Regulation

DOL Rolls Out Replacement for Fiduciary Rule

By David Isenberg December 16, 2020

A version of this story ran as a breaking news article on Dec. 15.

The Labor Department finalized an exemption that is widely seen as a replacement for the agency's now-defunct 2016 fiduciary rule, the agency said Tuesday afternoon.

The final rule does not dramatically change the proposal's provisions with respect to rollovers, which allowed investment advisors to receive compensation for making rollover recommendations that would otherwise violate their fiduciary duty.

The final rule effectively replaces a reactivated 1975 rule, which states that a person who provides investment advice for a fee and meets the criteria of a five-part test is considered a fiduciary under the Employee Retirement Income Security Act.

It also replaces 2005 guidance with respect to rollover recommendations. That guidance said that advisors could be self-dealing if they had a prior relationship with the plan sponsor or participant and then subsequently recommended a rollover into an investment vehicle, such as an individual retirement account, that pays the advisor more than other options.

The 1975 rule was reinstated in March 2018, after the DOL's 2016 fiduciary rule was overturned by the U.S. Court of Appeals for the 5th Circuit. Since then, experts such as the American Retirement Association have said that plan fiduciaries were in a legal "gray area" regarding rollovers.

DOL officials said Tuesday that its rulemaking aligns with the Securities and Exchange Commission's Regulation Best Interest, which that agency finalized in June 2019. That rule requires broker-dealers to act in the best interest of their retail clients.

"Today's action provides clear regulatory standards that ensure American workers and retirees have access to high-quality, affordable investment advice," stated Secretary of Labor Eugene Scalia in a press release. "In tandem with action taken last year by the Securities and Exchange Commission, this exemption gives Americans a greater opportunity to invest in the American economy with the assistance of professionals acting in their best interest."

The rule will become effective 60 days after it is published in the federal register.

“This exemption preserves access to investment advice and promotes choice for retirement investors,” stated Acting Assistant Secretary of Labor Jeanne Klinefelter Wilson in Tuesday's announcement. “Under the exemption, investment professionals must plainly tell retirement investors that they are acting as fiduciaries and they must act in the retirement investors’ best interest.” Klinefelter Wilson heads the Employee Benefits Security Administration, which developed the regulation.

Beyond rollovers, the DOL's final rule allows certain principal transactions, which are when a fiduciary sells or buys certain securities from their own accounts to or from retirement plans and IRAs.

The final rule also includes a prohibited-transaction class exemption for investment advice fiduciaries to allow them to offer a wide variety of services as long as they comply with impartial conduct standards. In other words, investment advice fiduciaries can still engage in some activity as long as they remain impartial. This will now include meeting a best interest standard as well as a reasonable compensation standard. They also cannot make any materially misleading statements.

The final rule also differs from the proposal in four key areas. First, the proposal required that records be available to the DOL, the IRS, any plan participants, sponsors and IRA owners. In the final rule, recordkeeping disclosures stemming from this rule can only be accessed by the DOL or the IRS.

This change was likely made to mitigate the chance that competitors or plaintiffs’ attorneys could access records and use them against the firm, says Jason Roberts, CEO of Pension Resource Institute and a former Erisa litigator. However, books and records will remain discoverable via subpoena or a court order.

Second, the final rule requires fiduciaries to disclose to customers what the basis was for why a fiduciary believed a rollover recommendation was in the customer’s best interest, essentially creating a public paper trail for why a decision was made.

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The final rule differs from the proposal in a third way in that it allows for any senior executive officer to sign off on a retrospective compliance review, not just the CEO, as the proposal said. A retrospective compliance review is an after-the-fact review of the

policies and procedures to ensure that they are in line with the impartial conduct standards.

Finally, the proposed rule did not include a so-called self-correction provision which, under the final rule, effectively allows a financial institution to correct an error when they spot one and remediate it themselves.

"They can remediate the violation without having the DOL discover it," Roberts says. "They can self-police, but the DOL can still police."

The rule clarifies when a financial professional becomes an investment advice fiduciary, including with rollovers, "hire me" communications and the different elements of the five-part test, says George Gerstein, cochair of fiduciary governance at Stradley Ronon.

"While the DOL continues to maintain that the new exemption aligns with SEC's Regulation Best Interest, they have distinct requirements. The new self-correcting mechanism in the exemption may also prove valuable to financial services firms," Gerstein says.

Some investor advocates criticized the rule proposal, saying that only certain rollovers would be covered by the regulation.

The Consumer Federation of America strongly opposes the final rule, as it did the proposal, says Barbara Roper, the organization's director of investor protection. However, she notes that the DOL did not give the financial services industry everything that it wanted, such as striking rollovers from the fiduciary scope altogether.

The rule's effective date will not be until after the Biden administration takes office, Roper notes. The Biden administration will likely put a six-month freeze on any pending regulations in order to do a legal and policy analysis of them, she adds.

"So, I do not actually expect this to take effect in its current form," she says. "We're cautiously optimistic that fixing Reg BI will be a priority in the Biden administration. It is possible that we will see the DOL and the SEC work together going forward to address the weaknesses in this regulatory approach."

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