EXECUTIVE SUMMARY[1]

Broadridge®

Improving Investment Advice for Workers & Retirees U.S. Department of Labor 'Prohibited Transaction Rule,' or PTE 2020-02

October 26, 2021

INTRODUCTION

Background. In 2016, the U.S. Department of Labor (the "Department" or "DOL") released a final rule[2] updating the definition of a fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA").[3] The rule was the culmination of a highly charged debate six years in the making over the appropriate standard of conduct for investment advice to ERISA plans and plan participants, as well as to individual retirement accounts ("IRAs"). The rule generally broadened the definition of a sec. 3(21) investment fiduciary and created several new safe harbors, some with stringent conditions attached, for conflicted investment advice.

Before the rule could be fully implemented, an administrative rule challenge was filed by industry groups that succeeded in completely vacating, i.e., overturning, this rule in March 2018[4]. The Trump Administration did not appeal and instead the new DOL leadership issued guidance[5] providing for a temporary enforcement policy that permitted limited relief to investment fiduciaries. The policy required investment fiduciaries to comply in good faith with "Impartial Conduct Standards."

In a cooperative effort with the U.S. Securities and Exchange Commission ("SEC"), as well as the National Association of Insurance Commissioners ("NAIC"), new "best-interest" regulations were adopted by all three organizations in response to withdrawal of the Obama-era fiduciary rule. The DOL was the last to promulgate a replacement rule amid calls by industry opponents for the SEC to take the lead on a new investment-advice rule.

Significant efforts were made by the SEC, DOL and NAIC to harmonize their advice-rules so that the investor protection component and industry compliance requirements were fairly consistent. According to the DOL's news release accompanying its Rule, "The standards...announced today align with standards of other regulators, including the SEC." However, the new rules are not uniform; although the compliance requirements in the NAIC model rule and the SEC's Regulation Best Interest ("Reg BI") are similar,[6] the new DOL rule contains several material differences. Moreover, the NAIC model rule must be adopted by each state, leaving open the possibility of state-specific amendments.[7]

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[2] Available at https://www.federalregister.gov/documents/2020/12/18/2020-27825/prohibited-transaction-exemption-2020-02-improving-investment-advice-for-workers-and-retirees

[3] See Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, 81 FR 20945 (Apr. 8, 2016).

[4] Chamber of Commerce of the United States v. U.S. Department of Labor, 885 F.3d 360 (5th Cir. 2018).

[5] Available at www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistancebulletins/2018-02. The Impartial Conduct Standards incorporated in the FAB were conditions of the new exemptions granted in 2016.

[6] The NAIC rule includes a safe harbor for annuity transactions if the agent is compliant with Reg BI or Adviser Act rules.

[7] At the end of 2020, seven states had either adopted the NAIC model rule for annuity transactions or the rule was pending final adoption (Arkansas, Arizona, Idaho, Iowa, Kentucky, Ohio and Rhode Island).

OVERVIEW

The DOL's new prohibited transaction exemption (generally referenced as the "Rule, "safe harbor," or "class exemption") differs significantly from previous PTEs that focused on specific advisory activities that required a safe harbor. In contrast, the new Rule provides a single, broad exemption for investment fiduciaries that provide conflicted investment advice to plans, participants, and IRA accounts with the safe harbor available to registered investment advisers ("RIAs"), broker-dealers, insurance companies, banks, and individuals who are their employees or agents.

Changes from Obama-era Rule. The Rule also differs from the Obama-era fiduciary rule by confirming replacement of the expanded definition of a sec. 3(21) investment fiduciary with the previous 1975 five-part test, a result of the Fifth Circuit's decision that effectively eliminated thousands of insurance and securities brokers from fiduciary status under ERISA. In addition, the proposed rule includes a technical amendment automatically reinstating Interpretative Bulletin 96-1, which provides guidance on the scope of educational advice to plan participants on investing that would not be deemed investment advice.

The new Rule also permits investment fiduciaries – principally brokerage firms and their agents – to execute principal transactions involving securities in their own inventories to (or from) plans and IRAs.

Retentions from Obama Rule. In addition to restoring the old five-part test of fiduciary status, the new Rule retains several components of the Obama-era rule, including a general availability of the exemption for rollover advice from plans to IRAs by RIAs. However, the new Rule extends fiduciary status for rollover advice by brokers and insurance producers in certain fact-specific situations and who would otherwise be exempted from fiduciary status. The new Rule also retains the Impartial Conduct Standards that were a key condition of several PTEs in the Obama-era rule.

New PTE Conditions. Other important features of the new Rule include restricting access of documentation to the DOL or Department of the Treasury, and not plan fiduciaries or participants. In addition, unlike Reg BI, investment fiduciaries under the Rule must provide a written disclosure to investors explaining the basis for their rollover recommendation. The final Rule also provides for self-correcting mechanisms in the event of an inadvertent violation of the safe harbor conditions.

Like Reg BI and the NAIC rule, the DOL Rule requires policies and procedures designed to ensure compliance. However, the proposed compliance review to periodically test the policies and procedures to detect and prevent violations was changed so that instead of the chief executive office attesting to the review, another senior executive officer in the firm could sign off.

Previous PTEs. A number of pre-Obama Rule exemptions that were amended by that rule have been reinstated in their original form, including PTEs 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128.

STATUS

The new Rule took effect on Feb. 16, 2021. However, the Department issued Field Assistance Bulletin ("FAB") 2021-02 to provide a temporary extension of enforcement relief. First, the December 20, 2021 relief issued in FAB 2018-02, was extended to January 31, 2022 at which time firms must meet the Impartial Conduct Standards . In addition, the Department offered relief from the requirement to document the specific reasons for a rollover recommendation (and to provide that documentation to the client) until June 30, 2022.

Note: The Biden administration has announced that it will propose a new set of rules, which are widely expected to expand the types of activities that trigger fiduciary status, impose additional conditions under PTE 2020-02, and impose new conditions on PTEs other than 2020-02 that might be relied upon. In other words, significant modifications to PTE 2020-02 are likely.

THE NEW RULE

a) Definition of a Fiduciary.

The four decades-old five-part test for determining functional fiduciary status under ERISA was restored and is in effect. As such, Sec. 3(21) of ERISA is (and was previously) defined as a person who does not have discretionary authority over plan assets and who, for compensation

1. Renders advice as to the value of securities or other property;
2. On a regular basis;
3. Pursuant to a mutual agreement;
4. The advice serves as the primary basis for investment decisions; and
5. The advice is individualized.

All five prongs of the test must be met to be deemed an investment fiduciary. The 'regular basis' prong, which was eliminated in the Obama-era rule definition of a fiduciary, is the most important component that commission-based brokers generally rely on for the exemption.

[8] Reg BI does not require documentation of the basis of an investment recommendation, although documentation is recommended to mitigate potentially liability and as a best practice.
[9] Fact Sheet, DOL, Dec. 15, 2020, at 3.
[10] Id.

b) Rollovers from Plans to IRAs

Although the fiduciary definition was narrowed to generally exclude commission-based brokers and insurance producers, in addition to investment fiduciaries, securities brokers and insurance producers may likely be subject to fiduciary status at the time of the rollover recommendation under a facts-and-circumstances test. Receipt of ongoing management fees, including commission trails, would likely meet the 'regular basis' prong of the five-part test. As such, the Department believes such activities may be the beginning of an ongoing advisory relationship and "that it is important that fiduciary status extend to the entire advisory relationship."[9]

However, the Department notes that rollover advice also may be an isolated or independent transaction that fails to meet the 'regular basis' prong and would not trigger fiduciary status. Parties can make clear if such is the case, although disclaimers on their own are not determinative of fiduciary status, the DOL said.[10]

Documentation. Importantly, and in contrast with the absence of such requirements under Reg BI, investment fiduciaries must document the specific reasons that the rollover recommendation (including transfers from one account to another), are in the best interest of the investor.

Note: Advisory opinion 2005-23A, which generally allowed non-investment fiduciaries to provide rollover advice without meeting the five-part test has been withdrawn as part of the new Rule. However, the DOL said it would not take enforcement action against parties that relied on the 2005 opinion prior to the effective date of the new Rule (and if the recommendations would not have been considered fiduciary communications).

c) Exclusions from the Safe Harbor

The new Rule does not include a safe harbor for certain advisory activities or individuals.

i) Financial Firms. The financial services firm is the plan sponsor of its own plan, or named fiduciary of the plan that was selected to provide advice to the plan.

ii) Agents. The ERISA fiduciary is an investment professional acting in another capacity than as a 3(21) advisor.

iii) Robo-Advisors. Advice arrangements that rely solely on automated investment advice generated by portfolio management algorithms, referred to as robo-advisors, are not covered under the new Rule.

iv) The new Rule does cover 'hybrid' arrangements in which advice generated by computer models is used by an investment professional as part of his or her additional interactions with the client.

Criminal Convictions/Rule Violations. Firms and individuals could lose access to the exemption for up to 10 years if convicted for certain crimes related to the provision of investment advice to retirement investors or for "systemic or intentional violation" of the Rule's conditions, or providing misleading information during a related investigation.

d) Conditions for Satisfying the Class Exemption

In general, investment fiduciaries relying on the safe harbor must meet the following conditions:

i) Act in the investor's best interest;

ii) Receive only reasonable compensation;

iii) Make no misleading statements about the transaction;

iv) Make required disclosures under the Rule;

v) Mitigate conflicts of interest; and

vii) Undertake and certify an annual review of policies and procedures designed to meet the Rule's compliance requirements

e) Best Interest Standard

In general, the best interest requirement is met if the advice meets ERISA's duties of prudence and loyalty.

i) The duty of prudence is generally defined by the so-called Prudent Expert Standard, meaning the advice reflects the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity would use.

ii) The duty of loyalty is generally defined as not placing the financial or other interests of the advisor or firm ahead of the interests of the investor, or subordinate the investor's interests to their own.

Note: Section (ii) closely tracks similar language in Reg BI.

[9] Fact Sheet, DOL, Dec. 15, 2020, at 3.
[10] Id.

f) Impartial Conduct Standards

In addition to the above Best Interest standard the investment fiduciary must

i) Meet the best interest standard;

ii) Charge only reasonable compensation; and

iii) Make no misleading statements about investments, compensation and conflicts of interest.

g) Disclosures

Investment fiduciaries relying on the exemption must disclose to the investor

i) Fiduciary status, including a written description of services and material conflicts of interest.

ii) Noted previously, disclosure of the basis for rollover advice must be documented and provided to the investor.

The Department stated that it believes the disclosure in (i) does not create a private right of action, not does it believe the exemption would do so.

Note: As a best practice, it is advisable to document all investment recommendations as part of a due diligence process by the investment fiduciary.

h) Retrospective Compliance Review

Firms are required to conduct an annual review that is reasonably designed to detect and prevent violations of the Impartial Conduct Standards and related compliance procedures, including mitigation of conflicts of interest.

Note: The requirement that the CEO, or equivalent, and the CCO, or equivalent in the proposed Rule has been revised to require a written report that has been reviewed and approved by a senior executive officer. A "senior executive officer" is defined as the chief compliance officer, chief executive officer, president, chief financial officer, or one of the three most senior officers in the firm.

Recordkeeping. The firm maintains records demonstrating compliance with the exemption for six years.

i) Self-Corrections

A firm that inadvertently violated the conditions of the class exemption may use a self-correction mechanism in the Rule to avoid loss of the safe harbor. The conditions of this requirement:

i) The violation did not result in investment losses, or were made whole by the firm;

ii) The firm corrects the violation and notifies the DOL via email to ILAWR@dol.gov within 30 days;

iii) The correction occurs no later than 90 days after discovery, or reasonably should have known of the violation; and

iv) The firm notifies the individuals responsible for the retrospective review and the violation/correction are included in the report.

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