SULLIVAN & CROMWELL LLP

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DOL Formally Reinstates Pre-2016 Fiduciary Rule Regulations and Proposes New Prohibited Transaction Exemption

Proposed Exemption Would Allow Financial Institutions and Their Employees to Receive Otherwise Impermissible Compensation and Engage in Principal Transactions.

SUMMARY

On June 29, 2020, the Department of Labor (the "DOL") formally reinstated the pre-2016 fiduciary rule regulations and issued a notice (the "Notice") proposing a new prohibited transaction exemption that would apply to investment advice fiduciaries that receive certain types of compensation or engage in principal transactions that would otherwise be impermissible under the self-dealing restrictions of the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code (the "Code"). The proposed exemption (the "Proposed Exemption") would require investment advice fiduciaries to satisfy "impartial conduct standards" and comply with additional disclosure, documentation and monitoring requirements.

BACKGROUND

ERISA Generally**.** ERISA imposes stringent duties on persons treated as fiduciaries of an employee benefit plan, including a duty of undivided loyalty, a duty to act for the exclusive purpose of providing plan benefits (and defraying costs) and a stringent duty of care. In addition, ERISA and Section 4975 of the Code prohibit a plan fiduciary from causing a plan to engage in certain "prohibited transactions," such as receiving commissions for advice provided to a plan and engaging in transactions involving a conflict of interest between the fiduciary and the plan. In particular, plan fiduciaries are prohibited from receiving compensation that varies based on their investment advice and compensation from third parties. Fiduciaries are also prohibited from engaging in purchases and sales with plans or IRAs on behalf of the fiduciaries' own accounts (referred to as "principal transactions").

Unless otherwise covered by a statutory or DOL exemption, a breach of ERISA's fiduciary duties or the prohibited transaction rules with respect to an employee benefit plan can result in liability under ERISA to make the plan whole for any losses, disgorge profits, pay civil penalties to the DOL and, under the comparable provisions of Section 4975, pay penalty taxes ranging from 15% to 100% of the face amount of the relevant transaction. ERISA and the Code provide several statutory exemptions to the prohibited transaction rules discussed above. In addition, the Secretary of Labor has the authority to grant administrative prohibited transaction exemptions ("PTEs").

Under ERISA and Section 4975 of the Code, a person who directly or indirectly renders investment advice for a fee or other compensation with respect to the assets of a plan or IRA is treated as a fiduciary. A DOL regulation issued in 1975 provides that a person who does not have discretionary authority or control with respect to the assets of a plan will not be treated as a fiduciary by reason of providing investment advice unless: (1) such person renders advice with respect to the value of securities or other property or makes recommendations as to the advisability of investing in particular securities or property, (2) on a *regular basis*, (3) the advice is provided pursuant to a mutual agreement, arrangement or understanding with the plan that (4) the advice will serve as a *primary basis* for investment decisions with respect to plan assets, and (5) the advice is individualized to the plan based on the needs of the plan.

In 2016, the DOL proposed new investment advice regulations that significantly broadened the circumstances in which a person is treated as a fiduciary by reason of providing investment advice to a plan or IRA. These regulations were briefly in effect before being vacated in their entirety by the courts in 2018. In connection with the 2016 rules, the DOL also proposed new PTEs that exempted certain transactions in which, among other requirements, the investment advice fiduciary entered into an enforceable contract with the plan or IRA, complied with an enumerated set of "impartial conduct standards" and adopted policies and procedures to ensure compliance with the terms of the exemption.

When the 2016 rules were vacated by the courts, the DOL issued a field advice bulletin (the "FAB") stating that the DOL would not pursue prohibited transaction claims against investment advice fiduciaries that worked diligently and in good faith to comply with "impartial conduct standards" for transactions that would have satisfied the requirements of the exemptions proposed in connection with the 2016 rules. The present proposed exemption would, when finalized, create a permanent PTE based largely on the FAB.

REINSTATED REGULATIONS

The DOL formally issued regulations identical to the 1975 regulations, including the five-part test described above, which has the effect of conforming the official text of the regulations to the pre-2016 language.

Accordingly, the Proposed Exemption is not necessary (and, as discussed below, is not applicable) in the case of investment advice that does not cause the adviser to become an investment advice fiduciary.

In addition to separately reinstating the 1975 regulations, the DOL used the Notice to provide its view on when advice to roll over plan assets to an IRA could be considered fiduciary investment advice. In particular, the five-part test requires that advice be made on a regular basis, and that such advice be pursuant to a mutual understanding that the advice will serve as a primary basis for investment decisions. According to the Notice, the regular basis prong can be satisfied if advice is given as part of an anticipated ongoing relationship, not just in connection with an already existing relationship. Additionally, the determination of whether investment advice is given pursuant to a mutual understanding is based on the reasonable understanding of both parties. Written statements disclaiming a mutual understanding or forbidding reliance on advice as a primary basis for investment decisions are not determinative, though such statements are appropriately considered for determining whether a mutual understanding exists.

THE PROPOSED EXEMPTION

The Proposed Exemption would be available to investment advice fiduciaries that are financial institutions (as specifically defined, "Financial Institutions") and licensed investment professionals ("Investment Professionals") that are employees, agents, or independent contractors of the Financial Institution. The Proposed Exemption would cover transactions in which the Financial Institution or Investment Professional receives certain types of compensation or participates in the transaction as a principal. While the exemption is largely modelled after the FAB and exemptions proposed in connection with the 2016 rules, it significantly does not contain a contract requirement, and therefore does not give rise to a private right of action for plans or IRA beneficiaries. Furthermore, the Proposed Exemption would provide a defense to private litigation otherwise available under ERISA for covered transactions.

A. ELIGIBLE INVESTMENT ADVICE FIDUCIARIES

As described above, the Proposed Exemption would be available to investment advice fiduciaries of a plan or IRA that are either Financial Institutions or Investment Professionals. For this purpose, Financial Institutions are defined as SEC- or state-registered investment advisers, broker-dealers, insurance companies and banks. Additionally, the definition of Financial Institution would automatically expand to include any additional types of entities if entities of such type are granted individual exemptions by the DOL under the same terms otherwise applicable to Financial Institutions in the Proposed Exemption.

An Investment Professional is an individual that is an investment advice fiduciary and that is an employee, independent contractor, agent or representative of a Financial Institution, and who satisfies any applicable licensing requirements of insurance, banking and securities laws with respect to the covered transaction.

B. COVERED TRANSACTIONS

The Proposed Exemption covers two types of transactions: (i) the receipt of reasonable compensation as a result of providing investment advice to a participant or beneficiary of a plan, the beneficial owner of an IRA acting on behalf of the IRA, or a fiduciary of a plan or IRA (a "Retirement Investor"), and (ii) certain principal transactions.

With respect to compensation, the Proposed Exemption would provide broad relief for the receipt of all forms of reasonable compensation as a result of providing investment advice to a Retirement Investor. For example, relief would be available with respect to advice to acquire, hold or dispose of securities or other investments, to receive a distribution from a plan, to roll over assets to an IRA, or to change account types (e.g., from a commission-based account to a fee-based account).

The Proposed Exemption also provides relief for riskless principal transactions and "Covered Principal Transactions." A riskless principal transaction is one in which the Financial Institution, after having received an order from a plan or IRA to buy or sell an investment product, purchases or sells the same product for the Financial Institution's own account to offset the contemporaneous transaction with the plan or IRA.

Covered Principal Transactions are a subset of principal transactions—other than riskless principal transactions—that includes the purchase of any securities or other investment property from a plan or IRA. However, with respect to a sale to a plan or IRA, Covered Principal Transactions include only transactions involving corporate debt offered pursuant to a registration statement under the Securities Act of 1933, various types of U.S. government debt, municipal bonds, certificates of deposit, and interests in unit investment trusts. As with the definition of Financial Institution, the definition of Covered Principal Transaction would automatically expand to include additional investments if the DOL grants an individual exemption that covers a new type of investment under the same terms otherwise applicable to the Proposed Exemption.

Principal transactions that are not either riskless principal transactions or Covered Principal Transactions would not be eligible for relief under the Proposed Exemption.

C. PROPOSED EXEMPTION REQUIREMENTS

1. Impartial Conduct Standard

The Proposed Exemption requires the investment advice fiduciary to satisfy the "Impartial Conduct Standard." This standard requires that:

- The investment adviser must provide advice that is in the "best interest" of the Retirement Investor, defined as advice that:
  - 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 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;

- The compensation received, directly or indirectly, by the Financial Institution, the Investment Professional or their affiliates for services does not exceed reasonable compensation;
- As required by federal securities laws, the Financial Institution and Investment Professional seek to obtain the best execution of the investment reasonably available under the circumstances; and
- The Financial Institution's and Investment Professional's statements to the Retirement Investor about the recommended transaction and other relevant matters are not, at the time the statements are made, materially misleading.

Best Interest Standard. The best interest standard does not require the Financial Institution or Investment Professional to identify the single "best" investment for the Retirement investor out of all investments in the national or international marketplace. Rather, the obligation would be to give advice that adheres to professional standards of prudence and that does not place the interests of the Financial Institution, Investment Professional or a related party ahead of those of the Retirement Investor. Additionally, the best interest standard does not impose an ongoing monitoring requirement for Financial Institutions or Investment Professionals. However, as described further below, Financial Institutions would be required to disclose which services they will provide. Additionally, the Notice contemplates that the best interest standard may be difficult to satisfy for certain investments (for example, those that possess unusual complexity and risk) without a mechanism for ongoing monitoring.

Reasonable Compensation. The reasonable compensation requirement entails compensation that is not excessive, as measured by the market value of the services provided and the benefits delivered to the Retirement Investor. In general, the reasonableness of fees will depend on the particular facts and circumstances surrounding the fees. However, relevant factors for this determination would include the market price of the service provided and/or the underlying asset, the scope of monitoring, and the complexity of the product. However, the Financial Institution and Investment Professional would not be required to recommend the transaction with the lowest cost, or that generates the lowest fees without regard to other factors.

Best Execution. Financial Institutions and Investment Professionals are subject to a wide variety of federal laws that require a duty of best execution, and the DOL intends to apply the best execution standard consistent with federal securities laws.

No Misleading Statements. Statements made by the Financial Institution and its Investment Professionals about the recommended transaction and other relevant matters must not be materially misleading at the time they are made. Other relevant matters would include fees and compensation, material conflicts of interest, and other facts that could reasonably be expected to affect the Retirement Investor's investment decisions. Significantly, the DOL would consider any exculpatory clauses or indemnification provisions that are prohibited by law to be materially misleading. For example, the DOL interprets any arrangement for the indemnification of a fiduciary of a plan to be void.

2. Disclosure Requirements

Prior to engaging in a transaction pursuant to the Proposed Exemption, the Financial Institution must provide (i) written acknowledgment of fiduciary status of the Financial Institution and Investment Professional under ERISA and the Code (as applicable), (ii) a written description of the services to be provided, and (iii) the material conflicts of interest arising out of the services and any recommended investment transaction. These descriptions must be accurate in all material respects, and must be made in plain English, taking into consideration the Retirement Investor's level of financial experience. However, the disclosure requirement can be satisfied through any disclosure, or combination of disclosures, required to be provided by other regulator so long as the items described above are included. Additionally, the disclosures do not need to be specifically tailored for each Retirement Investor or each transaction, as long as a compliant disclosure is provided before engaging in the transaction for which an exemption is sought.

In a notable departure from the exemptions that were proposed in connection with the 2016 rules, the disclosures required by the Proposed Exemption are not intended to create a private right of action as between a Financial Institution or Investment Professional and a Retirement Investor, and the DOL expresses its view in the Notice that these disclosures do not create such a right. ERISA otherwise provides a cause of action for fiduciary breaches and prohibited transactions with respect to ERISA-covered plans, but there is no corresponding cause of action for IRAs under the Code.

3. Policies and Procedures

To comply with the Proposed Exemption, Financial Institutions would be required to establish, maintain and enforce policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards. These policies and procedures would be required to mitigate conflicts of interest so that, when viewed as a whole, such policies and procedures—and the Financial Institution's incentive practices—are prudently designed to avoid misalignment of the interests of the Financial Institution and Investment Professionals and the interests of Retirement Investors. For commission-based compensation arrangements, the DOL encourages Financial Institutions to focus on both the financial incentives and the supervisory oversight of investment advice. In developing compliance structures, the DOL envisions that Financial Institutions would implement conflict of interest mitigation strategies identified by other regulators.

The Notice also acknowledges that the best interest standard can be satisfied through the use of proprietary products or a limited menu of investment options, including limitations to proprietary products and products that generate third-party payments. However, the Notice highlighted that these arrangements can result in heightened conflicts of interest. In such a case, the Financial Institution and Investment Professionals would satisfy the best interest standard provided they give complete and accurate disclosure of material conflicts, and adopt policies and procedures prudently designed to prevent conflicts of interest between the interests of the Financial Institution and Investment Professional with the interests of the Retirement Investor. The DOL contemplates that such policies would include policies applicable to situations where the Financial Institution or Investment Professional prudently determines that its proprietary products or limited menu do not offer the Retirement Investor an investment option in their best interest when compared with other investment alternatives available in the marketplace.

Additionally, rollover transactions and Covered Principal Transactions involving the sale of debt instruments to plans or IRAs require additional specific disclosures. In the case of rollover transactions, Financial Institutions would be required to document the specific reason or reasons why the recommendation was considered in the best interest of the Retirement Investor. Where the recommended transaction is a rollover from a plan to an IRA, such documentation would need to include the Retirement Investor's alternatives to a rollover, 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 service and investments available under the plan and the IRA.

For Covered Principal Transactions involving the sale of debt instruments to a plan or IRA by the Financial Institution, the recommendation must be made pursuant to written policies and procedures adopted by the Financial Institution that are reasonably designed to ensure that the 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.

The Financial Institution must also conduct a retrospective review, at least annually, of the policies and procedures required by the Proposed Exemption. The methodology of the review must be reduced to a written report that is provided to the Financial Institution's CEO. The CEO would be required to certify annually that (i) the CEO has reviewed the report on the retrospective review; (ii) the Financial Institution has in place policies and procedures prudently designed to achieve compliance with the conditions of this exemption, and (iii) the Financial Institution has in place a prudent process to modify such policies and procedures as business, regulatory and legislative changes and events dictate, and to test the effectiveness of such policies and procedures on a periodic basis, the timing and extent of which is reasonably designed to ensure continuing compliance.

This retrospective review, report and certification would be required to be completed within six months of the end of the period covered by the review, and retained for six years.

4. Recordkeeping

Finally, the Financial Institution must maintain records for six years demonstrating compliance with the Proposed Exemption, and these records must be made available to the DOL, any fiduciary of a plan that engaged in a transaction pursuant to the Proposed Exemption, any contributing employer or employee organization whose members are covered by a plan engaged in a transaction pursuant to the Proposed Exemption, and any participant or beneficiary of a plan or IRA that engaged in a transaction pursuant to the Proposed Exemption.

D. EXCLUSIONS

The Proposed Exemption would explicitly not apply to ERISA-covered plans if the Financial Institution, Investment Professional or an affiliate is the employer of the employees covered by the plan. Additionally, the Proposed Exemption would not be available if the Financial Institution, Investment Professional or an affiliate is a named fiduciary or plan administrator, unless the Financial Institution or Investment Professional was selected to provide investment advice by an independent fiduciary. A fiduciary would be treated as independent for this purpose if, among other requirements, the independent fiduciary does not receive compensation in excess of 2% of the person's annual revenues from the Financial Institution or Investment Professional.

The Proposed Exemption also does not extend to robo-advice arrangements that do not involve an interaction with an Investment Professional, though such arrangements may be covered by separate statutory exemptions.

Finally, the Proposed Exemption would not be available to fiduciaries acting in a fiduciary capacity other than as an investment advice fiduciary.

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