We'll Know an Investment Advice Fiduciary When We See One

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The Department of Labor (the "DOL") recently finalized a new prohibited transaction exemption that permits investment advice fiduciaries under Section 3(21) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), to receive consideration in connection with rendering investment recommendations to ERISA-covered plans ("Plans") and individual retirement accounts ("IRAs"). In the preamble to the new exemption, the DOL also added significant new gloss to the five-part investment advice test and continued the saga of its attempts to redefine who is an investment advice fiduciary. To a significant degree it appears to have embraced the storied logic of former U.S. Supreme Court Justice Potter Stewart. In a concurring opinion in *Jacobeliis v. Ohio*, 378 U.S. 174, when describing "pornography" not protected by the First Amendment to the Constitution, Justice Potter Stewart famously wrote: "I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description; and perhaps I could never succeed in intelligibly doing so. **But I know it when I see it**."

The exemption itself may be a welcome development to some investment advisors, who now have a path to compliance with the prohibited transaction rules of ERISA and Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"), with respect to previously forbidden compensation practices. However, the guidance from the DOL seems to provide a similar "I know it when I see it" standard for determining when advice or recommendations will cause someone to be an investment advice fiduciary to Plans and IRAs in the first place, and the certainty around investment advice fiduciary status that the five-part test had provided has certainly been diminished.

Exemptive Relief for Commission Based Transactions

The Trump administration apparently recognized that the structural framework that the Obama administration's vacated fiduciary investment advice regulation and its accompanying prohibited transaction exemptions attempted to impose would have left fiduciaries to Plans and IRAs with, at best, an uncertain and potentially dangerous path to receiving compensation that is linked to the advice they provide. The greatest risk of that proposed structure arose under the so-called “best interest contract exemption” (the “BIC Exemption”), which would have allowed individual and class action enforcement of alleged breaches of the exemption’s conditions. The concept of individual enforcement has not been embraced in the newly minted exemption. However, the Trump administration seems to have accepted that persons who provide investment advice, and who are viewed by the investor receiving such advice to be acting in a position of trust, should nonetheless be compelled to adhere to a “best interest” standard under which the interests of the investor cannot be rendered secondary to the interests of the person giving the advice. To that end, the newly adopted prohibited transaction exemption offers an avenue for the receipt of transaction-based compensation for those advisors *but only to the extent they accept and embrace their status as a fiduciary in the first place*. In so doing, the DOL has also adopted new interpretations of the historical five-part test that upend the prior interpretative terrain, introducing significant dangers for those who choose to offer commission-based services without admitting to fiduciary status. As a result of the latest iteration of the DOL’s guidance, advisors who wish to disclaim fiduciary status when advising Plan and IRA clients face a material risk of being retroactively found to be fiduciaries without access to the safety net that the new exemption offers. .

Reconstructing the Five-Part Test

When the Fifth Circuit vacated the regulation promulgated by the Obama administration that attempted to broadly redefine who is an investment advice fiduciary under Section 3(21) of ERISA, the five-part test for determining such status that was adopted by the DOL in 1975 was resurrected. Under that long-standing regulatory interpretation, to be an investment advice fiduciary, a person must

- render advice 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
- on a regular basis
- pursuant to a mutual agreement, arrangement or understanding with the Plan, Plan fiduciary or IRA owner that
- the advice will serve as a primary basis for investment decisions with respect to Plan or IRA assets and that
- the advice will be individualized based on the particular needs of the Plan or IRA.

The preamble to the new exemption, however, adds a new regulatory gloss to this 45-year-old rule that markedly changes the hue of the rule, if not its color entirely.

With respect to determining whether there is "a mutual agreement, arrangement, or understanding" that the investment advice will serve as "a primary basis for investment decisions," the preamble states:

> the Department intends to consider the *reasonable* understanding of each of the parties, if no mutual agreement or arrangement is demonstrated. Written statements disclaiming a mutual understanding or forbidding reliance on the advice as a primary basis for investment decisions will not be determinative, although such statements will be appropriately considered in determining whether a mutual understanding exists. Similarly, after consideration of the comments, the Department also intends to consider marketing materials in which Financial Institutions and Investment Professionals hold themselves out as trusted advisers, in evaluating the parties' reasonable understandings with respect to the relationship.

In prior practice, most advisors working with Plans and IRAs took great comfort that the five-part test would not make them investment advice fiduciaries if they affirmatively disclaimed such status, believing that an affirmative denial of such status would preclude the creation of a "mutual understanding" that they were serving as a fiduciary. In declining "to set forth evidentiary burdens applied to establish a mutual understanding" for purposes of this five-part test, the DOL appears to have adopted the logic of Justice Potter, stating "[t]hat question is better left to development by the courts or, if necessary, future guidance or rulemaking."

The Danger of an Ongoing Relationship

With regard to the prong of the five-part test that requires that a person provide advice on "a regular basis," the DOL acknowledged that financial services professionals could still "engage in one-time sales transactions without becoming fiduciaries under the Act, including by assisting with a rollover [into an IRA maintained with that professional or their organization]." But the DOL has concluded that, where a rollover recommendation marks "the beginning of an ongoing relationship, …. the functional fiduciary test under [ERISA] and the Code appropriately covers the entire fiduciary relationship, including the first instance of advice." Thus, under the DOL's view, the very first recommendation that a person makes may be sufficient to create fiduciary status if it is the first piece of advice provided in what *is expected to be* an ongoing relationship. In applying the five-part test historically, most persons providing investment advice did not understand that

yet-to-be-given recommendations needed to be factored into the analysis of whether their first interaction with a Plan or an IRA would deem them to be providing advice on a regular basis sufficient to be found a fiduciary within the meaning of ERISA and the Code.

The Need to Disavow a Position of Trust and Confidence

Indeed, while the DOL purported not to create a presumptive standard for determining whether the five-part test had been satisfied, it did seem to place a very heavy foot on the scales in guiding the conduct of those otherwise providing such investment advice, drawing what some might interpret to be a bright line test for whether certain conduct will or will not give rise to fiduciary status:

> [t]he Department believes that Financial Institutions and Investment Professionals who meet the five-part test and are investment advice fiduciaries relying on this exemption should clearly disclose their fiduciary status to their Retirement Investor customers. By making this disclosure, they provide important clarity to the Retirement Investor and put themselves in the best possible position to meet their fiduciary obligations and comply with the exemption. By setting clear expectations and acting accordingly, the mutual understanding prong of the five-part test should seldom be an issue for parties relying on the exemption. Similarly, if a Financial Institution or Investment Professional *does not want to assume a fiduciary relationship or create misimpressions about the nature of its undertaking, it can clearly disclose that fact to its customers up-front, clearly disclaim any fiduciary relationship, and avoid holding itself out to its Retirement Investor customer as acting in a position of trust and confidence*. (emphasis added)

This dichotomy will prove helpful to persons who are offering products for investment but who never intend to undertake to act *on behalf of* a Plan or IRA. Such persons had indeed worried that the vacated Obama administration regulation could have turned them into investment advice fiduciaries, particularly as to smaller plans, when what they were truly doing was marketing investment products for others to review and evaluate. But for those whose business entails a personal and ongoing relationship with the investor, the adoption of an “I’ll Know It When I See It” standard may force a choice between (1) accepting and acknowledging fiduciary status and opting to seek the benefit of the available prohibited transaction exemption (with its corresponding conditions and DOL oversight) and (2) embarking on the ERISA version of the Oregon Trail, using the (now less formidable) five-part test as a guide and hoping that it will lead safely to richer pastures despite the inherent dangers. The latter approach will be most precarious for those who give advice to individual participants about rolling assets out of a 401(k) or other ERISA-subject defined contribution plan, which under the DOL's newly espoused view of the "regular basis" prong of the test may make such persons fiduciaries with regard to assets subject to ERISA and therefore directly subject to the enforcement authority of the DOL.[1]

The Conditions of the Exemption

The exemption, which is largely the same as what the DOL proposed in July of 2020, permits qualifying financial institutions—generally, registered investment advisers, broker-dealers, banks and insurance companies—and their individual employees, agents and representatives to receive compensation that varies based on their investment advice, including compensation paid by third parties. As noted above, the exemption is only available if the persons providing the advice *acknowledge their fiduciary status under ERISA or the Code in writing* and accurately describe in writing the services they will provide as well as their material conflicts of interest.

The exemption also exempts certain principal transactions where the financial institution engages in so-called "riskless principal transactions" or sells securities or investments to the advice recipient from its own portfolio or purchases investments from the advice recipient for its own account. Where required by the federal securities laws, the financial institution and its investment professional must also seek to obtain the best execution of the investment transaction reasonably available under the circumstances.

Impartial Conduct Standards

To avail itself of the exemption, the institution or one of its advisors must comply with the following "impartial conduct standards":

Best Interest Standard

At the time the investment advice is provided, the advice must reflect the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person

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1 The DOL has authority to grant exemptions from the prohibited transaction provisions of Section 4975 of the Code that apply to IRAs, but it does not have authority to enforce the provisions of Section 4975 of the Code itself (including compliance with any applicable exemptions). Only the Internal Revenue Service may enforce these Code provisions. Thus, an advisor who determines it is not a fiduciary with respect to IRA assets could not be second-guessed on that determination by the DOL, only by the Internal Revenue Service.

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 investor. *The advice must also not place the financial or other interests of the financial institution or investment professional (or other parties) ahead of the interests of the recipient of the advice*. In contrast to the BIC Exemption that accompanied the now vacated Obama administration regulation, the interest of the institution and the advisor in the transaction can be a factor in the recommendation as long as the recommendation does not relegate the interest of the investor to a secondary position (i.e., a recommendation that is good for the investor, but still benefits the advisor, should be permissible). As it did when proposing the exemption, the DOL has stated that this second prong of the best interest standard should be interpreted consistently with the standard of conduct requirements applicable to broker-dealers under the Securities and Exchange Commission's Regulation Best Interest.

Reasonable Compensation Requirement

The compensation received by the financial institution or its representative in connection with rendering the advice (whether directly from the investor or indirectly from a third party) must be reasonable, applying the standard applicable under Section 408(b)(2) of ERISA and Section 4975(d)(2) of the Code. Under this standard, the question of whether the compensation is reasonable will be determined on the particular facts and circumstances, taking into account market factors, the services provided and the benefit of such services to the investor.

Statements Not Materially Misleading

Any statements that the financial institution or its investment professionals make with regard to any material matter, such as the description of their material conflicts of interest, the services they will provide or the compensation that they will receive, must not be "materially misleading" when made.

Additional Disclosure for Rollover Recommendations

If the advice provided pertains to a rollover transaction, a financial institution must document and disclose to the advice recipient the specific reasons why its recommendation to roll over assets from a Plan or IRA to another Plan or IRA or from one type of account to another (e.g., from a commission-based account to a fee-based account) is in the investor's best interest. As a practical matter, the advisor will be establishing the rationale that it will have to defend against any later challenge that it had in fact placed its interest ahead of that of the person receiving the recommendation.

Required Policies and Annual Review

In addition to satisfying the impartial conduct standards, the financial institution must also establish, maintain and enforce written policies and procedures prudently designed to ensure that it and its investment professionals comply with such impartial conduct standards. These policies must be crafted in a manner such that a reasonable person would conclude that they do not create an incentive for the institution and its investment professionals to place their interests ahead of the interests of the persons to whom they provide investment advice.

The financial institution must also conduct a retrospective review, at least annually, of its compliance with these impartial conduct standards. Such review must be reasonably designed to assist in identifying and preventing violations of the impartial conduct standards. The institution must produce a written report describing the methodology applied in conducting the review and the results of the review, and this report must be provided to and reviewed by a "senior executive officer," who must generally be the institution's chief compliance officer, chief executive officer, president or chief financial officer. Based on this report, the relevant senior executive officer must certify that the financial institution has in place policies and procedures prudently designed to achieve compliance with the conditions of the exemption and, as applicable, has modified such policies and procedures as and to the extent business, regulatory and legislative changes and events dictate. The institution must promptly provide the DOL a copy of such report upon its request.

Self- Correction Opportunity

The Obama administration BIC Exemption would have created a contractual right for the advice recipient (directly or as a participant in a class action) to enforce violations of the exemption, whether or not inadvertent. In contrast, the new exemption not only precludes direct enforcement by the investor but also permits a financial institution the opportunity to self-correct violations of the applicable conditions. To self-correct a violation, a financial institution must: (i) either determine that the violation did not result in investment losses or make the investor whole for any such losses; (ii) correct the violation *and notify the DOL* within 30 days of correction; (iii) complete the correction no later than 90 days after it learns of (or reasonably should have learned of) the violation; and (v) notify the senior executive officer responsible for conducting the retrospective review during the applicable review cycle so the correction can be included in the report.

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