DOL'S NEW FIDUCIARY RULE

On February 16, 2021, a new DOL fiduciary "rule" became effective. The rule is a combination of a new and expansive definition of fiduciary advice (and status) and an exemption from the prohibitions of ERISA and the Internal Revenue Code for certain conflicts of interest arising from nondiscretionary fiduciary recommendations. The summary below discusses the new guidance, the requirements already in effect, and the additional requirements that become effective later this year (on December 21, 2021).

SCOPE OF THE NEW RULE

The DOL's guidance applies to advice to ERISA retirement plans and participants, and to IRA owners (which are referred to as "retirement investors") by financial institutions and investment professionals. "Financial institutions" is defined as registered investment advisers, broker-dealers, banks and trust companies, and insurance companies. "Investment professionals" defines representatives and agents of those financial institutions. In the preamble to the exemption, the DOL announced an expanded definition of when financial institutions and investment professionals become ERISA and Code fiduciaries. Specifically, the DOL redefined parts of the 5-part functional test for fiduciary status. For example, as it relates to rollover recommendations, in an explanatory set of FAQs issued in April, the DOL asked and answered:

> Q7. When is advice to roll over assets from an employee benefit plan to an IRA considered to be a on a "regular basis"?
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> A single, discrete instance of advice to rollover assets from an employee benefit plan to an IRA would not meet the regular basis prong of the 1975 test. However, advice to rollover plan assets can also occur as part of an ongoing relationship or as the beginning of an intended future ongoing relationship that an individual has with an investment advice provider. When the investment advice provider has been giving advice to the individual about investing in, purchasing, or selling securities or other financial instruments through tax-advantaged retirement vehicles subject to ERISA or the Code, the advice to roll assets out of the employee benefit plan is part of an ongoing advice relationship that satisfies the regular basis prong. ***Similarly, when the investment advice provider has not previously provided advice but expects to regularly make investment recommendations regarding the IRA as part of an ongoing relationship, the advice to roll assets out of an employee benefit plan into an IRA would be the start of an advice relationship that satisfies the regular basis requirement.*** The 1975 test extends to the entire advice relationship and does not exclude the first instance of advice, such as a recommendation to roll plan assets to an IRA, in an ongoing advice relationship.

In other words, if an investment adviser or broker-dealer recommends a rollover to a participant, and the contemplation is that the rollover will be to an IRA with the advisory firm or the broker-dealer…and that investment recommendations will be made periodically to the IRA owner, the "regular basis" part of the 5-part test of fiduciary status is satisfied. (The significance of satisfying the regular basis requirement is that the other 4 parts of the test are often also satisfied in the ordinary course of events, meaning that the broker-dealer or the advisory firm would be a fiduciary.) The 5-part test is a functional test and cannot be avoided by contract or disclosure alone.

Also, the DOL interprets a "rollover" very broadly to include, e.g., a rollover from a plan to an IRA, from an IRA to a plan, from an IRA to an IRA, or a change of account types for a plan or an IRA (e.g., from commission-based to fee-based). While this example is of a rollover recommendation, other advice to plans, participants and IRA owners is similarly impacted.

Once a firm (and its representative) become a fiduciary under these tests, the next step is to determine whether the fiduciary recommendation results in a conflict of interest (or, in the language of ERISA and the Code, a "prohibited transaction"). For example, a rollover recommendation, if accepted by the participant, will usually result in a prohibited transaction because of the compensation that will be earned from the IRA. (Other common conflicts that are prohibited are any third-party payments (e.g., revenue sharing, insurance commissions, solicitor fees), any transaction-based payments (e.g., securities commissions, 12b-1 fees), and proprietary investments.) As a result, investment advisory firms and broker-dealers will need the protection of the new Prohibited Transaction Exemption (PTE) 2020-02. However, the exemption has a number of conditions that must be satisfied.

Below discusses the DOL's temporary non-enforcement policy in effect until December 20 and the full conditions of the PTE which must be satisfied beginning December 21.

DOL NON-ENFORCEMENT POLICY

While the new rule was fully effective on February 16, the DOL issued (with concurrence by the IRS) a non-enforcement policy. That is, the DOL (and IRS) will not enforce the full conditions of the PTE ***until December 21*** so long as the financial institution and investment professional satisfy the Impartial Conduct Standards. Here is how the DOL explained those Standards in their April FAQs:

> Q11. What are the Impartial Conduct Standards?
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> The Impartial Conduct Standards are consumer protection standards that ensure that financial institutions and investment professionals adhere to fiduciary norms and basic standards of fair dealing. The standards specifically require financial institutions and investment professionals to:
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> - Give advice that is in the "***best interest" of the retirement investor***. This best interest standard has two chief components: prudence and loyalty;
>   - Under the prudence standard, the advice must <u>meet a professional standard of care</u> as specified in the text of the exemption;
>   - Under the loyalty standard, advice providers may <u>*not place their own interests ahead of the interests of the retirement investor*</u>, or subordinate the retirement investor's interests to their own;
> - Charge no more than ***reasonable compensation*** and comply with federal securities laws regarding "best execution"; and
> - Make ***no misleading statements*** about investment transactions and other relevant matters.

Of the three Standards, the best interest standard is the more difficult to satisfy. Essentially it is a combination of ERISA's prudent man rule and duty of loyalty. That standard requires that the financial institution and investment professional engage in a process that considers the appropriate information and reaches an informed decision that is in the best interest of the retirement investor. For example, in a rollover context, the financial institution would need to gather and consider:

- information about the ***investments, costs and services in the plan;***
- information about the ***investments, services and costs in the available IRA***;
- information about the ***needs and circumstances of the participant.***

The best interest standard then requires that the information be evaluated at the level of a person knowledgeable about the relevant issues (e.g., plans, IRAs, retirement investing, etc.) and the resulting recommendation would need to be in the best interest of the retirement investor.

THE FULL CONDITIONS OF PTE 2020-02

The non-enforcement policy expires on December 20, and thereafter the full conditions of the exemption must be satisfied. Here is a list of those conditions:

- The *Impartial Conduct Standards* (ICS) continue to apply.
  REFER TO Impartial Conduct Standards LIST ABOVE.

- A ***written acknowledgement*** that the financial institution and investment professional are fiduciaries.
- A ***written description of the services to be provided and the material conflicts of interest*** of the financial institution and investment professional. (Presumably, e.g., a rollover recommendation results in a material conflict.)
- For rollover recommendations, the retirement investor ***must be given documentation of the specific reasons why the rollover recommendation is in the best interest of the retirement investor***. (Keep in mind that "rollover" is broadly defined.)
  THESE 3 BULLETS ABOVE WILL BE INCLUDED IN THE WRITTEN STATEMENT TO THE CLIENT WITH SERVICES, FEE ANALYSIS, COST REVIEW, RATIONALE ON WHY ROLLOVER IS IN THE BEST INTEREST OF THE CLIENT.

- The financial institution must have ***written policies and procedures to ensure compliance with the Impartial Conduct Standards***.
- The Financial Institution's ***policies and procedures must mitigate conflicts*** so that they do not create an incentive for the firm or its investment professionals "to place their interests ahead of the interest of the Retirement Investor".
  CRP WILL ASSIST IN PROVIDING POLICIES AND PROCEDURES IN Q4 TO ADDRESS ICS AND CONFLICT MITIGATION.

- Each year the Financial Institution must do a retrospective review of compliance with the requirements of the PTE. The ***results must be documented in a report that is reviewed and signed by a senior executive officer of the firm***.
  THIS CAN BE INCLUDED IN THE ANNUAL COMPLIANCE REPORT/REVIEW (REFER TO RULE 206 4-7). CRP PROVIDES A SAMPLE REPORT FOR FIRMS TO TAILOR AND SUMMARIZE THE COMPLIANCE PROGRAM. FIRMS CAN PROVIDE A SUPPLEMENTAL REVIEW TO ADDRESS IS CONDITION.

In the coming months, the required written materials (e.g., the policies and procedures) and sample training materials for supervisory personnel and investment professionals will assist with this area of compliance for firms As mentioned above, the processes and documentation must be in place by December 21, and the training should occur before that. While some broker-dealers may be thinking that their Reg BI compliance efforts will cover these new requirements. the PTE's mitigation requirements appear to be more demanding than the SEC's. The PTE's mitigation rules apply at the firm level, while the SEC's do not. **Continue to be diligent on the review of the Rollover Analysis at your firm. We will be updating the Rollover Analysis to assist with compliance of this rule.** This will assist advisors in developing good habits for when full compliance of the new rule comes around!

As we learn more about this rule, the difference between expectations of the DOL and SEC, we will keep you informed.