Exemption.

- **Riskless Principal Transactions** – These would include transactions where a financial institution, after having received an order from a retirement investor to buy or sell an investment product, purchases or sells the same product for the financial institution's own account to offset the contemporaneous transaction with the retirement investor.

- **Covered Principal Transactions** – These are defined in the Proposed Exemption as principal transactions involving certain enumerated types of investment.
    - For purchases by the financial institution from a retirement plan or IRA, the term is broadly defined to include any securities or other investment property.

- For sales from the financial institution to a retirement plan or IRA, however, the Proposed Exemption would provide more limited relief and would only apply to transactions involving: corporate debt securities offered pursuant to a registration statement under the Securities Act of 1933, U.S. Treasury securities, debt securities issued or guaranteed by a U.S. federal government agency other than the Department of Treasury, debt securities issued or guaranteed by a government-sponsored enterprise, municipal bonds, certificates of deposit, and interests in Unit Investment Trusts. This list of securities may be expanded by the DOL in the future.

Comparison of the Proposal with the 2016 Fiduciary Rule

Overall, the DOL's proposal represents a significant departure from its 2016 Fiduciary Rule. However, there are also a few areas where the DOL preserved certain positions or requirements that were included in the prior rule. The following table shows some of the key differences and similarities between the DOL's proposal and its 2016 Fiduciary Rule.

Topic	2016 Fiduciary Rule	Proposal
Expanded scope of persons who are considered investment advice fiduciaries	Yes, it expanded covered persons to include anyone making recommendations on investments	No. The proposal retains the 1975 regulation's five-part test for what constitutes investment advice, and as a result, who would be considered a fiduciary for providing such advice
Whether a rollover to or from a retirement account would constitute fiduciary advice	Yes	Yes
Inclusion of an exception from fiduciary status for dealing with sophisticated counterparties	Yes	No
Whether automated investment advice that involves computer models utilizing portfolio management algorithms ("robo-advice") would be covered	No	No, if advice is solely automated, but hybrid robo-advice arrangements involving some interaction with the investment professional would be covered
Requiring extra analysis and documentation when recommending proprietary products or products that include third-party payments	Yes	No
Requiring acceptance / acknowledgment of fiduciary status	Yes	Yes
Requiring a written contract	Yes	No

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Topic	2016 Fiduciary Rule	Proposal
Creating a new private right of action	Yes	No
Permitting limited principal trading	Yes	Yes
Requiring additional compliance policies and practices	Yes	Yes
Requiring public disclosure of fee / compensation arrangements	Yes	No
Requiring adjustments to typical compensation structures	Yes	No

If you would like to discuss the impact that the DOL's new approach may have on any aspect of your business, please feel free to reach out to any of the attorneys listed.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2020 Ropes & Gray LLP

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