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Fiduciary Rule Prohibited Transaction Class Exemption Released by the DOL

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On December 15, 2020, the U.S. Department of Labor (DOL) released a final prohibited transaction class exemption for certain fiduciary investment advice actions. Issuance of the exemption is the latest in the tug of war of what began as the DOL's Fiduciary Rule under the Obama administration. The exemption will become effective 60 days after publication by the DOL unless the Biden administration takes action to delay or modify it. The final exemption is broader than the proposed exemption issued by the DOL [see our client alert, "U.S. Department of Labor Proposes New (Simpler) Fiduciary Rule Exemption"].

General. The prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 (Code) generally prohibit a fiduciary from engaging in self-dealing or from receiving compensation from third parties in connection with transactions involving an employee benefit plan (Plan) or IRA. The DOL's newly issued "Improving Investment Advice for Workers & Retirees Exemption" (the Exemption) will allow registered investment advisers, broker-dealers, banks, insurance companies, and their agents, employees, and representatives (collectively, Financial Institutions) that provide fiduciary investment advice to retirement plan investors to receive compensation from third parties in connection with such advice without violating those prohibited transaction restrictions. For example, the Exemption will allow Financial Institutions to receive payments from investment providers or third parties that could otherwise violate the prohibited transaction rules, including, but not limited to, commissions, 12b-1 fees, trailing commissions, sales loads, markups and markdowns, and revenue-sharing payments.

Fiduciary Investment Advice. The Exemption reinserts the five-part test used to determine whether a Financial Institution is considered an investment advice fiduciary. The five-part test had been in existence prior to the issuance of the (now vacated) Fiduciary Rule established by the Obama administration. Under the five-part test, a Financial Institution is considered an investment advice fiduciary if it (i) renders advice 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, (ii) on a regular basis, (iii) pursuant to a mutual agreement, arrangement, or understanding with the Plan fiduciary or IRA owner that (iv) the advice will serve as a primary basis for investment decisions with respect to the Plan or IRA, and (v) the advice is individualized based on the particular needs of the Plan or IRA.

Exemption. To qualify for the Exemption, a Financial Institution that serves as an investment advice fiduciary must:

- Adhere to Impartial Conduct Standards (described below).
- Provide the retirement investor with a written description of the services to be provided, including any material conflicts of interest and an acknowledgment that it and its investment professionals are acting as a fiduciary under ERISA and/or the Code, as applicable.
- If applicable, document the reasons that a rollover recommendation is in the best interest of the retirement investor (and provide such documentation to the retirement investor).
- Adopt policies and procedures designed to ensure compliance with the Impartial Conduct Standards.
- Conduct a retrospective review of compliance.
- Maintain records of compliance.

- The Exemption is not available if (i) within the past 10 years, the Financial Institution was convicted of certain crimes related to providing investment advice to retirement investors or (ii) the Financial Institution engaged in systematic or intentional violation of the exemption's condition or provided materially misleading information to the DOL in connection with the Financial Institution's conduct under the Exemption.

Impartial Conduct Standards Requirement. To meet the Impartial Conduct Standards, a Financial Institution must satisfy a best-interest standard and a "no misleading statements" standard, and charge no more than reasonable compensation.

1. *Best-Interest Standard.* Investment advice provided by a Financial Institution is required to be in the best interest of retirement investors. To meet this standard, a Financial Institution must (i) provide advice that reflects care, skill, prudence, and diligence based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor, and (ii) put the interests of its retirement investors ahead of its own interests.
2. *No Misleading Statements Standard.* Statements made by a Financial Institution to a retirement investor about a recommended transaction and other relevant matters (such as fees, compensation, and material conflicts of interest) must not, at the time the statements are made, be materially misleading.
3. *Reasonable Compensation Standard.* A Financial Institution is prohibited from receiving excessive compensation for providing financial services. The standard requires that compensation not be excessive, as measured by the market value of the particular services, rights, and benefits. No single factor is dispositive in determining the reasonableness of compensation received.

Documentation and Recordkeeping Requirements. To satisfy the requirements of the Exemption, fiduciaries will be required to provide written disclosures to retirement investors that (i) acknowledge their status as a fiduciary, and (ii) describe the material services to be provided, including any material conflicts of interest and any recommended investment transaction prior to or at the time of the recommendation. The disclosure should be written in plain English, and any description must be accurate in all material respects. The DOL has provided model language to address the fiduciary acknowledgement component. To the extent the advice involves a rollover recommendation, the disclosure must also specify the reasons why such rollover is in the best interests of a retirement investor.

A Financial Institution providing fiduciary advice must establish, maintain, and enforce written policies and procedures that are designed to comply with the Impartial Conduct Standards. These policies are required to mitigate conflicts of interest and to avoid misalignment of Financial Institutions' and retirement investors' interests.

Each investment advice fiduciary must create and maintain a record demonstrating compliance with the Exemption for six years.

Compliance Review. In order to comply with the Exemption, Financial Institutions will need to review policies and procedures periodically to ensure they continue to satisfy the Exemption. Further, a Financial Institution must conduct an annual retrospective review of its policies/procedures. The review must be completed within six months following the end of the period covered by the review and be certified in writing by one of the institution's senior executive officers (which are the chief compliance officer, chief executive officer, president, chief financial officers, or one of the three most senior officers of the Financial Institution).

Self-Correction. A Financial Institution may correct certain violations of the Exemption provided that (i) the violation did not result in investment losses to the retirement investors or the Financial Institution made the retirement investor whole for any resulting losses; (ii) the Financial Institution corrects the violation and notifies the DOL within 30 days of the correction; (iii) the correction occurs no later than 90 days after the Financial Institution learned of the violation or reasonably should have learned of the violation; and (iv) the Financial Institution notifies the person responsible for conducting the retrospective review during the applicable review cycle, and the violation and correction is specifically set forth in the written report of the retrospective review. This correction procedure was not part of the proposed Exemption and provides welcome relief for certain violations due to administrative oversight.

Conclusion. The Exemption is relevant for Financial Institutions advising Plans and/or IRAs, or for Financial Institutions involved with selling or purchasing securities to and from Plans and IRAs. If a fund manager meets the fiduciary test described above, it will need to comply with the Exemption if it is engaging in these activities or advising Plans or IRAs. If not, a fund manager

need not be concerned with complying with the Exemption; however, any fund documents should make clear that the fund manager is not acting as a fiduciary in transactions involving Plans or IRAs.

Given the history associated with these rules, Financial Institutions could be excused for wanting to wait and see whether the Biden administration shelves or modifies the Exemption before expending resources to review and/or modify internal policies and procedures.

Our Employee Benefits and Investment Management teams will continue to monitor and report on developments.

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