Investment Management and Employee Benefits Update

Godfrey & Kahn Attorneys Responsible for this Update:

Susan M. Hoaglund

262.951.7136
shoaglund@gklaw.com

Michael W. Taibleson

414.287.9384
mtaibleson@gklaw.com

Final DOL Exemption and Guidance on Fiduciary Investment Advice in Connection with Rollover Recommendations

In December 2020, the U.S. Department of Labor (DOL) issued final prohibited transaction exemption (PTE) 2020-02, "Improving Investment Advice for Workers & Retirees" (exemption). The DOL also provided its final interpretation of when advice to roll over plan assets to an IRA will be considered fiduciary investment advice under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (Code). The exemption allows investment advice fiduciaries to receive compensation, including as a result of advice to roll over assets from an ERISA plan to an IRA. The exemption went into effect February 16, 2021. The DOL is expected to publish related guidance for retirement investors, employee benefit plans and investment advice providers. Below is a review of where things stand now for investment advisers.

If you prefer to read a summary of this topic, please see our Executive Summary: Investment Management and Employee Benefits here.

Transition Period

The new exemption replaces the DOL's 2016 fiduciary rule and Best Interest Contract Exemption, which were vacated in 2018. After the vacatur, the DOL issued Field Assistance Bulletin (FAB) 2018-02, a temporary non-enforcement policy providing that it would not pursue prohibited transaction claims against investment advice fiduciaries who worked diligently and in good faith to comply with the Impartial Conduct Standards, which require investment advisers to:

- Give prudent advice that is in the retirement investor's best interest (i.e., based on the investment objectives, risk tolerance, financial circumstances and needs of the retirement investor, without regard to financial or other interests of the investment adviser or investment adviser representative);
- Charge no more than reasonable compensation; and
- Avoid making misleading statements.

The non-enforcement policy will remain in effect until December 20, 2021 and provide a transition period for investment advisers to comply with the provisions in the new exemption, provided they comply with the Impartial Conduct Standards in the interim.

Fiduciary Investment Advice

Discretionary Advisers. Investment advisers with discretionary authority over IRAs and ERISA plans are and always have been investment advice fiduciaries under the Code and ERISA, as applicable.

Non-Discretionary Advisers. Investment advisers with non-discretionary authority, on the other hand, were previously able to take the position that they were not fiduciaries under the Code or ERISA when they gave rollover advice. The DOL, however, has changed its position regarding fiduciary status in the context of rollover recommendations and, as a result, non-discretionary investment advisers who give rollover advice are now investment advice fiduciaries under the Code and ERISA, provided they intend to have an ongoing relationship with the retirement investor and meet the other prongs of the five-part test.

Final Interpretation of Five-Part Test

Five-Part Test. The DOL established a five-part test for fiduciary status under ERISA and the Code in 1975. A person with non-discretionary authority is an investment advice fiduciary if they receive a fee or other compensation and give advice: (1) 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; (4) that will serve as a primary basis for investment decisions with respect to plan or IRA assets; and (5) that will be individualized based on the particular needs of the plan or IRA. Although all prongs of the five-part test must be satisfied, the first two are of particular interest.

First Prong. The DOL issued guidance in a 2005 advisory opinion (known as the Deseret letter) that took the position that a person with no prior relationship to an ERISA plan would not become a fiduciary by reason of providing a rollover recommendation to a participant. The DOL had opined that a rollover recommendation would not meet the first prong of the five-part test. However, the DOL now believes that its analysis was incorrect when it stated that advice to take a distribution of assets is not advice to sell, withdraw or transfer assets. According to the DOL, the better view is that a recommendation to roll assets out of a plan is advice with respect to moneys or other property of the plan, thus satisfying the first prong.

Regular Basis Prong. The DOL acknowledges that a single instance of advice to take a distribution from a plan and roll over the assets would fail to meet the regular basis prong. Likewise, certain sporadic interactions may not meet the regular basis prong. However, advice to roll over plan assets can also occur as part of an ongoing relationship or an *intended* ongoing relationship. Advice to roll over assets where the investment advice provider has not previously provided advice but will be regularly giving advice regarding the IRA would be the start of an advice relationship that satisfies the regular basis prong. The DOL says that its interpretation "merely recognizes that the rollover recommendation can be the beginning of an ongoing advice relationship" and the DOL believes it is important that fiduciary status extend to the entire advisory relationship.

Other Prongs. A rollover recommendation would still need to satisfy the other prongs to be considered fiduciary investment advice.

Fees. In addition to satisfying the five-part test, an investment adviser must receive a "fee or other compensation, direct or indirect" to be an investment advice fiduciary. The DOL has long interpreted this requirement broadly and, in the rollover context, views fees and compensation received from transactions involving rollover assets to be incident to the advice to take a distribution from the plan and to roll over the assets to an IRA. In other words, an investment adviser does not need to charge a fee for its rollover recommendation. It is sufficient that the investment adviser charges a fee for the ongoing relationship.

Reliance on the Exemption for Rollover Recommendations

In light of the potential conflicts of interest related to rollovers from ERISA plans to IRAs, ERISA and the Code prohibit an investment advice fiduciary from receiving fees (including an ongoing management fee paid with respect to the IRA) resulting from investment advice to plan participants to roll over assets from the plan to an IRA, unless an exemption applies.

The DOL confirmed that investment advisers may rely on the new exemption solely for a rollover recommendation under circumstances in which the advice arrangement after the rollover does not involve prohibited transactions (e.g., the adviser's fee is an AUM fee) or is not eligible for relief (i.e., the investment adviser has discretionary authority). In other words, the exemption is available for fiduciary investment advice regarding rollover transactions, even in situations where the exemption is not available (or not needed) before or after the rollover transaction. Therefore, both non-discretionary and discretionary investment advisers may rely on the exemption to recommend clients roll over plan assets to an IRA and charge their ongoing AUM fee to the IRA.

Alternatively, if an investment adviser decides not to comply with the exemption for rollovers, the investment adviser must refrain from making rollover recommendations and limit its practices to only "hire me" communications and investment education as discussed below.

Reliance on the Exemption for Ongoing Management of IRAs or ERISA Plans

Non-Discretionary Advisers. The exemption allows investment advisers with non-discretionary authority over IRAs or ERISA plans to engage in principal transactions and to receive otherwise prohibited compensation, including compensation in connection with proprietary mutual funds. The exemption also allows dual registrants with non-discretionary authority over IRAs or ERISA plans to receive commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs or revenue sharing payments from investment providers or third parties.

Discretionary Advisers. The exemption only covers non-discretionary advice so its only application for investment advisers with discretionary authority is limited to advice about rollovers. Investment advisers with discretionary authority over an IRA or ERISA plan may not rely on the exemption for ongoing management and must avoid all conflicts of interest and prohibited compensation and not engage in principal transactions. Discretionary investment advisers may still rely on current PTEs and advisory opinions if needed. For example, in reliance on PTE 77-4, investment advisers typically waive their advisory fee for any portion of an IRA that is invested in proprietary mutual funds.

Final Exemption

Covered Transactions. The exemption specifically covers compensation received as a result of investment advice to roll over assets from a plan to an IRA. It also covers compensation received as a result of investment advice regarding other similar transactions including rollovers from one plan to another plan, one IRA to another IRA or from one type of account to another account (e.g., from a commission-based account to a fee-based account).

The exemption also provides relief from the restrictions of ERISA and the Code for the receipt of prohibited compensation (such as commissions, 12b-1 fees, trailing commissions, sales loads and revenue sharing payments from investment providers or third parties) in connection with providing non-discretionary investment advice. The exemption covers recommendations of proprietary investment products or investment products that generate payments from third parties. Finally, in addition to recommendations to engage in agency transactions, the exemption covers recommendations to engage in riskless principal transactions and principal transactions involving certain types of covered securities.

Exclusions. The exemption is not available where (1) the investment adviser is the employer of employees covered by the ERISA plan; (2) the adviser is a named fiduciary of an ERISA plan, unless the adviser was selected to provide advice by an independent fiduciary; (3) the investment adviser representative exercises discretion with respect to the transaction; or (4) the transaction involves only robo-advice.

Conditions of the Exemption

Investment adviser representatives and investment advisers must comply with all of the following conditions to obtain relief under the exemption:

- Satisfying the Impartial Conduct Standards;
- Providing written disclosure to clients;
- Providing retirement investors with documentation of the specific reasons that a rollover recommendation is in their best interest;
- Adopting new policies and procedures; and
- Conducting annual compliance reviews.

Impartial Conduct Standards

Best Interest. Investment advice must meet a "best interest" standard, meaning it "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 does not place the financial or other interests of the investment adviser representative, investment adviser or any affiliate, related party or other party ahead of the interests of the retirement investor, or subordinate the retirement investor's interests to their own.

The DOL indicates that the standard is to be interpreted and applied consistently with Regulation Best Interest for broker-dealers and the SEC's fiduciary duty interpretation for investment advisers.

Reasonable Compensation. Compensation received by the investment adviser, the investment adviser representative and their affiliates and related parties for their services must not exceed reasonable compensation within the meaning of ERISA Section 408(b)(2) and Code Section 4975(d)(2)—i.e., as measured by the market value of the particular services, rights and benefits delivered by the investment adviser. In addition, the investment adviser and investment adviser representative must seek to obtain best execution as part of the "reasonable compensation" standard.

No Materially Misleading Statements. The investment adviser and investment adviser representative must not make materially misleading statements.

Written Disclosure

An investment adviser must provide a written disclosure at the time of the recommendation:

- Acknowledging that it and its investment adviser representatives are fiduciaries under ERISA and the Code, as applicable; and
- Describing the services to be provided and material conflicts of interest.

The disclosure can be included in an investment adviser's Form ADV brochure or a separate disclosure document, (e.g., an IRA disclosure statement or 408(b)(2) disclosure). The DOL provides the following model fiduciary acknowledgment language as an example:

> *When we provide investment advice to you regarding your retirement plan account or individual retirement account, we are fiduciaries within the meaning of Title I of the Employee Retirement Income Security Act and/or the Internal Revenue Code, as applicable, which are laws governing retirement accounts. The way we make money creates some conflicts with your interests, so we operate under a special rule that requires us to act in your best interest and not put our interest ahead of yours.*

Investment advisers may want to consider revising the model language to better fit their circumstances. "The way we make money creates some conflicts with your interests" seems to be more closely aligned with receipt of commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs or revenue sharing payments from investment providers or third parties than asset-based fees.

In addition, although the exemption does not require it, the DOL suggests investment advisers could more fully explain the exemption's terms with the following model disclosure:

Under this special rule's provisions, we must:

- *Meet a professional standard of care when making investment recommendations (give prudent advice);*
- *Never put our financial interests ahead of yours when making recommendations (give loyal advice);*
- *Avoid misleading statements about conflicts of interest, fees, and investments;*
- *Follow policies and procedures designed to ensure that we give advice that is in your best interest;*
- *Charge no more than is reasonable for our services; and*
- *Give you basic information about conflicts of interest.*

Documentation of Rollover Recommendations Provided to Retirement Investors

An investment adviser representative must provide retirement investors, prior to engaging in a rollover, with documentation of the specific reasons that the rollover recommendation is in the best interest of the retirement investor. This must be done for any recommendation to roll over assets from: (1) a plan to another plan; (2) a plan to an IRA; (3) an IRA to a plan; (4) an IRA to another IRA; or (5) one type of account to another (e.g., from a commission-based account to a fee-based account).

Plan to IRA. Before making a recommendation to roll over assets from a plan to an IRA, the new exemption requires an investment adviser representative to consider and document the following:

- The retirement investor's alternatives to a rollover, including leaving the money in his or her current employer's plan, if permitted, and selecting different investment options;
- The fees and expenses associated with both the plan and the IRA;
- Whether the employer pays for some or all of the plan's administrative expenses; and
- The different levels of services and investments available under the plan and the IRA.

Diligent and Prudent Effort to Obtain Information About ERISA Plan. An investment adviser representative should make a "diligent and prudent effort" to obtain information regarding the retirement investor's existing plan. In general, such information should be readily available as a result of DOL regulations mandating disclosure of plan-related information to the plan's participants. If the retirement investor is unwilling to provide the information, even after a full explanation of its significance, and the information is not otherwise readily available, the investment adviser representative should make a reasonable estimation of expenses, asset values, risk and returns based on publicly available information. The investment adviser representative should document and explain the assumptions used and their limitations. In such cases, the investment adviser representative could rely on alternate data sources, such as the most recent Form 5500 or reliable benchmarks on typical fees and expenses for the type and size of plan at issue.

IRA to IRA; Change in Account Type. Before making a recommendation to roll over assets from an IRA to an IRA or change from a commission-based account to a fee-based account, the new exemption requires an investment adviser representative to consider and document the services that would be provided under the new arrangement.

Documentation During the Transition Period. If investment advisers do not already document the fact that they have a reasonable basis for their rollover recommendations, they should consider starting that practice now and may wish to dust off their rollover checklists from 2016. In the *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, the SEC notes that an investment adviser's fiduciary duty applies to advice about rollovers so it would be prudent under both the SEC and ERISA fiduciary standards for investment advisers to have documentation supporting rollover recommendations even during the current transition period. Moreover, Regulation Best Interest has required broker-dealers to do a comparative analysis of plans and IRAs before making a recommendation to roll over plan assets into an IRA since June 2020.

Policies and Procedures

An investment adviser must adopt and enforce policies and procedures that (1) are prudently designed to ensure compliance with the Impartial Conduct Standards and (2) mitigate conflicts of interest to the extent that a reasonable person would not view the investment adviser's practices to create an incentive for the investment adviser or investment adviser representative to place their interests ahead of the interest of the retirement investor. Investment advisers should review their policies and procedures periodically.

Proprietary Products. The DOL confirms that investment advisers and investment adviser representatives can satisfy the best interest standard when they provide investment advice on proprietary products. However, they should provide complete and accurate disclosure of their material conflicts of interest in connection with proprietary products. In addition, their policies and procedures should mitigate these conflicts of interest.

Annual Retrospective Compliance Review

An investment adviser must conduct an annual retrospective review reasonably designed to assist in detecting and preventing violations of the Impartial Conduct Standards and the investment adviser's policies and procedures. The methodology and results of the review must be set forth in a written report submitted to one of its senior executive officers, who must certify that the officer reviewed the report and the investment adviser has in place policies and procedures prudently designed to achieve compliance with the exemption and a prudent process to modify and test its policies and procedures. The investment adviser must provide the written report, certification and supporting documents within ten business days of DOL's request. The DOL envisions the annual review process involving a sample of recommended transactions across a wide range of transactions types and sizes.

Self-Correction Procedure

Generally, if an investment adviser representative or investment adviser provides fiduciary investment advice and receives compensation resulting from that advice but fails to comply with any of the conditions of the exemption, a non-exempt prohibited transaction will occur. The exemption permits investment advisers to self-correct violations by following a self-correction procedure described in the exemption.

Principal Transactions

The exemption is available to exempt prohibited transactions that arise by reason of an investment adviser representative or investment adviser recommending that a retirement investor engage in the following principal transactions: (1) a riskless principal transaction; (2) a principal transaction involving the purchase of a security from a retirement investor by the investment adviser; and, (3) a principal transaction involving the sale of only certain, specified securities by an investment adviser to a retirement investor ("Covered Principal Transactions"). In the case of Covered Principal Transactions, the security involved in the transaction must be: (1) U.S. dollar denominated debt security issued by a U.S. corporation and offered pursuant to a registration statement under the Securities Act of 1933; (2) a U.S. Treasury Security; (3) a debt security issued or guaranteed by a U.S. federal government agency other than the U.S. Department of Treasury; (4) a debt security issued or guaranteed by a government-sponsored enterprise; (5) a municipal security; (6) a certificate of deposit; or (7) an interest in a unit investment trust.

Alternate Option: Avoid Rollover Recommendations

If an investment adviser decides not to comply with the exemption for rollovers, the adviser must refrain from making rollover recommendations and limit its practices to only "hire me" communications and investment education.

Hire Me. The DOL does not believe that there should be significant concerns about introductory ''hire me'' conversations and confirmed that the following communication should not be treated as investment advice covered under the five-part test.

> *I have been working with our mutual friend, Bob, for fifteen years, helping him to invest for his kids' college tuition and for retirement. I would love to talk with you about the types of services my firm offers, and how I could help you meet your goals. Here is my business card. Please give me a call on Monday so that we can discuss.*

To the extent, however, that 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 if all five parts of the test were satisfied.

Investment Education. The DOL believes that education about retirement savings and general financial and investment information is not only beneficial and helpful to plans and plan participants, but might not rise to the level of recommendations.

Investment advisers may provide general financial and investment information to inform a participant about (1) general financial and investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return and tax deferred investment; (2) historic differences in rates of returns between different asset classes (e.g., equities, bonds or cash) based on standard market indices; (3) effects of inflation; (4) estimating future retirement income needs; (5) determining investment time horizons; and (6) assessing risk tolerance without making a recommendation.

Conclusion

Based on the current sunset date of the DOL's temporary non-enforcement policy, investment advisers should evaluate how they are advising IRA owners and ERISA plan fiduciaries, participants and beneficiaries under the DOL's new interpretation of fiduciary status. Investment advisers will need to either develop policies and procedures to be ready to comply with the conditions of the exemption by December 20th of this year (2021) or refrain from making rollover recommendations and limit their practices to only "hire me" communications and investment education.

Please contact your Godfrey & Kahn investment management or employee benefits team attorney if we can be of assistance.

Source: Prohibited Transaction Exemption 2020-02, Improving Investment Advice for Workers & Retirees (Dec. 18, 2020), available here.