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ALERT ▪ Executive Compensation & Employee Benefits

December 21, 2020

The DOL Releases Final Investment Advice Prohibited Transaction Exemption

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On December 18, 2020, the U.S. Department of Labor (DOL or Department) published its final prohibited transaction exemption addressing investment advice fiduciaries to ERISA plans and IRAs. Similar to the proposal the DOL released in June, (see our previous client alert for background), the final exemption takes a principles-based (rather than a prescriptive) approach to resolving conflicts that arise under ERISA when an investment advice fiduciary, its affiliate or a related party is paid certain types of compensation (such as commissions, trailing fees or revenue-sharing) or engages in certain principal transactions. The final exemption should provide a new and more flexible approach to ERISA compliance for certain types of transactions, which financial institutions may choose to utilize in place of other existing exemptions. Like the proposal (but in contrast to the precursor rule the DOL finalized in April 2016 that the U.S. Court of Appeals for the Fifth Circuit later vacated in June 2018), the final exemption does not materially change the scope of fiduciary activities under ERISA, with the exception of including certain rollover-related advice as fiduciary advice.

In addition to the prohibited transaction exemption, the preamble to the final exemption includes some new interpretations of the 1975 investment advice regulation, which has been reinstated following the dismantling of the 2016 fiduciary rule.

New DOL Interpretations of the Five-Part Test

While the final exemption expressly does not alter the long-standing five-part test for determining whether a person is acting as a fiduciary under ERISA, the preamble provides a lengthy discussion setting forth the DOL's interpretation of that test and its application in the current market environment. While this is not binding guidance, it signifies the most formal interpretative guidance from the Department on this topic in years. Some notable DOL positions include a statement that disclaimers of fiduciary status are not dispositive but will be considered if they are sufficiently clear:

> *A financial services provider should not, for example, expect to avoid fiduciary status through a boilerplate disclaimer buried in the fine print, while in all other communications holding itself out as rendering best interest advice that can be relied upon by the customer in making investment decisions. While financial services professionals may contractually disclaim engaging in activities that trigger elements of the five-part test, such as rendering advice that can be relied upon as a primary basis for the Retirement Investor's investment decisions, they must do so clearly and act accordingly to demonstrate that there is in fact no mutual agreement, arrangement, or understanding to the contrary.*

The DOL also reasserted the position expressed in the preamble to the 2016 fiduciary rule that marketing and "hire me" communications are generally not enough on their own to establish a fiduciary relationship, but the Department cautions that if "the marketing of advisory services is accompanied by an investment recommendation, such as a recommendation to invest in a particular fund or security, the investment recommendation would be covered [as fiduciary advice] if all five parts of the test were satisfied."

Financial institutions should evaluate their current disclosures, marketing and uses of fiduciary disclaimers/acknowledgements in light of the DOL's interpretations, to avoid unintentionally assuming fiduciary status where the intent is to provide non-fiduciary information, marketing materials or education.

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Overview of the Final Exemption

Like the proposed exemption, the final 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 and offers broad relief for certain principal transactions where the financial institution giving investment advice sells securities or investments from its own inventory to the advice recipient or purchases securities or investments for its own account from the advice recipient.

The final exemption generally includes the same conditions, which are broadly intended to align with Regulation Best Interest (Regulation BI) that the U.S. Securities and Exchange Commission adopted in June 2019, as the proposed exemption. However, due to differences between the two rules, financial institutions that have already developed Regulation BI compliance procedures will likely need to adopt new or varied policies to comply with the final exemption.

I. Impartial Conduct Standards

Like the proposed exemption, the final 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.

    - That said, 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. Although ERISA fiduciaries have generally been understood to be required to obtain best execution, this explicit requirement is unusual under ERISA.

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- **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 final 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 accurate and not misleading in all material respects.

- **Prior to Engaging in a Rollover Transaction, Provision of the Documentation Specifying the Reasons for Such Recommendation** – Although this is a new requirement under the final exemption, the information will have already been collected as part of the financial institution's policies and procedures to ensure compliance with the impartial conduct standards.

III. Policies and Procedures

To rely on the final exemption, a financial institution must have policies and procedures designed to facilitate compliance with the exemption in place, which must satisfy the following requirements:

- **Written Policies and Procedures** – The final exemption requires 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, under the final exemption, the policies and procedures, as well as the financial institution's incentive practices, must be designed so that a reasonable person reviewing them would conclude that they do not create an incentive for the financial institution and its investment professionals to place their interests ahead of the interests of the retirement investors. This requirement has been changed from the proposal, which did not contain the "reasonable person" standard.

- **Documentation of the Specific Reasons for a Rollover Transactions** – For rollover transactions, the financial institution must 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.

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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 final exemption.

- **Written Report** – The methodology and results of the retrospective review would have to be conveyed in a written report that is provided to a "Senior Executive Officer."

- **Senior Executive Officer Certification** –The chief compliance officer, the chief executive officer, president, chief financial officer, or one of the three most senior officers of the financial institution is required 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 final 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 is reasonably designed to ensure continuing compliance with the conditions of the final exemption.

    - Although the substance of this requirement is unchanged from the proposal, under the final exemption, a senior executive officer may make these certifications, instead of the CEO.

- **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. Self-Correction

- One of the most significant changes from the proposed exemption is the new ability for a financial institution to self-correct violations of the conditions of the final exemption. To self-correct, a financial institution must:

    - Determine that the violation did not result in investment loss, or it must make the retirement investor whole for any such loss;

    - Correct the violation and notify the DOL within thirty days of correction;

    - Complete the correction no later than ninety days after the financial institution learned of (or reasonably should have learned of) the violation; and

    - Notify the person(s) responsible for conducting the retrospective review during the applicable review cycle so the correction can be included in the report.

- As the DOL explained in the preamble, this section has been added in response to commenters' requests for a means for financial institutions, acting in good faith, to avoid loss of the exemption for violations of the conditions. Although many commenters cited minor or technical violations, the DOL said that it does not view violations of any condition of the exemption as necessarily minor or technical, noting that this section allows for

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corrections even if a retirement investor has suffered investment losses, provided that the retirement investor is made whole.

VI. Eligibility

- **Types of Financial Institutions Covered** – The exemption is available to registered investment advisers, broker-dealers, banks, insurance companies, and their individual employees, agents, and representatives that provide fiduciary investment advice to retirement investors.

- **Ten-Year Bar for Certain Criminal Convictions** – Investment advice fiduciaries will lose access to the exemption for a period of ten years for certain criminal convictions in connection with the provision of investment advice. However, the exemption provides an opportunity for ineligible investment advice fiduciaries to request a waiver from the DOL.

VII. Recordkeeping

- **Six-Year Recordkeeping Obligation** – The financial institution has to maintain for a period of six years, records demonstrating compliance with the exemption, and it must make such records available (to the extent permitted by law), to any authorized employee of the DOL or U.S. Department of Treasury.

  - This recordkeeping requirement has been significantly narrowed from the proposed exemption, which would have required access to records for (i) any fiduciary of a retirement plan that engaged in a transaction pursuant to the exemption, (ii) any contributing employer, (iii) any employee organization whose members are covered by a retirement plan that engaged in an investment transaction pursuant to the exemption, or (iv) any participant or beneficiary of a retirement plan, or IRA owner that engaged in a transaction pursuant to the exemption.

VIII. Certain Principal Transactions

The final exemption mirrors the proposed exemption in allowing financial institutions to enter into certain principal transactions with retirement investors where the institution purchases or sells certain investments from its own account. The final exemption extends to both riskless principal transactions and Covered Principal Transactions, as defined in the exemption text. Principal transactions that do not fall into one of these categories will not be covered by the exemption.

- **Riskless Principal Transactions** – These 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** – As defined in the final exemption, these are principal transactions involving certain enumerated types of investments.

  - 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 final exemption provides more limited relief and only applies 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

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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.

Considerations for Financial Institutions

The final exemption provides financial institutions with new options for structuring their retail-focused retirement advice businesses. In addition, the new principal transaction relief may enable financial institutions to develop product offerings with enhanced liquidity to retirement clients. Financial institutions should evaluate how the final exemption would impact their existing and evolving retirement plan business, to determine whether following the exemption could result in simplified compliance for certain activities. In addition, financial institutions should consider their current marketing and disclosure materials and contractual representations in light of the DOL's new interpretations on when fiduciary status applies under the existing regulations.

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 below.

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