New Fiduciary Rule Brings Opportunity

On April 25, 2024, the Department of Labor (DOL), through its Retirement Security Rule, published final regulations on who is an "investment advice fiduciary" when making an investment recommendation to a "retirement investor."

For the past decade, the fiduciary rules have changed repeatedly. A federal court blocked certain provisions, the DOL withdrew others, and policies have shifted with different federal administrations. As a result, many investors and advisors were confused about the current requirements. The DOL has continued to wrestle with how to protect retirement plan investors from advisors with potential conflicts of interest—especially considering the changing retirement plan landscape. While updating the rules, the DOL also wanted to make sure that any new requirements would not limit the access that investors have to competent advisors.

The Retirement Security Rule removes some of the more controversial provisions that existed in earlier versions of the regulations. Still, there are service providers in the retirement plan industry that fear the implications of an expanded definition of "investment advice" and the potential liability that this could create. Others, who willingly hold themselves out as plan fiduciaries, recognize the new fiduciary rule as a great opportunity to offer more complete investment and administrative services to their retirement plan clients.

The Importance of Having a Fiduciary Rule

Whether or not someone is considered a fiduciary is critically important because fiduciaries are held to the highest standard of care that the law imposes. Among other things, fiduciaries must subordinate their own interests to the interests of plan participants and beneficiaries and must act as prudent experts in fulfilling their duties. And there are consequences for failing to meet this high standard of care: fiduciaries can be held personally liable for breaching their obligations.

Some in the industry believe that the new rule will limit the access that some retirement investors have to investment advice. For example, more burdensome rules may lead to advisors becoming accessible only to those who are able to pay costs that average retirement investors may not be able to afford. Despite this objection, the DOL has written the proposed regulations to "ensure that retirement investors' reasonable expectations are honored when receiving advice from financial professionals who hold themselves out as trusted advice providers." The rule is "intended to protect the interests of retirement investors by requiring investment advice providers to adhere to stringent conduct standards and mitigate their conflicts of interest." The DOL also expects that the new definition will help retirement investors by creating a more uniform fiduciary standard.

A Brief History of the Fiduciary Rule

The Employee Retirement Income Security Act of 1974 (ERISA) has defined the term "fiduciary" for nearly 50 years. Under ERISA Section 3(21)(A), a person is a fiduciary with respect to a plan to the extent that the person:

- exercises any discretionary authority or discretionary control respecting management or disposition of its assets;
- renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has authority or responsibility to do so; or
- has any discretionary authority or discretionary responsibility in the administration of such plan.

This ERISA definition of fiduciary is also found in Section 4975(e)(3) of the Internal Revenue Code of 1986 (IRC), which addresses prohibited transactions. Whether someone is a fiduciary is determined on a transactional, or functional, basis. In other words, just because someone is a fiduciary for one purpose doesn't necessarily mean that they are a fiduciary regarding other aspects of plan operations.

Example: Fran provides investment advice to a 401(k) plan administrator for a fee, making Fran a fiduciary. But Fran would not be considered a plan fiduciary regarding other aspects of the plan merely because of Fran's status regarding investment advice. Fran wouldn't have a broader duty to, for instance, make sure that plan loans were being properly administered—unless Fran had specifically undertaken that additional responsibility.

Just after ERISA was enacted, the DOL, in 1975, released regulations that further defined the term "fiduciary." Among other provisions, the regulations included a "five-part test" that imposed this fiduciary duty on those who advised plans "on a regular basis," carving out one-time advice—even if it was intended to address a plan's (or a participant's) particular needs. In addition, because another portion of the five-part test required that the advice serve as a "primary basis" for an investment decision, advisors could insulate themselves with a disclaimer. For instance, the fine print in an agreement could simply state that the advice was "a basis," versus a primary basis, for a decision, thus avoiding liability under the rule.

Times Have Changed

The retirement world has evolved considerably since the 1970s. Defined benefit pension plans were much more common then. Today, 401(k) plans are the predominant retirement plan type, especially in the private sector. Participant direction of plan investments is routine. And account balances have ballooned in many cases, making the eventual decision to roll over assets to an IRA—or not—especially important. The old approach no longer adequately addressed many of the situations that retirement plans, participants, and IRA owners face today.

In 2016, after considerable effort and after years of proposals, the DOL released a final fiduciary rule. This 2016 rule imposed much more stringent requirements on investment advisors and gave retirement investors additional remedies that ERISA provisions did not expressly authorize. At the same time that the 2016 final rule was released, the DOL also released two prohibited transaction class exemptions: the Best Interest Contract (BIC) Exemption and the Principal Transactions Exemption. In short, these exemptions required investment advice fiduciaries to follow "Impartial Conduct Standards," under which they must:

- provide advice in the retirement investors' best interest,
- charge no more than reasonable compensation, and
- make no misleading statements about investment transactions and other important matters.

For IRAs and other plans not covered by ERISA, the exemptions required that these standards be placed in an enforceable contract—with certain warranties and disclosures. And this contract could not contain certain liability disclaimers in order to be valid. This created quite a stir.

Without recounting all the details, a federal appeals court invalidated the 2016 final rule, along with the exemptions above, essentially sending the DOL back to square one. In response, the DOL took several actions in 2020, including reinserting the 1975 regulations into the Code of Federal Regulations and releasing Prohibited Transaction Exemption (PTE) 2020-02. This PTE provided relief similar to the BIC Exemption and Principal Transactions Exemptions but removed the warranty and contract provisions.

Other Entities Have Been Busy

The Department of Labor is not the only entity protecting investors. Other federal and state agencies have also been working on addressing protections for consumers when they invest. The U.S. Securities and Exchange Commission (SEC) released a regulatory package in 2019. And in 2020, the National Association of Insurance Commissioners (NAIC) also revised its Suitability in Annuity Transactions Model Regulation to provide that insurance agents must act in a consumer's best interest, as defined by the Model Regulation, when making a recommendation of an annuity. The Financial Industry Regulatory Authority (FINRA), the independent regulatory authority of the broker-dealer industry, has its own rules that govern members and their representatives—and that can result in sanctions for violators.

Rationale for the Final Fiduciary Rule

But having a patchwork of different entities—with different rules and authority to enforce them—does not lend itself to a uniform fiduciary standard with broad application. Plus, some of the other regulatory agencies simply don't go far enough (in the DOL's view). For example, the NAIC expressly disclaims that its standard creates fiduciary obligations. There are sometimes fundamental differences between standards introduced by various enforcement entities. In crafting the new final fiduciary rule, the DOL has consulted and coordinated with these various entities to:

- replace the antiquated, "underinclusive" 1975 rule;
- narrow the 2016 rule to avoid legal challenges;
- create an objective standard for determining fiduciary status; and
- provide a more uniform standard.

The DOL views itself as uniquely positioned to create a broad fiduciary rule that checks fiduciaries' conflicts of interest and carefully regulates them through "rules requiring adherence to basic fiduciary norms and avoidance of prohibited transactions." It notes that other regulatory agencies do not have the broad authority to regulate all investments (e.g., the SEC's mandate to regulate securities transactions only). They may also allow certain conflicts if financial professionals meet prescribed disclosure obligations. And their rules may not cover advice or transactions involving plan assets or plan fiduciaries. But ERISA's authority permits the DOL to broadly "cover advice to plan and IRA fiduciaries as well as plan participants, beneficiaries, and IRA owners and beneficiaries."

Last fall, the Department of Labor released proposed regulations defining "investment advice fiduciary." After the normal comment period (with over 400 comment letters submitted) and a public hearing, the DOL has now slightly modified the definition to emphasize an objective standard in the final rule—a standard that would be less dependent on the parties' intentions regarding what constitutes advice.

Who's an Investment Advice Fiduciary?

This definition of who is considered an "investment advice fiduciary" under the Retirement Security Rule is important because it dictates the standards under which many investment professionals must act when working with retirement clients. It could require more diligence by these professionals because fiduciary duty is now dictated by the reasonable expectations of their clients rather than by antiquated rules from the 1970s.

The DOL's final rule defines an investment advice fiduciary as a person who provides a recommendation for a fee or other compensation (direct or indirect) in either one of the following contexts:

- The person makes professional investment recommendations to investors on a regular basis as part of their business and the recommendation is made under circumstances that would indicate to a reasonable investor in like circumstances that the recommendation:
  - is based on a review of the retirement investor's particular needs or individual circumstances,
  - reflects the application of professional or expert judgment to the retirement investor's particular needs or individual circumstances, and
  - may be relied upon by the retirement investor as intended to advance the retirement investor's best interest; or
- The person represents or acknowledges that they are acting as a fiduciary with respect to the recommendation.

The rule is “intended to protect the interests of retirement investors [including plan sponsors] by requiring . . . investment advice fiduciaries to adhere to stringent conduct standards and mitigate their conflicts of interest.” By creating a more uniform fiduciary standard, irrespective of the investment product, the DOL hopes to honor retirement investors’ reasonable expectations when they get advice from financial professionals who hold themselves out as trusted advice providers.

Other Provisions in the Final Rule

Although the definition of “investment advice” and its attendant fiduciary duty is the key provision in the final fiduciary rule, other items in the rule are also worth noting. Some appear in the regulation itself; others appear in the preamble of the regulation. While the preamble may not have the same authority as the regulation’s text, it is generally relied on for insight into the DOL’s viewpoint and for clarifying a regulation’s meaning.

- Written disclaimers about a person’s fiduciary status will not control to the extent that they are inconsistent with the person's other representations.
- A fiduciary with respect to a plan or IRA assets will not be considered a fiduciary with respect to other plan or IRA assets with respect to which the person does not meet the fiduciary definition. (This emphasizes the functional definition of the term “fiduciary.”)
- Investment advice provided “for a fee or other compensation, direct or indirect” is defined expansively, and includes even expense reimbursements, gifts, and other non-cash payments.
- The mere presentation of investment information or education, without an investment recommendation, is not considered fiduciary advice.
- The rule includes IRA owners and beneficiaries as “retirement investors”—and a rollover recommendation is a transaction potentially covered by the final rule.

Amendments to PTE 84-24 and PTE 2020-02

The DOL also released two updated prohibited transaction exemptions along with the final rule. These PTEs address conditions under which a party may receive compensation (or other consideration) when transacting with plan assets. The DOL notes that the amended PTEs’ compliance obligations of “impartial conduct standards” are generally consistent with other SEC obligations, and so compliance with the PTEs should not be overly burdensome.

- The exemptions (like the final rule) contain no contractual rights or warranty requirements. The sole remedies for non-compliance are precisely those set forth in ERISA and the Internal Revenue Code, which generally include only the imposition of excise taxes (in the context of IRA advice) and excise taxes and plan restoration in other contexts.
- The amended PTEs do not prohibit financial institutions and advisers from entering into class-wide binding arbitration agreements with retirement investors.

- PTE 2020-02 specifically provides an exemption from the prohibited transaction rules for pure robo-advice relationships.
- PTE 84-24 does not require insurance companies to assume fiduciary status with respect to independent insurance agents, an important concern of insurers with respect to the 2016 rulemaking.
- Neither PTE 2020-02 nor PTE 84-24, as amended, require financial institutions to disclose all their compensation arrangements with third parties on a publicly available website.

Some Providers Will Embrace Their Fiduciary Duties

Considering the multitude of comments the DOL received in response to the proposed fiduciary regulations, many retirement plan service providers and investment advisors may wish to limit or avoid fiduciary duty. Other providers look forward to the opportunity to offer the kind of service that includes this duty. Pentegra specifically offers fiduciary services that acknowledge our responsibility to act as prudent experts for our plan sponsors and to elevate our clients' interests above our own.

What's Next?

The DOL has released guidance that is intended to benefit plan sponsors and other retirement investors without imposing unnecessary burdens on advisors. This final rule will become effective on September 23, 2024, as will PTE 84-24 and PTE 2020-02. These two exemptions —although becoming effective soon—come with a one-year transition period after their effective date. The new final rule is already being challenged in federal court. But at least the DOL seems to be working toward a realistic, uniform fiduciary standard that expands protections for retirement investors.

To learn more on SECURE 2.0 guidance reach out to Pentegra's retirement plan experts at solutions@pentegra.com or 855-549-6689.

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