The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 32581

July 6, 2020

DOL Issues Fiduciary Rulemaking Package, Including Proposed Class Exemption

[32581]

July 6, 2020 TO: ICI Members
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Transfer Agent Advisory Committee SUBJECTS: Compliance
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Pension RE: DOL Issues Fiduciary Rulemaking Package, Including Proposed Class Exemption

On June 29, 2020—one day before the Securities and Exchange Commission's (SEC's) Regulation Best Interest ("Reg BI") took effect—the Department of Labor (DOL) finally revealed its proposed prohibited transaction exemption ("Proposed PTE")[1] that would permit investment advice fiduciaries to receive compensation for their advice.[2] The Proposed PTE would be available only to registered investment advisers, broker-dealers, insurance companies, banks and individual investment professionals who are their employees or agents.

To qualify for the exemption, an investment professional or financial institution, among other requirements, must abide by the impartial conduct standards, which, as outlined in a 2018 DOL field assistance bulletin (FAB), have three components: a best interest standard; a reasonable compensation standard; and a requirement to make no misleading statements about investment transactions and other relevant matters.[3] Gone are the often criticized contract requirement, arbitration ban and prescriptive conflict mitigation procedures from the 2016 rulemaking's Best Interest Contract Exemption.

In conjunction with issuing the Proposed PTE, DOL is also reinstating its five-part test used since 1975 to determine whether a person is an investment advice fiduciary.[4] It is also restoring several exemptions that were modified by the DOL's 2016 rulemaking to their pre-2016 content. As such, the proposal is dramatically narrower in scope than the 2016 fiduciary rulemaking,[5] which significantly expanded the range of persons who would be treated as fiduciaries to retirement plans or IRAs, and which was vacated after a legal challenge in 2018.[6]

DOL officials have said that "[t]he best interest standard in the new proposed class exemption is aligned with the conduct standards in the [SEC's] Regulation Best Interest and the fiduciary duty of registered investment advisers under securities laws."[7]

While this latest effort from DOL represents an important step toward aligning standards of care for all investors, whether they are saving in a retirement account or other investment accounts, there are questions to be worked out and conditions that would benefit from additional clarification. Comments on the Proposed PTE are due 30 days after the proposal is published in the Federal Register, which is scheduled for July 7.

A detailed description of (1) DOL's actions regarding its pre-2016 positions, and (2) it's Proposed PTE, is provided below. Additionally, a chart comparing the conditions of the PTE with the applicable conditions of the SEC's Regulation BI is attached.

Technical Amendment to Reinstate the Five-Part Test and Other Guidance

As discussed above, in addition to proposing a new exemption for investment professionals, DOL took other actions which it states were necessary to conform the text of the Code of Federal Regulations and its own internal public records sources to a 2018 decision by the U.S. Court of Appeals for the Fifth Circuit. That decision vacated DOL's 2016 fiduciary rule and the exemptions that accompanied the rule, which DOL argues had the effect of reinstating the previous regulatory text, including the 1975 regulation and its five-part test for defining an investment-advice fiduciary as well as Interpretive Bulletin 96-1 regarding participant investment education. While generally returning to pre-2016 guidance for the most part, DOL broadly expanded the application of the five-part test to rollover recommendations.

Five-Part Test for Status as an Investment Advice Fiduciary Reinstated

As noted above, DOL confirmed that its 1975 regulation defining investment advice by virtue of a five-part test remains in effect and directed that it be re-codified in the Code of Federal Regulations. Under DOL's five-part test—issued pursuant to a 1975 regulation[8]—a financial institution or investment professional who is not a fiduciary under another provision of ERISA will be considered to be acting as a fiduciary by virtue of providing "investment advice,"[9] if the person: (1) renders advice to a 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 understanding; (4) that such advice will be a primary basis for investment decisions; and that (5) the advice will be individualized to the plan.

Exemptions Revert to Pre-2016 Status

DOL also updated its website to reflect changes to its pre-existing prohibited transaction class exemptions to reflect the Fifth Circuit's vacatur of the 2016 rulemaking.

- Two class exemptions that were newly granted in 2016—the Best Interest Contract Exemption and the Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs—are removed.
- Pre-existing class exemptions that were amended in 2016 have reverted to their pre-amendment form. This includes Prohibited Transaction Exemptions (PTEs) 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128.

Interpretive Bulletin 96-1 Reinstated to Pre-2016 Form

As noted above, DOL also directed that Interpretive Bulletin 96-1[10] ("IB 96-1"), defining the safe harbor from fiduciary investment advice applicable to investment education, be re-codified. The 2016 fiduciary rulemaking had the effect of superseding and replacing commonly used IB 96-1 which generally permits the furnishing of (1) plan information, (2) general financial, investment and retirement information, (3) asset allocation models, and (4) interactive investment material by a plan sponsor to its participants (but has been widely understood to apply more broadly to other persons). While the provisions of IB 96-1 were largely mirrored in the 2016 rule, DOL added several new conditions. Most notably, and in a stark deviation from IB 96-1, investment allocation models could not refer to a specific investment product available under the plan or IRA. This was widely considered a departure from the commonly held position that asset allocation models could generally be populated with specific investment choices.

Deseret Letter Analysis Overridden

In the proposed exemption's preamble, DOL provides important information on its views regarding rollovers from employee benefit plans to IRAs. Perhaps most significantly, the DOL has overridden its analysis in a 2005 advisory opinion (the so-called Deseret letter) that generally provided that a party with no prior relationship to an ERISA plan would not become a fiduciary by reason of providing a rollover recommendation to a participant.[11] More specifically, DOL had opined that a rollover recommendation would not meet one of the prongs of the above referenced five-part test defining fiduciary investment advice—that the advice must concern purchasing or selling securities or other property. The DOL withdrew this advisory opinion in connection with its 2016 fiduciary rulemaking, but its status was unclear following the Fifth Circuit decision vacating the 2016 Fiduciary Rule.

In the preamble to the proposed exemption, DOL says that it no longer agrees with its 2005 analysis, and now believes that a rollover recommendation would involve a sale and purchase of securities or other property, thereby meeting the first prong of the five-part test. The DOL clarified that recommendations to roll over would still need to meet the other prongs of the five-part test in order to be considered fiduciary investment advice, including that advice must be provided on a regular basis. DOL also stated in the preamble that it intends to interpret the five-part test broadly, explaining:

- A recommendation that begins an ongoing advice relationship may meet the regular basis prong;
- Advice that is made pursuant to a best interest standard such as the one in the SEC's Reg BI, or another requirement to provide advice based on the individualized needs of the retirement investor may meet the "primary basis" prong of the five-part test;
- 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 is appropriately based on the reasonable understanding of each of the

parties, if no mutual agreement or arrangement is demonstrated; and
- A disclaimer of fiduciary status would not be determinative under the five-part test.

Given the absence of another prohibited transaction exemption covering rollovers other than the exemption now being proposed, the DOL's statements expanding the breath of the five-part-test take on particular importance to the coverage of rollover recommendations.

Proposed Prohibited Transaction Class Exemption

As discussed above, a key part of the new rulemaking package is a proposed prohibited transaction class exemption. The Proposed PTE would allow investment advice fiduciaries under both ERISA and the Code to receive compensation (including as a result of advice to roll over assets from a Plan to an IRA) and to engage in principal transactions, that would otherwise violate the prohibited transaction provisions of ERISA and the Code.[12] The best interest standard in the new Proposed PTE is intended to be aligned with the conduct standards in the SEC's Reg BI and the fiduciary duty of registered investment advisers under securities laws.[13] According to the preamble, the Proposed PTE takes into consideration the public correspondence and comments received by DOL since February 2017.[14]

Scope of Relief

The Proposed PTE would be available to registered investment advisers, broker-dealers, insurance companies, banks, and individual investment professionals who are their employees or agents.[15] Investment advice fiduciaries could lose access to the class exemption for a period of 10 years for certain criminal convictions in connection with the provision of investment advice to retirement investors or for egregious conduct with respect to compliance with the class exemption.

The Proposed PTE could not be used for:

1) transactions involving ERISA-covered plans if the investment professional, financial institution, or an affiliate is either (i) the employer of employees covered by the plan, or (ii) is a named fiduciary or plan administrator, or an affiliate thereof, who was selected to provide advice to the plan by a fiduciary who is not independent of the financial institution, investment professional, and their affiliates;

2) transactions that result from robo-advice arrangements that do not involve interaction with an investment professional; and

3) transactions in which the investment professional is acting in a fiduciary capacity other than as an investment advice fiduciary.

Conditions on Advice

The new Proposed PTE would require fiduciary investment advice to be provided in accordance with the following "Impartial Conduct Standards": a best interest standard; a reasonable compensation standard;[16] and a requirement to make no materially misleading statements about recommended investment transactions and other relevant matters. The new Proposed PTE also would include other protective conditions requiring disclosure to retirement investors, conflict mitigation, and a retrospective compliance review.

Investment advice fiduciaries relying on the class exemption would have to provide advice

in the best interest of retirement investors.

The best interest standard[17] is satisfied if the advice is:

- Prudent: the advice reflects 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
- Loyal: the advice does not place the financial or other interests of the investment professional, financial institution 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.

Significantly, the new Proposed PTE would require financial institutions to disclose to retirement investors their status as investment advice fiduciaries under ERISA and the Code, as applicable, and provide an accurate written description of their services and material conflicts of interest.[18] This suggests that only an advice professional willing to acknowledge its fiduciary status could make use of the exemption. However, the DOL states that it does not intend 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 and it does not believe the exemption would do so. The Proposed PTE does not establish a monitoring requirement, but financial institutions must disclose which services they will provide.[19]

The new Proposed PTE would require financial institutions to establish, maintain, and enforce policies and procedures prudently designed to ensure that they and their investment professionals comply with the Impartial Conduct Standards in connection with covered fiduciary investment advice. The financial institution's policies and procedures would be required to mitigate conflicts of interest which would be achieved to the extent that the policies and procedures, and the financial institution's incentive practices, when viewed as a whole, are prudently designed to avoid misalignment of the interests of the financial institution and investment professional with the interests of retirement investors.[20]

Financial institutions would be required to conduct an annual review that is reasonably designed to assist them in detecting and preventing violations of, and achieving compliance with, the Impartial Conduct Standards and the policies and procedures governing compliance with the class exemption.

Additional Conditions Required for Advice Regarding Rollovers

The Proposed PTE would be available to cover compensation received as a result of (1) investment advice to take a distribution from a plan or to roll over the assets to an IRA, or (2) investment advice regarding other similar transactions including (but not limited to) rollovers from one plan to another plan, one IRA to another IRA, or one type of account to another account (e.g., from a commission-based account to a fee-based account).[21] DOL notes that while a registered investment adviser charging only a level fee generally may not need to rely on a PTE, if the registered investment adviser provides investment advice that causes itself to receive the level fee (such as due to advice to roll over plan assets to an IRA), then the fee would result in a prohibited transaction that would require a PTE.[22]

Under the Proposed PTE, financial institutions would be required to document the specific reasons that recommendations to roll over employee benefit plan assets from a plan to an IRA, or from one type of account to another, are in the best interest of the retirement investor. "In addition, investment advice fiduciaries under Title I of ERISA would remain subject to the fiduciary duties imposed by section 404 of that statute."[23] DOL requests comments on all aspects of this part of the Proposed PTE.[24]

Additional Conditions Required for Principal Transactions

The Proposed PTE includes relief for principal transactions that is limited in scope and subject to additional conditions. Certain transactions, including those that are "riskless principal transactions" would not be considered principal transactions for purposes of the exemption, and so could occur under the more general conditions.[25] DOL requests comments regarding whether definitions are needed to provide clarity.[26]

For transactions that meet the exemption's definition of Covered Principal Transaction, the Proposed PTE would require the financial institution to adopt written policies and procedures related to credit quality and liquidity. The policies and procedures must be reasonably designed to ensure that the debt security, at the time of the recommendation, has no greater than moderate credit risk and has sufficient liquidity that it could be sold at or near its carrying value within a reasonably short period of time.[27] In the case of tax-exempt municipal bonds, DOL notes that investment advice fiduciaries may wish to document the reasons for any recommendation of such investment and why the recommendation was in the retirement investor's best interest.[28]

Proprietary Products and Limited Menus of Investment Products

DOL confirms in the preamble that the best interest standard can be satisfied by financial institutions and investment professionals that offer proprietary products or provide a limited menu, "including limitations to proprietary products and products that generate third party payments."[29] To meet the Impartial Conduct Standards when recommending proprietary products and using limited menus, DOL describes in the preamble the following requirements:

- give complete and accurate disclosure of their material conflicts of interest in connection with such products or limitations; and
- adopt policies and procedures that are prudently designed to prevent any conflicts of interest from causing a misalignment of the interests of the financial institution and investment professional with the interests of the retirement investor.

DOL cautions that the limited menu cannot be used to justify a recommendation that does not meet the Impartial Conduct Standards; rather, financial institution must prudently conclude "that its offering of proprietary products, or the limitations on investment product offerings, in conjunction with the policies and procedures, would not cause a misalignment of interests."

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Attachment

endnotes

[1] The proposed exemption is available at https://www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/rules-and-regulations/proposed-regulations/investment-advice-fiduciaries/improving-investment-advice-for-workers-and-retirees.pdf. DOL's press release is available at https://www.dol.gov/newsroom/releases/ebsa/ebsa20200629, and DOL's fact sheet is available at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/improving-investment-advice-for-workers-and-retirees.

[2] The Employee Retirement Income Security Act of 1974 (ERISA) prohibits fiduciaries from self-dealing, meaning they cannot cause themselves, their affiliates or related entities to receive additional compensation from transactions involving plans and IRAs unless an exemption applies.

[3] For a summary of FAB 2018-02, see ICI Memorandum No. 31200, dated May 7, 2018, available at https://www.ici.org/my_ici/memorandum/memo31200.

[4] The technical amendment to reinstate the prior guidance is available at https://www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/rules-and-regulations/proposed-regulations/investment-advice-fiduciaries/coi-retirement-investment-advice-notice-of-court-vacatur.pdf.

[5] For a summary of DOL's 2016 fiduciary rulemaking, see ICI Memorandum No. 29837, dated April 13, 2016, available at https://www.ici.org/my_ici/memorandum/memo29837.

[6] For a summary of the Fifth Circuit's decision, see ICI Memorandum No. 31137, dated March 16, 2018, available at https://www.ici.org/my_ici/memorandum/memo31137.

[7] See DOL fact sheet, available at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/improving-investment-advice-for-workers-and-retirees. SEC Chairman Jay Clayton commended the Labor Department's efforts. "The proposed exemption announced today reflects in part the Commission's constructive and ongoing engagement with the Department," Mr. Clayton said in a statement. "I look forward to continuing our work with the Department so that collectively we can enhance investor choice and increase investor protections." See SEC Chairman Jay Clayton's Statement on the Department of Labor's Investment Advice Proposal, June 29, 2020, available at https://www.sec.gov/news/public-statement/clayton-dol-investment-advice-proposal-2020-6-29.

[8] 29 CFR 2510.3-21(c).

[9] ERISA and the Internal Revenue Code ("Code") provide that a person is an investment advice fiduciary to the extent he or she renders investment advice for a fee or other

compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so.

[10] 29 CFR 2509.96-1.

[11] Advisory Opinion 2005-23A (the Deseret Letter).

[12] Under these prohibited transaction provisions, a fiduciary may not deal with the income or assets of a plan or IRA in his or her own interest or for his or her own account, and a fiduciary may not receive payments from any party dealing with the plan or IRA in connection with a transaction involving assets of the plan or IRA. See preamble, page 5. The Proposed PTE would enable receipt of "all forms of reasonable compensation as a result of their investment advice," (see preamble, page 18) and DOL specifies this would cover "a wide variety of payments that would otherwise violate the prohibited transaction rules, including, but not limited to, commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs, and revenue sharing payments from investment providers or third parties." See preamble, page 10.

[13] In addition to the SEC;s recent rulemaking, DOL also mentions standards of conduct developed by other standard setting bodies, including (1) the New York State Department of Financial Services amendment of its insurance regulations to establish a best interest standard in connection with life insurance and annuity transactions; (2) the Massachusetts Securities Division's amendment to its regulations for broker-dealers to apply a fiduciary conduct standard; and (3) The National Association of Insurance Commissioners' revision of its Suitability In Annuity Transactions Model Regulation. DOL explains that "[t]he approach in this proposal includes Impartial Conduct Standards that are, in the Department's view, aligned with those of the other regulators. In this way, the proposal is designed to promote regulatory efficiencies that might not otherwise exist under the Department's existing administrative exemptions for investment advice fiduciaries." See preamble, page 9.

[14] See preamble, page 6. ICI provided a number of comment letters since February 2017 regarding the rulemaking. Most recently, we provided a letter in November 2019 regarding the comparisons and differences between SEC standards and ERIA standards. See ICI Memorandum No. 32050, dated November 12, 2019, available at https://www.ici.org/my_ici/memorandum/memo32050. For a summary of ICI's response to DOL's July 2017 request for information, see ICI Memorandum No. 30818, dated August 8, 2017, available at https://www.ici.org/my_ici/memorandum/memo30818.

[15] DOL seeks comments on whether this list of entities is overly broad, or whether additional entities should be included. DOL also notes that entities not listed here, but that meet the five-part test, would be permitted to apply for individual exemptions and would be granted coverage under the same conditions as in the Proposed PTE. See preamble, pages 16-17.

[16] In the preamble, DOL explains that the reasonableness of fees depends on the facts and circumstances at the time of the recommendation, and depends on factors such as "the market price of service(s) provided and/or the underlying asset(s), the scope of monitoring, and the complexity of the product" and that the standard does not require recommendation of "the transaction that is the lowest cost or that generates the lowest fees without regard to other relevant factors." See preamble, page 39.

[17] In the preamble, DOL states that "[t]he standard is to be interpreted and applied

consistent with the standard set forth in the SEC's Regulation Best Interest and the SEC's interpretation regarding the conduct standard for registered investment advisers." See page 36. DOL also clarifies that the "best interest standard in this proposal would not impose an unattainable obligation on Investment Professionals and Financial Institutions to somehow identify the single 'best' investment for the Retirement Investor out of all the investments in the national or international marketplace" and that the standard should be applied at the time the advice is provided. See preamble, pages 35 and 37.

[18] DOL makes clear that a separate disclosure document is not required; rather, the disclosure "can be satisfied through any disclosure, or combination of disclosures, required to be provided by other regulators so long as the disclosure required by Section II(b) is included." See preamble, page 42.

[19] DOL cautions, however that financial institutions "should carefully consider whether certain investments can be prudently recommended to the individual Retirement Investor in the first place without ongoing monitoring of the investment. Investments that possess unusual complexity and risk, for example, may require ongoing monitoring to protect the investor's interests. An Investment Professional may be unable to satisfy the exemption's best interest standard with respect to such investments without a mechanism in place for monitoring." See preamble, page 37.

[20] To meet the conflict mitigation requirement with respect to commission-based compensation arrangements, DOL specifies that financial institutions should focus on financial incentives to investment professionals and supervisory oversight of investment advice. See preamble, page 48. DOL further notes that it envisions that financial institutions would implement conflict mitigation strategies identified by the financial institutions' other regulators, and DOL specifically identifies a number of examples of practices identified as options by the SEC that might be implemented for compliance with the Proposed PTE. See preamble, page 49.

[21] See preamble, page 19.

[22] See preamble, pages 14-15.

[23] See preamble, page 21.

[24] In the preamble, DOL also specifically asks (1) whether there are other rollover scenarios (not discussed in the preamble) that are not clear and which DOL should address; (2) whether the discussion in the preamble reflects real-world experiences and concerns; and (3) whether the language provides enough clarity to financial entities interested in the proposed exemption. See page 27.

[25] DOL also specifies that the sale of an insurance or annuity contract, or a mutual fund transaction, would not be considered principal transactions for purposes of the exemption, and so could occur under the more general conditions. As with the provision above regarding which entities may use the Proposed PTE, DOL intends the principal transaction provision to be able to accommodate additional investments, by allowing individuals to apply for individual exemptions to allow investment advice fiduciaries to sell the investment in a principal transaction, under the same conditions as the Proposed PTE.

[26] See preamble, page 28.

[27] See preamble, page 29.

[28] DOL asserts that "[t]ax-exempt municipal bonds are often a poor choice for investors in ERISA plans and IRAs because the plans and IRAs are already tax advantaged and, therefore, do not benefit from paying for the bond's tax-favored status." See preamble, pages 29-30.

[29] See preamble, pages 53-54.
