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ERISA Advisory

The DOL's Re-Proposed Redefinition of Fiduciary

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Three-and-a-half years after its last effort[1] bogged down in controversy, the Department of Labor (DOL) issued a new proposal to redefine the key ERISA term "fiduciary."[2] Published in the *Federal Register* on April 20, 2015, the proposed regulation will, if adopted, significantly expand the circumstances in which discussing investments with ERISA-covered retirement and welfare plans, or individual retirement accounts (IRAs), will make a person a fiduciary under ERISA and the Internal Revenue Code (Code). Unlike in 2010, the DOL has also released two proposed prohibited transaction class exemptions and proposed amendments to six existing class exemptions along with the proposed regulation. Comments on the entire regulatory package are due on or before July 6, 2015.

The proposed regulation, which would become applicable eight months after the publication of a final rule in the *Federal Register*, makes substantial changes to the current regulatory definition of "investment advice" under ERISA § 3(21)(A)(ii). Under the proposed rule, a service provider who makes recommendations about investments or investment management (including whether assets should be rolled over or distributed), offers appraisals or fairness opinions in connection with specific transactions, or makes recommendations about other persons who offer investment advice for a fee becomes an investment advice fiduciary (IAF). The significance of this designation is that IAFs to plans will be required to comply with ERISA's fiduciary standards in making such recommendations, and IAFs to plans and IRAs will be subject to new Impartial Conduct Standards (including a new best interest standard) if they use any of a variety of prohibited transaction exemptions. As a consequence, they (or their affiliates) may be subject to prohibited transaction excise taxes if they recommend affiliated products or services, receive payments from third parties in connection with plan/IRA transactions (*e.g.*, revenue sharing, 12b-1 fees, sub-TA fees, sub-accounting fees), enter into fixed income trades on a principal basis or receive compensation that is conditioned on consummating a transaction in which a recommendation was made (*e.g.*, sales loads, brokerage commissions, or insurance commissions). The DOL has proposed various exceptions and exemptions to mitigate the impact of the rule in certain areas, but compliance undoubtedly will require dramatic changes in the practices of financial institutions that provide products and services to plans and IRAs.

The 250-page "Regulatory Impact Analysis" that accompanies the proposal argues that the current definition of "fiduciary," promulgated in 1975, has left the door open to pervasive

[1] Proposed Rule, "Definition of the Term Fiduciary," 75 Fed. Reg. 65263 (Oct. 22, 2010) ("2010 proposal"). The DOL announced in September 2011 that it would re-propose the rule.
[2] Proposed Rule, "Definition of the Term 'Fiduciary;' Conflict of Interest Rule – Retirement Investment Advice," 80 Fed. Reg. 21928 (April 20, 2015) ("proposed regulations").

conflicts of interest that cost plans, plan participants and IRA owners billions of dollars a year, as a result of excessive fees and unsuitable investment choices. This Advisory will discuss in Part I exactly what the proposal says and what it may mean to broker-dealers, insurance companies and other parties that market investments to ERISA-covered retirement plans, welfare plans and individual retirement accounts. Part II discusses the new proposed prohibited transaction class exemptions and the proposed amendments to existing class exemptions.

Part I – The Proposed Regulation Redefining Fiduciary Investment Advice

Background: "Investment Advice" and Fiduciary Status

Fiduciary status has two important implications. First, a fiduciary of an ERISA-covered plan is required to carry out his duties solely in the interest of plan participants and "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man 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" (ERISA, §404(a)(1)(B), often referred to as duties of loyalty and prudence). Individuals who act as fiduciaries and breach that duty are subject to personal liability for resulting losses.

Second, fiduciaries are also "parties in interest" (called "disqualified persons" in the Code). Their dealings with the plans or IRAs for which they act as fiduciaries are restricted by prohibited transactions rules (ERISA § 406; Code § 4975), which prohibit the provision of services and other transactions between the plans or IRAs and the fiduciaries and prohibit fiduciaries from engaging in self-dealing or receiving compensation from third parties in connection with a transaction involving the plan or IRA. The net effect of these prohibitions is that, without an exemption, a fiduciary cannot transact with plans or IRAs or exercise the authority that makes it a fiduciary to increase its (or an affiliate's) compensation or otherwise collect payments from third parties in connection with transactions involving the plan or IRA for which the fiduciary acts. Without an exemption, a fiduciary under ERISA or the Code cannot engage in principal transactions (*i.e.*, selling products out of inventory) with or extend credit (*e.g.*, lend cash or securities) to a plan or IRA. Without an exemption, a fiduciary cannot recommend the purchase of affiliated (*i.e.*, proprietary) products or services. Hence, the proposed regulation is of critical importance for broker-dealers, insurance agents, pension consultants, recordkeepers, custodians, and other providers of investment products or administrative services to plans and IRAs. If the newly proposed definition of "fiduciary" is adopted, many in the financial services industry will have to make significant changes in their business practices.

The statutory definition of "fiduciary" (ERISA § 3(21), reiterated almost verbatim in Code § 4975(e)(3)), has three parts, two of which pertain to plan investments. First, persons who exercise authority or control over management or disposition of plan assets are fiduciaries. Second, a person who does not exercise such authority or control but who "renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan" is also a fiduciary (ERISA §3(21)(A)(ii)) (such a person is referred to herein as an investment advice fiduciary or "IAF"). The proposed regulation addresses only IAFs.

Defining Fiduciary Investment Advice: The Status Quo

Soon after the enactment of ERISA, the DOL issued a regulation[3] describing the circumstances under which a person would be treated as providing investment advice under ERISA § 3(21)(A)(ii). That regulation remains in effect today. It provides that a person will be deemed to be providing "investment advice" within the meaning of Section 3(21)(A)(ii) only if:

> (i) Such person *renders advice to the plan as to the value of securities or other property, or makes recommendation as to the advisability of investing in, purchasing, or selling securities or other property* and
>
> (ii) Such person either directly or indirectly (e.g., through or together with any affiliate)—
>
> > …
> >
> > (B) Renders any advice described in paragraph (c)(1)(i) of this section *on a regular basis* to the plan *pursuant to a mutual agreement, arrangement or understanding*, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, *that such services will serve as a primary basis for investment decisions* with respect to plan assets, *and that such person will render individualized investment advice* to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.

The italicized language effectively establishes a five-part test: To provide "investment advice," a person must (1) render advice as to the value of securities or other property or make recommendations as to the advisability of investing in, purchasing or selling securities or other property (2) on a regular basis (3) pursuant to a mutual agreement, arrangement or understanding that (4) the advice will serve as the primary basis for investment decisions, and (5) provide advice that is individualized based on the particular needs of the plan. Historically, providers of investment products and services have relied heavily on the last three factors, endeavoring to ensure that no such mutual agreement, arrangement or understanding exists, that any information provided cannot form a primary basis for any investment decision in any event, and that any information provided is not individualized.

The Department of Labor's New Position: "Time for a Change"

The preamble to the new proposed regulation asserts that the 1975 regulation departed from Congressional intent by "significantly narrow[ing] the breadth of the statutory definition of fiduciary investment advice." Whether that was truly the case can be debated; the legislative history of ERISA is completely silent about the meaning of "investment advice," and not much can be inferred from the text or structure of the statute.

The preamble observes that the market has changed vastly since 1975. It notes that back then, participant direction of investments was a rarity. Today it is commonplace in individual account

[3] 29 C.F.R. § 2510.3-21(c) (filed with the Federal Register on October 28, 1975) ("1975 regulation").

plans and universal in IRAs, which were then a new investment vehicle. The proposed regulations purport to address the new retirement plan landscape, where decisions about the investment of many retirement assets are now in the hands of individuals whose investment sophistication and attention to their portfolios are, in the view of the DOL, limited. The DOL sees this situation as a serious problem necessitating an updated regulatory regime.

Dismantling the Five-Part Test

The DOL's proposed solution is to expand the scope of the first element (*i.e.*, covered advice) of the current five-part test, eliminate the second and fourth elements (*i.e.*, "regular basis" and "primary basis"), drop the word "mutual" from the third element, and then rephrase and expand the fifth element (*i.e.*, individualized nature of advice).

- **Expanding the Scope of Covered Advice***.* The proposed regulation specifies four types of advice that may, when provided to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner in exchange for a fee or other compensation, make the provider of the advice an IAF:

  > (i) A recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA
  >
  > (ii) A recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA
  >
  > (iii) An appraisal, fairness opinion, or similar statement whether verbal or written concerning the value of securities or other property if provided in connection with a specific transaction or transactions involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA
  >
  > (iv) A recommendation of a person who is also going to receive a fee or other compensation for providing any of the types of advice described in paragraphs (i) through (iii)[4]

  This enumeration combines new positions with positions articulated previously by the DOL. It significantly broadens the first element of the current five-part test to include fairness opinions and advice concerning distributions and rollovers. The latter reverses the position that the DOL took in 2005, when it opined that advising a plan participant about whether to take a distribution and whether and where to roll it over was not a fiduciary act. (ERISA Adv. Op. 2005-23A (Dec. 7, 2005)). In addition, although the DOL previously took the position that the current five-part test already covers recommendations regarding the selection of managers or advisers, many have argued based on the literal language of ERISA § 3(21) that advice regarding manager selection

[4] 80 Fed. Reg. at 21956-57 (Prop. 29 C.F.R., §2510.3-21(a)(1)).

rather than security selection is not fiduciary advice. The proposed regulation's last category of covered advice would codify the DOL's position.

The DOL's proposal defines the term "recommendation" expansively to mean "a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action." The preamble to the proposal indicates that the DOL based this definition on FINRA Policy Statement 01-23, which sets forth guidelines for identifying communications that require compliance with the "suitability" rule for securities brokerage transactions (FINRA Rule 2111). A FINRA notice quoted with approval in the preamble employs substantially similar language in identifying subject communications: "An important factor in this regard is whether – given its content, context and manner of presentation – a particular communication from a firm or associated person to a customer reasonably would be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy."

In addition, the proposal defines "fee or other compensation, direct or indirect" to mean "any fee or compensation for the advice received by the person (or by an affiliate) from any source and any fee or compensation incident to the transaction in which the investment advice has been rendered or will be rendered." The term specifically includes brokerage fees, mutual fund and insurance sales commissions. Although this definition is consistent with the views expressed by the DOL in the preamble to the 1975 regulation, the existing regulation does not address the statutory "fee or other compensation" requirement. The backward looking "has been rendered" language means that a service provider's sales pitch could make the provider a fiduciary if the pitch is considered by the recipient in making an investment decision and the provider subsequently receives a fee as an "incident to the transaction." There is no exception or carve-out in the proposed regulation for sales pitches made by service providers (including not just brokers and insurance agents but also investment managers, trustees and custodians).

- **Expanding the Circumstances in Which Covered Advice is Considered Fiduciary Investment Advice**. A person who provides one of the foregoing types of advice to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner in exchange for a fee or other compensation will be an IAF under the proposed regulation if such person, directly or indirectly (*e.g.*, through an affiliate), does either of the following:

  (i) Represents or acknowledges that it is acting as a fiduciary within the meaning of the Act with respect to the advice

  (ii) Renders the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA

> The first prong reflects the DOL's position that "advisers who claim fiduciary status under ERISA or the Code in providing advice would be taken at their word." There are important consequences to being deemed an IAF under the first prong. As explained further below, persons who represent or acknowledge that they are acting as fiduciaries would not be allowed to rely on any of the proposed exceptions or "carve outs" to IAF status. Further, persons who acknowledge fiduciary status to use the two new exemptions proposed by the DOL may no longer argue against fiduciary status in the alternative; they will have only one option – *i.e.*, showing that the conditions of the exemption(s) are met. This would appear to be a catch-22 in the context of sales pitches, making clarification in this area even more critical.
>
> The second prong is all that is left of the third and fifth elements of the current five-part test. "Specifically directed" is a new and significant broadening of the test, and "mutual" no longer appears before "agreement, arrangement or understanding." Indeed, the preamble criticizes the use of the term "mutual" in the 1975 regulations, and its omission suggests that a service provider could be held to a fiduciary standard solely on the basis of a one-sided "understanding" by a plan fiduciary, plan participant or IRA owner that the provider is giving individualized or specifically directed advice. In addition, advice "specifically directed to" a plan fiduciary, plan participant or IRA owner falls within this language, whether or not the advice is "individualized to" the recipient, heightening the concern that the DOL meant to capture sales pitches made by service providers. The preamble emphasizes that this "specifically directed to" language "addresses concerns that the general circulation of newsletters, television talk show commentary, or remarks in speeches and presentations at financial industry conferences would result in the person being treated as a fiduciary." But having said that, the preamble then draws a direct line between the "specifically directed to" language and *advertising*, stating that advisers could not "continue the practice of advertising advice or counseling that is one-on-one or that a reasonable person would believe would be tailored to their individual needs and then disclaim that the recommendations are fiduciary investment advice in boilerplate language in the advertisement or in the paperwork provided to the client." This targeted shot at advertising could have a major impact on the marketing of retirement services, particularly in the IRA rollover setting where the provider could be deemed to be an ERISA fiduciary. Regardless, there is no question that the "specifically directed to" language represents a broad expansion of the fifth element of the current five-part test, which requires "individualized investment advice to the plan based on the particular needs of the plan."

Unlike the 2010 proposal, the current proposal does not treat a person who provides a covered type of advice as an IAF simply because the person is registered as an investment adviser under the Investment Advisers Act or 1940 or is already a plan fiduciary for reasons other than providing investment advice for a fee. Even so, the effect of the proposed changes discussed above is to substantially broaden the circumstances under which a person will be treated as providing fiduciary investment advice for a fee under ERISA and the Code. Unless one of the exceptions or "carve-outs" described below applies, anyone who makes a single, isolated investment recommendation to a plan fiduciary, participant, or IRA owner would be deemed to be an IAF if there is a written or verbal understanding that the advice is specifically directed to the recipient for consideration in making an investment decision. In contrast to the current regulation, no "meeting of the minds" on the extent of the recipient's reliance would be required.

The proposal does not change the securities brokerage exception to fiduciary status provided in the current regulations. That exception provides that a U.S. registered broker-dealer will not be deemed a fiduciary for acting as agent in a securities transaction, so long as an independent fiduciary specifies the security, the minimum and maximum quantity, a price range and a time span not to exceed five days.[5] Although it would have been helpful to update the securities brokerage exception to include broker-dealers registered under other laws as well as futures commission merchants, no such update was included in the proposal.

The Carve-Outs

There are seven specific carve-outs to the proposed rule's "investment advice" definition. As explained above, these exceptions are inapplicable to service providers who affirmatively represent or acknowledge that they are acting as fiduciaries. Furthermore, only two of the seven exceptions – the education and financial reports exceptions – cover communications with participants, beneficiaries, and IRA owners. Here is a quick overview:

- **The Counterparty Exception** (similar to the 2010 proposal's "seller's exception"). The exception is available only with respect to a sale, purchase, loan or bilateral contract. It does not apply to IRAs or plan participants. It does not apply to any plan with fewer than 100 participants unless the plan is managed by a fiduciary with more than $100 million of ERISA plan assets under management. And critically, it does not apply to services. Thus, the exception would not preclude incidental advice from a service provider that is specifically directed to the plan from being fiduciary advice, even with the largest, most sophisticated clients. For example, such incidental advice could include information provided by a futures commission merchant executing a futures trade for the biggest, most sophisticated client; information provided by the institutional agency desk at a broker-dealer, again dealing with the most sophisticated institutions; any such information from a plan's prime broker; all marketing pitches from trustees, investment managers, or commodities trading advisers; all marketing or corporate finance recommendations made to a company's corporate financial staff that may later be communicated to plan fiduciaries; and all sales pitches by collective investment trust trustees, brokers, third party administrators, etc. For virtually all of these service provider communications, the counterparty exception is inapplicable. While the DOL has indicated that it will fix this omission, the failure to extend the carve-out to services is worrisome, especially since the 2010 proposal also failed to cover services and the DOL received scores of adverse comments on this point.

  The counterparty exception requires the counterparty to either:

  - Obtain written representations from the plan fiduciary that the plan has 100 or more participants and that the plan fiduciary will not rely on the person to act in the best interests of the plan, to provide impartial advice or to give fiduciary

[5] 29 C.F.R. 2510.3-21(d).

advice. The counterparty also must disclose its financial interests in the transaction, must know or reasonably believe that the plan fiduciary has sufficient expertise to evaluate the merits of the transaction, and cannot receive a fee for advice as opposed to other services in connection with the transaction.

- Know or reasonably believe that the fiduciary (apparently contemplating a professional asset manager) has responsibility for managing at least $100 million in assets for one or more employee benefit plans. The counterparty also must fairly inform the plan fiduciary that the counterparty is not undertaking to provide impartial advice or give fiduciary advice and cannot receive a fee for investment advice.

- **Swap Transactions**. Communications in connection with swap transactions regulated under the Securities Exchange Act or the Commodities Exchange Act will not be classified as fiduciary investment advice if the conditions of the exception are met. The exception applies only to plans, not to IRAs or individual participants, and the plan must be represented by a fiduciary independent of the swap counterparty. It does not appear to cover pooled funds that hold plan assets, which is a significant omission. In addition, it covers only the swap counterparty (if a swap dealer or security-based swap dealer) or its agent, and not the clearing firms who are the agent of the plan or fund. This omission is quite significant and troubling, since it cuts back on the relief the DOL recently gave in Advisory Opinion 2013-01A. While the DOL has indicated that it did not intend to cut back on that relief, the carve-out is clearly inadequate to cover current swap transactions. Under the carve-out, the swap counterparty cannot be acting as a trading adviser under Dodd Frank in connection the swap and must obtain a written representation that the independent fiduciary will not rely on the swap counterparty's recommendations. This carve-out will need to be revised if normal swap transactions in the cleared swap world are to continue unimpeded.

- **Employees of the Plan Sponsor**. Advice given to plan fiduciaries by the sponsor's employees will not be fiduciary investment advice, unless the employee receives compensation for the advice beyond the employee's regular pay.

- **Platform Providers**. Marketing a set of investment alternatives, where plan fiduciaries select the alternatives that will be made available to participants, will not be fiduciary investment advice, so long as the platform provider "discloses in writing to the plan fiduciary that [it] is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity." The exception specifically does not cover IRAs, even though many mutual fund companies, broker-dealers and insurers maintain platforms for IRAs. Thus, any narrowing of mutual fund options for IRAs, and any recommendations provided in connection with the options, will be fiduciary advice not covered by a carve-out.

- **Objective Advice on the Selection and Monitoring of Investment Alternatives**. A platform provider will not be considered to be rendering fiduciary investment advice if it merely "identifies investment alternatives that satisfy objective criteria specified by the plan fiduciary" or "provides objective financial data and comparisons with independent benchmarks to the plan fiduciary." Again, this exception does not apply to IRAs.

- **Financial Reports and Valuations**. Although the new proposal would generally bring appraisals and fairness opinions relating to plan assets within the scope of fiduciary investment advice, it excludes reports that are provided to an ESOP, to a pooled investment fund that holds assets of unrelated plans, or to a plan, participant or IRA owner for the purpose of complying with reporting and disclosure requirements. The 2010 proposal had no carve-out for ESOP valuations. The preamble to the new proposal reiterates the DOL's concerns with ESOP valuations and indicates that the DOL is still considering separate regulatory action to address that concern. The carve-out covers valuations of securities for regulatory purposes, but does not cover the monthly account statements sent by custodians, brokers and insurance agents.

- **Investment Education**. This exception would replace 29 C.F.R. § 2509.96-1 (also known as "Interpretive Bulletin 96-1"), which excludes general financial, investment and retirement information from the scope of investment advice. Major changes include extending "investment education" to certain information provided to plan fiduciaries and IRA owners, and excluding asset allocation models that refer to specific examples of investment products. Even though the current interpretive bulletin requires "investment education" materials to state that other investments with similar characteristics may be available, the DOL suggests that service providers can "effectively steer" participants and IRA owners to specific investments by identifying a particular fund available under the plan. To quote the DOL, "[t]hus, for example, we would not treat an asset allocation model as mere education if it called for a certain percentage of the investor's assets to be invested in large cap mutual funds, and accompanied that proposed allocation with the identity of a specific fund or provider." Whether participants will be better able to grasp abstract descriptions of investment categories remains to be seen. Finally, the DOL specifically declined to provide a separate carve-out for call centers.

Part II – Prohibited Transaction Class Exemptions

The Proposed Best Interest Contract Exemption

The most sweeping and significant PTE is the proposed "Best Interest Contract Exemption" (the BIC exemption).[6] The BIC exemption permits an adviser to receive compensation for services provided to a "Retirement Investor" in connection with a purchase, sale or holding of an "Asset" by a plan, a plan participant or an IRA. The term "Retirement Investor" is defined to include a plan participant or beneficiary with the ability to self-direct his or her account or take a distribution, an IRA owner, or a plan sponsor of a plan with fewer than 100 participants that is not participant-directed. The term "Asset" is defined to include *only*:

[6] Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21960 (April 20, 2015).

- Bank deposits[7]
- Certificates of deposit
- Shares or interests in registered investment companies, bank collective funds, insurance company separate accounts, exchange-traded REITs, or exchange-traded funds
- Corporate bonds offered pursuant to a registration statement under the Securities Act of 1933
- Agency debt securities as defined in FINRA Rule 6710(l) or its successor
- US Treasury securities as defined in FINRA Rule 6710(p) or its successor
- Insurance and annuity contracts[8]
- Guaranteed investment contracts
- Equity securities within the meaning of 17 C.F.R. § 230.405 that are exchange-traded securities within the meaning of 17 C.F.R. § 242.600[9]

The term "Asset" is expressly defined to exclude "any equity security that is a security future or a put, call, straddle, or other option or privilege of buying an equity security from or selling an equity security to another without being bound to do so." Also not included in the definition of "Asset" are rollover accounts, IRAs,[10] private funds such as hedge funds, private equity funds or other structured products, foreign bonds, municipal bonds, futures contracts, and currency. The preamble states the DOL's rationale:

> Limiting the exemption in this manner ensures that the investments needed to build a basic diversified portfolio are available to plans, participant and beneficiary accounts, and IRAs, while limiting the exemption to those investments that are relatively transparent and liquid, many of which have a ready market price. The Department also notes that many investment types and strategies that would not be covered by the

[7] Because of the inclusion of deposits, it would appear that cash sweep programs might be covered, assuming the disclosure and other conditions are met.

[8] The preamble to the proposed PTE 84-24 amendments make clear that the term "annuity contract" in the BIC exemption includes variable annuities as well as fixed annuities.

[9] These "exchange" definitions make clear that only equities traded on a US exchange are covered under the exemption.

[10] While the DOL has indicated that it did not intend to exclude all relief for selling an IRA, the term "Asset" is not defined to include IRAs or rollover accounts. In addition, a person who makes a fiduciary recommendation to take a rollover would be unable to comply with the BIC exemption's requirement that the recommendation *follow* the execution of the written contract satisfying the conditions of the exemption. *See* 80 Fed. Reg. at 21984 (Section 2(a)).

exemption can be obtained through pooled investment funds, such as mutual funds, that are covered by the exemption.

Additionally, there is no exception for sophisticated investors. The same "Asset" definition applies regardless of the size of a participant's or IRA owner's account.

The BIC exemption further excludes from coverage:

- An employer sponsored plan if the plan covers employees of the adviser or if the adviser is a named fiduciary or plan administrator selected to provide advice by someone who is not independent (although it does cover IRAs maintained by employees of financial institutions)

- Compensation that is received from a principal transaction with the adviser

- Compensation that is received on account of advice generated solely by an interactive website

- Any compensation paid to an adviser who is a fiduciary with respect to the plan or IRA for reasons other than providing investment advice for a fee

For purchases and sales of assets covered by the BIC exemption,[11] advisers and their affiliates will be allowed to receive compensation that is ordinarily prohibited to fiduciaries (*e.g.*, commissions, sales charges, 12b-1 fees, revenue sharing and other payments from third parties), provided that they –

> contractually agree to adhere to Impartial Conduct Standards in rendering advice regarding [plan or IRA] Assets; warrant that they have adopted policies and procedures designed to mitigate the dangers posed by Material Conflicts of Interest; disclose important information relating to fees, compensation, and Material Conflicts of Interest; and retain documents and data relating to investment recommendations regarding Assets.

The practical effect of this provision is to impose an excise tax on prudence violations. A party that wishes to rely on the BIC exemption must comply with a series of conditions, all of which apply to the individual who gives the advice, any institution with which he is associated as an employee, independent contractor or agent, and the institution's affiliates (all of which will be referred to in this discussion of the BIC exemption as "the adviser," except as otherwise noted). These conditions (discussed immediately below) in large measure require an adviser to abide by the same standards as an ERISA fiduciary, whether or not the adviser would otherwise have that status.

[11] The BIC exemption would provide relief from the prohibitions of ERISA §§ 406(a)(1)(D) and 406(b), and Code §§ 4975(c)(1)(D), (E) and (F).

The following is a summary of the conditions:

- **Voluntary Assumption of Fiduciary Status**. Before making any recommendations, the adviser must enter into a written contact with the retirement investor that incorporates the various exemption requirements and "affirmatively states that the Adviser and Financial Institution are fiduciaries under ERISA or the Code, or both, with respect to any investment recommendations to the Retirement Investor." That statement will be sufficient, in and of itself, to establish fiduciary status under the proposed regulation. As the preamble puts it, advisers will not be able rely on this exemption and "later argue that the advice was not fiduciary in nature."

- **Impartial Conduct Standards**. The adviser must affirmatively agree to comply with, and in fact comply with, Impartial Conduct Standards. The Impartial Conduct Standards require the adviser to provide advice that is prudent in light of the circumstances of the retirement investor, without regard to its own financial or other interests. They also prohibit the adviser from receiving unreasonable compensation for its services, and prohibit misleading statements about the recommended asset, fees, material conflicts of interest and other matters pertinent to the retirement investor's investment decisions.

  Noncompliance with these Impartial Conduct Standards undoubtedly will result in different claims and remedies against advisers depending upon whether the contract is with an ERISA plan or an IRA. If the contract is with an ERISA plan, federal courts would have exclusive jurisdiction over any claim for violation of these standards and any resulting non-exempt prohibited transaction, and any state law breach of contract claims should be preempted by ERISA § 514(a). For an ERISA plan adviser that acknowledges fiduciary status, the effect of the Impartial Conduct Standards would be to shift the burden to the adviser to prove in any lawsuit brought under ERISA that it acted prudently and without regard to its own interests in providing the advice covered by the exemption. Although the DOL suggests in the preamble that ERISA plans and their participants could seek to enforce the Impartial Conduct Standards in "an action based on breach of the agreement," any such action would have to be brought under ERISA. In the event of a breach, the Secretary of Labor, a plan fiduciary or a participant would be allowed to seek only those remedies available under ERISA § 502(a), and there should be no right to a trial by jury. If, however, the contract is with an IRA, the IRA holder would have a state law breach of contract claim against the adviser that could be brought in state court and tried by a jury. Whether the contract is with an ERISA plan or an IRA, the adviser and its financial institution employer would be exposed to an excise tax under Section 4975 of the Code for prudence violations.

- **Warranties**. The adviser must warrant that it will comply with all applicable federal and state laws regarding investment advice and securities transactions; it has identified material conflicts of interest that might result in breaches of the Impartial Conduct Standard and has adopted policies and procedures to prevent violations; and it does not use "quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives to the extent that they would tend to encourage individual Advisers to make recommendations that are not in the Best Interest of the Retirement Investor."

Differentiated commissions, 12b-1 fees, sales loads and trailers are ubiquitous in the financial world. Where much of an adviser's compensation is received from third parties, fee-leveling is not a viable approach. To warrant that these fee arrangements do not "tend to encourage" violations of the best interest standard, financial institutions may be forced to use wrap programs and to build systems for small plans and IRAs that allow for an offset against the wrap fee of all 12b-1 fees and other compensation payable by third parties. The preamble specifically refers to the DOL's advisory opinions in *Frost* and *Country Trust Bank*,[12] which approved the use of fee-offset arrangements as a means of avoiding a prohibited transaction in the receipt of payments from third-party investment funds. Of course, if the adviser follows the *Frost* or *Country Trust* models, there would be no need for the BIC exemption in the first instance. The warranty regarding compensation practices also may require financial institutions to eliminate bonus or incentive programs for advisers in the provision of investment products and services to small plans and IRAs.

The preamble suggests several methods of satisfying the "policies and procedures" warranty, including the use of computer models to generate advice delivered by advisers,[13] asset-based compensation, fee offsets, compensation systems based on the financial institution's determination of what products take more time or effort to sell, and compensation arrangements that are designed to align the interests of the adviser with the interests of the investor. The preamble then offers several tips for "effective" compensation policies and procedures:

- Avoid creating compensation thresholds that enable an adviser to increase his or her compensation disproportionately through an incremental increase in sales
- Monitor the activity of advisers approaching compensation thresholds such as higher payout percentages, back-end bonuses, or participation in a recognition club, such as a "President's Club"
- Maintain neutral compensation grids that pay the adviser a flat payout percentage regardless of product type sold
- Refrain from providing higher compensation or other rewards for the sale of proprietary products or products for which the firm has entered into revenue sharing arrangements
- "Stringently" monitor recommendations around key liquidity events in the investor's lifecycle where the recommendation is particularly significant (*e.g.*, when an investor rolls over his pension or 401(k) account)
- Develop metrics for "good and bad behavior" (red flag processes) and use claw backs of deferred compensation to adjust compensation for employees who do not properly manage conflicts of interest

12 Adv. Op. 97-15A (May 22, 1997); Adv. Op. 2005-10A (May 11, 2005).

13 Robo advice by itself is not covered by the BIC exemption, so advice based on a computer model would have to be delivered by the adviser.

Suffice to say, compliance with these mandated warranties will require financial institutions to make significant changes in their compensation practices. Although the DOL states in the preamble that the failure to comply with these warranties would not result in a loss of the exemption, any breach of these warranties in the IRA setting, including the warranty regarding compensation policies and procedures, would be actionable under state contract law (since ERISA § 514(a) preemption applies only to ERISA-covered plans, not to IRAs). Indeed, that is the intended result.[14]

- **Contract Disclosures**. The written contract must disclose all material conflicts of interest, inform the investor of its right to obtain complete information about all fees associated with the assets in which the plan or IRA is invested, and disclose the existence of proprietary investment products, any fees that the adviser will receive from third parties in connection with the purchase, holding or sale of any asset, and the address of the website required by the exemption (see below). Failure to include any of these disclosures will preclude reliance on the exemption.

- **Prohibited Contract Provisions**. The contract between the adviser and the retirement investor may not limit the adviser's liability for violations of the contract, nor may it waive or limit the retirement investor's right to participate in class actions against the adviser. The DOL states in the preamble that "[t]he right of a Retirement Investor to bring a class-action claim in court (and the corresponding limitation on fiduciaries' ability to mandate class-action arbitration) is consistent with FINRA's position that its arbitral forum is not the correct venue for class-action claims." The DOL also states, however, that "this section would not affect the ability of a Financial Institution or Adviser, and a Retirement Investor, to enter into a pre-dispute binding arbitration agreement with respect to individual contract claims." Thus, outside the class-action context, arbitration clauses should be enforceable.

- **Cost Disclosure at Time of Purchase**. Whenever the adviser executes a purchase of an asset for a retirement investor, it must give the investor a chart showing the total cost of the acquired asset over periods of one, five, and ten years. The "total cost" includes the acquisition cost (such as loads, commissions, mark-ups on assets bought from dealers, and account opening fees), ongoing fees and expenses of pooled investment funds (such as mutual fund charges), and costs of disposition (such as surrender fees and back-end loads). The reference to mark-ups is puzzling. Mark-ups are charged only on principal transactions, which are not covered by the exemption. Even if a fixed income security is sold on an agency basis, the adviser would have no way of knowing what the mark-up is, since it is charged by an unrelated dealer that has no securities law duty to disclose the mark-up. The reference to account opening fees also seems odd. Because a rollover account is not an "Asset" under the BIC exemption, the fees associated with opening a rollover account are not costs of acquiring an "Asset."

[14] *See* 80 Fed. Reg. at 21970 ("Failure to comply with the [policies and procedures] warranty could result in contractual liability for breach of warranty."); *id*. at 21972 ("The Department intends that all the contractual obligations (the Impartial Conduct Standards *and the warranties*) will be actionable by IRA owners.") (emphasis added).

- **Annual Fee and Compensation Disclosure**. Within 45 days after the end of each year, the adviser must give the retirement investor a list of each asset purchased, sold, or held for his account during the preceding year, as well as a statement of the total fees that the investor paid to the adviser, directly or indirectly, during the year with respect to each asset. A statement of the total compensation received by the adviser directly or indirectly from any party, as a result of each asset purchased, sold or held for the investor's account during the year also must be included.

- **Web Disclosure**. The financial institution must maintain a web page that lists all "direct or indirect material compensation" payable to the adviser for services in connection with each asset (or, if uniform across a class of assets, the class of assets) that an investor is able to purchase, hold or sell through the adviser and that has been purchased, held or sold in the last 365 days, along with the source of the compensation and how it varies within and among assets. The information also must be accessible in a machine readable format. This presumably requires the detailing of every insurance company separate account, every collective trust by unit class, every mutual fund by share class, every annuity contract and every GIC. A sample appended to the proposed exemption summarizes the information that will have to be furnished. (*See Appendix I*)

- **Range of Investment Options**. The financial institution must offer and the adviser must make available a range of assets that is broad enough for the adviser to make recommendations with respect to every asset class necessary to serve the retirement investor's best interests. The exemption permits the financial institution to offer only proprietary products, only those that generate third party fees or only those of a particular asset class or product type, if it makes a written finding that the limitations do not prevent the adviser from providing advice that is in the investor's best interest, if the compensation received for the services provided to the investor is reasonable, and if the investor is given written notice of the limitations placed on assets that may be offered to the investor. The adviser must notify the investor if the adviser does not in fact recommend a sufficiently broad range of assets to meet the investor's needs.

  There is an exception to the broad range requirement for participant-directed plans in which a fiduciary other than the adviser has, without input from the adviser, established a limited menu of investment options. This exception is inapplicable to brokerage windows.

- **Notice to the Department of Labor**. Financial institutions that wish to rely on the BIC exemption must give advance notice to the DOL of their intention to do so. This would be the first prohibited transaction class exemption to require such notification. The notification requirement is apparently intended to allow the DOL to create a list of financial institutions that will be subject to the detailed data requests described below.

- **Recordkeeping and Data Requests**. Financial institutions must maintain information at the financial institution level by quarter concerning investment inflows, outflows and holdings for each asset purchased, sold or held under the exemption, including: the identity and quantity of each asset purchased, held or sold; the aggregate dollar amount invested or received and the cost to the investor for each asset purchased or sold; the cost incurred by the investor for each asset held; all revenue received by the financial institution or its affiliate in connection with the purchase, holding or sale of each asset, disaggregated by source; the identify of each revenue source and the reason for the payment. In addition, financial institutions must maintain information at the investor level concerning the identity of the adviser, the beginning- and end-of-quarter value of each investor's portfolio, and each external cash flow to or from the investor's portfolio during the quarter. The data must be maintained for a period of six years from the date of the transaction for which relief is sought under the exemption and must be made available to the DOL upon request *within six months from the date of the request*. The preamble states that the purpose of this requirement is to "assist the Department in evaluating the effectiveness of the exemption." Its effect, however, would be to invalidate past and future compensation covered under the exemption if the DOL's data request cannot be met within the six month period. Creating a system that would be able to respond to such a data request seems to be one of the first orders of business for brokers and insurance agents.

The financial institution also must maintain for a period of six years records demonstrating that the conditions of the exemption have been satisfied. Such records must be made available to the DOL, the IRS, any retirement investor and any contributing employer or employee organization whose members are covered by a plan that engaged in a transaction under the exemption.

The proposed exemption also includes "supplemental" relief for purchases of insurance and annuity contracts and for pre-existing transactions. The exemption for insurance and annuity purchases provides relief from the prohibitions of ERISA §§ 406(a)(1)(A) and (D) and Code §§ 4975(c)(1)(A) and (D) for a fiduciary causing such purchases from an insurance company that is a party in interest or disqualified person. The preamble explains that this exemption is being proposed at least in part to ensure that relief is available for IRA purchases of variable annuities and other annuity contracts that are securities under the federal securities laws, since the DOL is proposing to revoke PTE 84-24 to the extent it provides relief for such transactions (see discussion below).

Like the broader BIC exemption, the supplemental relief for insurance contracts and annuity purchases applies only to purchases by IRAs, participant accounts and non-participant-directed ERISA plans with fewer than 100 participants. The transaction must be effected by the insurance company in the ordinary course of its business, the total of all fees must be reasonable, and the purchase must be for cash and at least as favorable as an arm's length transaction with an unrelated party. The DOL states in the preamble that the fiduciary causing the purchase would not be the adviser or the insurance company, but another fiduciary. The exemption appears to assume that the adviser is acting as the insurance company's agent in recommending the purchase (thus making the insurance company a party in interest service provider), or that the insurance company is already a party in interest service provider for some other reason. The supplemental relief does not apply to an ERISA plan if the plan covers employees of the adviser or if the adviser is a named fiduciary or plan administrator selected to provide advice by someone who is not independent of the adviser. Since the supplemental relief encompasses only the prohibitions of ERISA §§ 406(a)(1)(A) and (D) and Code §§ 4975(c)(1)(A) and (D), the adviser would have to rely separately on either the primary BIC exemption or, to the extent applicable, the amendments to PTE 84-24 for relief from the self-dealing prohibitions of ERISA § 406(b) and Code §§ 4975(c)(1)(E) and (F).

The supplemental relief for pre-existing transactions would provide relief from the prohibitions of ERISA §§ 406(a)(1)(D) and 406(b) and Code §§ 4975(c)(1)(D), (E) and (F) for the receipt by advisers of prohibited compensation in connection with transactions that were entered into prior to the applicability date of the proposed regulation. Unlike the remainder of the BIC exemption, the supplemental relief for pre-existing transactions applies to the receipt of compensation for services in connection with the purchase, holding or sale of assets by IRAs, participant accounts and *all* ERISA plans, regardless of size and whether or not the plan is participant-directed. The supplemental relief would cover advisers who did not consider themselves fiduciaries prior to the applicability date, as well as advisers who considered themselves fiduciaries but relied on an exemption that has since been amended. The exemption would require that the compensation be received under an arrangement that was entered into prior to the applicability date. It also would require that the adviser not provide any additional advice regarding the purchase, holding or sale of the asset after the applicability date. This latter requirement could be a real trap for the unwary, since any isolated advice regarding the holding or sale of the asset after the applicability date would appear to cause a loss of the exemption. Like the broader BIC exemption, the supplemental relief excludes from coverage:

- An employer sponsored plan if the plan covers employees of the adviser or if the adviser is a named fiduciary or plan administrator selected to provide advice by someone who is not independent (although it does cover IRAs maintained by employees of financial institutions)
- Compensation that is received from a principal transaction with the adviser
- Compensation that is received on account of advice generated solely by an interactive website
- Any compensation paid to an adviser who is a fiduciary with respect to the plan or IRA for reasons other than providing investment advice for a fee

The supplemental relief also would not apply to any compensation received in connection with a purchase or sale that was a non-exempt prohibited transaction when it occurred.

The preamble to the proposed exemption asks for comments on whether the DOL should issue a separate class exemption, with fewer conditions, for advice concerning low-fee index funds. Examples mentioned in the preamble are “a long-term recommendation to buy and hold a low-priced (often passively managed) target date fund that is consistent with the investor’s future risk appetite trajectory” and “a medium-term recommendation to buy and hold (for 5 or perhaps 10 years) an inexpensive, risk-matched balanced fund or combination of funds, and afterward to review the investor’s circumstances and formulate a new recommendation.” The stated reason for requesting comments is that “at this point, the Department has been unable to operationalize this concept.” The preamble’s positive tone in discussing this concept suggests that the DOL may attempt to “operationalize” it in the near future.

Significantly, the BIC exemption is the only exemption in the DOL's proposed regulatory package that would provide relief for a service provider's receipt of 12b-1 fees, revenue sharing payments, marketing fees, administrative fees, sub-TA fees, sub-accounting fees, and other third-party payments from investment providers (with the exception of sales loads paid by mutual funds and sales commissions paid by insurance companies). However, the BIC exemption is inapplicable to the marketing of investment products or platforms to sponsors or fiduciaries of participant-directed 401(k) plans, regardless of plan size. Consequently, providers that receive such third-party payments in connection with the provision of such products or platforms to participant-directed 401(k) plans would have to structure their operations to fit within the proposed "carve-outs" to fiduciary status for platform providers and investment selection and monitoring assistance. Alternatively, these providers could use a wrap fee arrangement that allows for an offset of such third-party payments against the wrap fee or provide the services for a flat fee.

As explained previously, the proposed "carve-outs" for platform providers and investment selection and monitoring assistance do not apply to IRAs. Although the BIC exemption would permit advisers to receive payments from third parties in connection with transactions involving IRAs, participant accounts, and non-participant-directed ERISA plans with fewer than 100 participants, the liability risk created by the Impartial Conduct Standards and mandated warranties may leave such advisers with little choice but to use wrap fee arrangements in that context as well. This dynamic puts the DOL in a quandary: by making the conditions of the BIC exemption so difficult to use, the DOL encourages people to find other ways to avoid a prohibited transaction (*e.g.*, wrap fee arrangements or fixed fees), thereby undercutting the BIC exemption's attempt to impose contractual Impartial Conduct Standards on those who provide services to IRA owners.

The Proposed Exemption for Principal Transactions in Certain Debt Securities

The proposed regulatory package includes a new class exemption that would permit certain advisers and financial institutions to engage in purchases and sales of certain debt securities in principal transactions with ERISA plans, participant accounts, and IRAs, and receive mark-ups or mark-downs for themselves or an affiliate as a result of the adviser's and financial institution's advice.[15] The exemption would provide relief from the prohibitions of ERISA §§ 406(a)(1)(A) and (D) and 406(b)(1) and (2), and Code §§ 4975(c)(1)(A), (D) and (E) if the conditions of the exemption are satisfied.

The term "debt security" is defined for purposes of the proposed exemption to mean a debt security under Rule 10b-10(d)(4) of the Securities Exchange Act of 1934 that is (a) dollar denominated, issued by a US corporation and offered pursuant to a registration statement under the Securities Act of 1933; (b) an agency debt security as defined in FINRA Rule 6710(1); and (c) a US Treasury security as defined in FINRA Rule 6710(p). Foreign debt is thus excluded from the proposed exemption. The term "financial institution" is defined to include only registered investment advisers, banks, and registered broker-dealers that customarily purchase or sell debt securities for their own account in the ordinary course of business. "Adviser" is

[15] Proposed Class Exemption for Principal Transactions in Certain Debt Securities between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs, 80 Fed. Reg. 21989 (April 20, 2015).

defined to mean an employee, independent contractor, agent or registered representative of a financial institution.

Like the BIC exemption, the proposed exemption for principal transactions does not apply if the adviser is a fiduciary for reasons other than providing investment advice for a fee, or if the plan is covered by Title I of ERISA and the adviser or financial institution or any affiliate is an employer of employees covered by the plan, or a named fiduciary or plan administrator that was selected by a fiduciary who is not independent. The proposed exemption for principal transactions is subject to the following conditions:

- **Voluntary Assumption of Fiduciary Status**. Like the BIC exemption, the adviser and financial institution must affirmatively agree in a written contract that they are fiduciaries under ERISA, the Code or both.

- **Impartial Conduct Standards**. Like the BIC exemption, the adviser and financial institution must affirmatively agree to comply with, and in fact comply with, Impartial Conduct Standards. The Impartial Conduct Standards require the adviser and financial institution to provide advice that is in the investor's best interest, prohibit them from entering into a principal transaction if the price of the debt security (including the mark up or mark down) is unreasonable under the circumstances, and prohibit misleading statements about the debt security, the fees, the material conflicts of interest, the principal transaction or any other matters relevant to the investor's decision. Although an ERISA plan adviser would already be subject to ERISA's fiduciary duties of loyalty and prudence, the Impartial Conduct Standards would effectively shift the burden to the adviser to prove in any lawsuit brought under ERISA that it acted prudently and in the plan's best interest in providing the advice covered by the exemption. In the IRA setting, the Impartial Conduct Standards would give the IRA owner a private state cause of action for breach of contract. Advisers to both ERISA plans and IRAs also would be exposed to an excise tax for prudence violations. In the event of a non-exempt prohibited transaction involving the purchase or sale of a debt security on a principal basis, the excise tax would be imposed on the entire principal amount of the security, not just the mark-up or mark-down.

- **Warranties**. The adviser and financial institution must warrant the same four items as in the BIC exemption regarding policies and procedures, compliance with state and federal law, and no use of incentives that would tend to encourage advisers to make recommendations that are not in the investor's best interest. The requirement that the adviser not be able to earn differentiated compensation would be particularly difficult to satisfy in the principal transaction setting. The DOL states in the preamble that the failure to comply with these warranties would not result in a loss of the exemption. As with the BIC exemption, however, the warranties would give IRA owners a private state cause of action for breach of contract.

- **Contract Disclosures**. The written contract must set forth in writing the circumstances under which the adviser and financial institution may engage in principal transactions. What the DOL has in mind here is unclear. Since the exemption excludes discretionary control and purchases and sales will only be at the investor's direction, it is difficult to understand what the written contract would disclose here. The contract also must identify and disclose material conflicts associated with the principal transactions, obtain the investor's written consent to principal transactions, notify the investor that the consent is terminable at will at any time without penalty, and notify the investor of the right to obtain complete information about all fees and other payments currently associated with its investments, apparently not limited to principal transactions.

- **Prohibited Contract Provisions**. As with the proposed BIC exemption, exculpatory provisions and waivers of the right to bring or participate in a class action are prohibited.

- **Debt Security Requirements**. The debt security may not have been issued by the financial institution or any affiliate. This exclusion applies regardless of the size and sophistication of the plan, and regardless of how highly rated the debt is, how liquid the debt is, or the depth of other dealers making a market in the security. The proposed exemption also precludes purchases of new issues where the financial institution is in an underwriting syndicate, although presumably PTE 75-1, Part III still could be used in that situation. The debt security also must possess no greater than moderate credit risk, although "moderate" is undefined. In addition, the debt security must be "sufficiently liquid" that it could be sold at or near its fair market value within a reasonably short period of time. These provisions may significantly limit the use of the exemption, since the credit markets change and the credit of the issuer may change. To avoid the threat of an excise tax on the entire principal amount of the bond, the seller essentially would have to guarantee its performance.

- **Prohibited Arrangement**. The transaction must not be part of an agreement to evade compliance with ERISA or the Code or to otherwise impact the value of the debt security.

- **Cash Consideration**. The purchase or sale of the debt security must be for cash.

- **Transaction Pricing**. The transaction price must be at least as favorable as the price available in a transaction that is not a principal transaction – presumably the price from any other dealer plus a commission. The price also must be at least as favorable as that offered by two ready and willing unaffiliated dealers. Thus, automated systems like Bonddesk will be insufficient to satisfy the exemption, and financial institutions will have to create new systems to document compliance with the two ready and willing dealers requirement. More importantly, requiring quotes from two unaffiliated dealers could throw the parties into an endless loop of obtaining quotes, sending them to the client, and then having them expire due to the time it takes for the client to respond.

- **Pre-Transaction, Annual and Upon Request Disclosures**. Prior to the transaction, the adviser or financial institution must provide the investor, orally or in writing, a statement that the purchase or sale will be on a principal basis, and any available pricing information, including the two quotes and the mark-up, mark-down or other payment that will be charged. Written confirmation of the principal transaction must be provided in accordance with Rule 10b-10 under the Securities and Exchange Act of 1934, and must include disclosure of the mark-up, mark-down or other payment received by the adviser, financial institution or its affiliate.

The adviser or financial institution also must provide annually a list identifying each principal transaction engaged in during the year, the prevailing market price at which the debt security was purchased or sold, the applicable mark-up or mark-down or other payment, and a statement that the investor's consent to principal transactions is terminable at will without penalty to the plan or IRA.

Upon request, the adviser or financial institution must provide the investor with additional information regarding the debt security and its purchase or sale. The proposed exemption does not specify what this "additional information" might include.

- **Recordkeeping**. The financial institution must maintain for a period of six years records demonstrating that the conditions of the exemption have been satisfied.

Unlike the BIC exemption, the proposed exemption for principal transactions in debt securities would apply to all ERISA plans regardless of size and whether or not they are participant-directed. However, for ERISA plans with more than 100 participants, dealers probably would find it more advantageous to rely on the proposed counterparty exception (or "seller's carve-out") to fiduciary status, along with PTE 75-1, Part II(1) for relief from the prohibitions of ERISA § 406(a). At a minimum, dealers would have to think carefully before relying on the proposed principal transaction exemption, since reliance on the proposed exemption requires an acknowledgement of fiduciary status that would make it impossible to rely on the counterparty exception. Market-makers in US debt securities that also provide investment advice to ERISA plans and IRAs could continue to rely on the relief provided by PTE 75-1, Part IV, although, as explained below, the DOL is proposing to add Impartial Conduct Standards to the list of conditions for relief under that exemption, and thus again shifting the burden of proof on the standard of care and imposing an excise tax on a prudence failure.

Proposed Amendments to and Partial Revocation of PTE 84-24

PTE 84-24 currently provides relief from the prohibitions of ERISA § 406(a)(1)(A) through (D) and 406(b) and the parallel Code provisions for certain transactions relating to purchases by ERISA plans and IRAs of insurance and annuity contracts and for the receipt by an insurance agent or broker or pension consultant of a sales commission in connection with such purchases, provided that the conditions of the exemption are satisfied. PTE 84-24 also provides similar relief for purchases by ERISA plans and IRAs of mutual fund shares and for the related receipt by principal underwriters of a sales commission, if the exemption's conditions are met.

The DOL proposes to revoke PTE 84-24 for certain transactions and to amend the conditions under which IAFs otherwise will be able to rely on the exemption.[16] With respect to IRAs, the DOL proposes to revoke PTE 84-24 for IRA purchases of variable annuities and other annuity contracts that are securities under the federal securities laws, for IRA purchases of mutual fund

[16] Proposed Amendment to and Proposed Partial Revocation of Prohibited Transaction Exemption (PTE) 84-24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies and Investment Company Principal Underwriters, 80 Fed. Reg. 22010 (April 20, 2015).

shares, and for the receipt by insurance agents and brokers, pension consultants and principal underwriters of commissions in connection with such sales. Insurance agents, brokers, pension consultants and insurance companies engaging in such transactions would have to rely on the proposed BIC exemption (including the supplemental exemption for purchases of insurance and annuity contracts), which would expose advisers and financial institutions to state contract law claims for any alleged breach of the Impartial Conduct Standards, warranties and other contract requirements of the BIC exemption. As proposed, PTE 84-24 would continue to apply to IRA purchases of insurance and annuity contracts that are *not* securities and for the receipt by insurance agents and brokers and pension consultants of a sales commission in connection with such purchases, provided that the conditions of the exemption are satisfied.

The proposed amendments to PTE 84-24's conditions would require anyone providing fiduciary investment advice to an ERISA plan or IRA in reliance on the exemption to satisfy Impartial Conduct Standards, which require the adviser to act in the investor's best interest, disclose material conflicts of interest, and not make misleading statements about recommended investments, fees, material conflicts of interest and any other matters relevant to the investor's decision. As explained previously, these Impartial Conduct Standards would effectively shift the burden to the adviser to prove that it acted in the investor's best interest and expose the adviser to an excise tax for any prudence violation.

In addition, the DOL proposes to add specific definitions for "insurance commissions" and "mutual fund commissions" that would be covered by PTE 84-24. The term "insurance commission" is defined to mean "a sales commission paid by the insurance company or an Affiliate to the insurance agent or broker or pension consultant for the service of effecting the purchase or sale of an insurance or annuity contract, including renewal fees and trailers, but not revenue sharing payments, administrative fees or marketing payments, or payments from parties other than the insurance company or its Affiliates." The term "mutual fund commission" is defined to mean "a commission or sales load paid either by the plan or the investment company for the service of effecting or executing the purchase or sale of investment company shares, but does not include a 12b-1 fee, revenue sharing payment, administrative fee or marketing fee." Under these narrow definitions, insurance agents, brokers, and pension consultants selling variable annuities to ERISA plans would have to limit their compensation to a sales commission, and principal underwriters selling mutual fund shares to ERISA plans would have to limit their compensation to a sales load. To receive any other compensation from a third party, the party effectuating the sale would have to be compensated under a wrap fee arrangement that allows for an offset of any third-party payments against the wrap fee.

Proposed Amendments to and Partial Revocation of PTE 86-128 and PTE 75-1, Parts I and II

PTE 86-128 currently provides relief from the self-dealing prohibitions of ERISA § 406(b) and Code §§ 4975(c)(1)(E) and (F) for a fiduciary to receive commissions for effecting and executing securities transactions as agent for ERISA plans and IRAs, provided that the conditions of the exemption are met. PTE 86-128 also allows the fiduciary of an ERISA plan or an IRA to engage in an "agency cross transaction" as an agent both for the plan or IRA and for another party and receive reasonable compensation from the other party, provided that it does not act as a fiduciary on both sides of the transaction and that the conditions of the exemption are otherwise met.

The DOL proposes to amend and partially revoke PTE 86-128.[17] The proposed changes in PTE 86-128 would have a significant impact on broker-dealers, reporting dealers and banks who engage in securities transactions with ERISA plans and IRAs. In the IRA setting, the proposed amendments to PTE 86-128 would provide relief only for IRA fiduciaries who have discretionary authority or control over the management of the IRA's assets, and not for IRA fiduciaries who provide fiduciary investment advice for a fee. Advisers to IRAs would have to rely on the BIC exemption for relief, effectively requiring level commissions for advised IRAs.

The DOL simultaneously proposes to revoke Parts I(b) and (c) of PTE 75-1 so that all relief from the self-dealing prohibitions of ERISA § 406(b) for these agency transactions is in either PTE 86-128 for ERISA plans and managed IRAs or in the BIC exemption for IRAs and non-participant-directed small plans. Because the BIC exemption provides relief from the prohibitions of ERISA § 406(b)(3), advisers to IRAs and non-participant-directed small plans presumably can rely on the BIC exemption for the receipt of a commission from the counterparty to an agency cross transaction. Fiduciaries of managed IRAs and participant-directed small plans apparently would be able to rely on either PTE 86-128 or the BIC exemption for relief from the prohibitions of ERISA § 406(b). However, neither PTE 86-128 nor the BIC exemption provide ERISA § 406(a) relief, which means that advisers seeking 406(a) relief for these transactions must in the future rely on only the statutory exemption for services in ERISA § 408(b)(2) (unless QPAM, INHAM or one of the pooled fund exemptions is available).

In addition, PTE 86-128 would be amended to require all fiduciaries relying on the exemption to comply with Impartial Conduct Standards. As with the BIC exemption, these Impartial Conduct Standards generally would require the fiduciary to act in the investor's best interest, limit compensation to what is reasonable, disclose material conflicts of interest, and not make misleading statements about recommended investments, fees, material conflicts of interest, and any other matters relevant to the investor's decision. And again, adding the Impartial Conduct Standards to the exemption would effectively shift the burden of proof on the standard of care and expose the manager to an excise tax on any prudence violation, prompting many sophisticated managers to rethink their use of affiliates unless there is no risk that another broker could provide best execution at a lower cost.

The proposed amendments to PTE 86-128 also would incorporate and expand on the exemption currently contained in PTE 75-1, Part II(2), allowing a fiduciary to act as principal in selling mutual fund shares to plans and IRAs.[18] As proposed, this amendment to PTE 86-128 would provide relief from the prohibitions of ERISA §§ 406(a)(1)(A) and (D), and 406(b) and Code §§ 4975(c)(1)(A), (D), (E) and (F) for a fiduciary to cause an ERISA plan or managed IRA to purchase mutual fund shares from the fiduciary in a principal transaction, and to receive a

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[17] Proposed Amendment to and Proposed Partial Revocation of Prohibited Transaction Exemption (PTE) 86-128 for Securities Transactions Involving Employee Benefit Plans and Broker-Dealers; Proposed Amendment to and Proposed Partial Revocation of PTE 75-1, Exemptions From Prohibitions Respecting Certain Classes of Transactions Involving Employee Benefits Plans and Certain Broker-Dealers, Reporting Dealers and Bank, 80 Fed. Reg. 22021 (April 20, 2015).
[18] PTE 75-1, Part II (2) would be revoked.

commission from the plan or managed IRA or mutual fund. The fiduciary for purposes of this transaction must be a registered broker-dealer and cannot be the principal underwriter for or an affiliate of the investment company, which is usually the entity that acts as principal. The preamble characterizes the type of transaction contemplated by this exemption as "a 'riskless principal' transaction, in which the fiduciary that is providing the investment advice purchases shares on its own account for the purpose of covering a purchase order previously received from a plan or IRA, and then sells the shares to the plan or IRA to satisfy the order." One result of this characterization is that the proposed relief for mutual fund purchases would require a principal transaction confirmation, even though many market participants confirm these sales as agent. The revision omits sales from the relief because in the DOL's view, a sale to the fiduciary as principal is "not necessary." The DOL asks for comments on this change.

The securities transaction section of the proposed amendments to PTE 86-128 would cover only "[a] plan fiduciary's using its authority *to cause a plan* to pay a Commission." Although the new mutual fund transaction section of the exemption would cover the receipt of such a "Commission" from a third party, the term "Commission" is narrowly defined to include "a brokerage commission or sales load paid for the service of effecting or executing the transaction, but not a 12b-1 fee, revenue sharing payment, marketing fee, administration fee, sub-TA fee or sub-accounting fee." The DOL thus intends to limit commission relief for executing mutual fund transactions to sales loads paid either by the plan or the mutual fund, thereby forcing advisers into wrap fee arrangements if they wish to receive revenue sharing, 12b-1 fees and other payments from mutual funds or other third parties in connection with ERISA plans that are not self-directed and have more than 100 participants.

Proposed Amendments to PTE 75-1, Part V

Part V of PTE 75-1 permits covered broker-dealers to provide extensions of credit to plans and IRAs in connection with various transactions where an extension of credit is intrinsic to the transaction, such as settlement failures, options, short sales, margin transactions and other transactions. Under this exemption, if the broker is a fiduciary, the extension of credit must be without charge. The proposed change to Part V of PTE 75-1 provides relief for IAFs to receive a fee, but only for settlement failures.[19] It is unclear how any plan or IRA will be permitted to do short sales, option trades, margin transactions and a variety of other trades unless the transactions are covered by the QPAM, INHAM, or the pooled fund exemptions or the broker is covered by the counterparty exception (or "seller's carve-out"). Like the "legal list" of assets in the BIC exemption and the principal transaction exemption, this may be an attempt by the DOL to limit those strategies that it considers inappropriate.

Proposed Amendments to PTE 75-1, Parts III and IV, PTEs 77-4, 80-83 and 83-1

The DOL also proposes to require adherence to Impartial Conduct Standards as a condition for obtaining relief for transactions covered by the following exemptions[20]:

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[19] Proposed Amendment to Prohibited Transaction Exemption (PTE) 75-1, Part V, Exemptions From Prohibitions Respecting Certain Classes of Transactions Involving Employee Benefit Plans and Certain Broker-Dealers, Reporting Dealers and Banks, 80 Fed. Reg. 22004 (April 20, 2015).

[20] Proposed Amendments to Class Exemptions 75-1, 77-4, 80-83 and 83-1, 80 Fed. Reg. 22035 (April 20, 2015).

- **PTE 75-1, Part III** permits a fiduciary to cause a plan or IRA to purchase securities from a member of an underwriting syndicate other than the fiduciary, when the fiduciary is also a member of the syndicate

- **PTE 75-1, Part IV** permits a plan or IRA to purchase securities in a principal transaction from a fiduciary that is a market maker with respect to such securities

- **PTE 77-4** provides relief for a plan's or IRA's purchase or sale of open-end investment company shares where the investment adviser for the open-end investment company is also a fiduciary to the plan or IRA

- **PTE 80-83** provides relief for a fiduciary causing a plan or IRA to purchase a security when the proceeds of the securities issuance may be used by the issuer to retire or reduce indebtedness to the fiduciary or an affiliate

- **PTE 83-1** provides relief for the sale of certificates in an initial issuance of certificates by the sponsor of a mortgage pool to a plan or IRA, when the sponsor, trustee or insurer of the mortgage pool is a fiduciary with respect to the plan or IRA assets invested in such certificates

As with the BIC exemption, the proposed addition of Impartial Conduct Standards to these current exemptions generally would require the adviser to act in the investor's best interest, limit compensation to what is reasonable, disclose material conflicts of interest, and not make misleading statements about recommended investments, fees, material conflicts of interest and any other matters relevant to the investor's decision. And as noted throughout this Advisory, the addition of these Impartial Conduct Standards will effectively shift the burden of proof on the standard of care and expose the adviser to an excise tax on any prudence violation, thus increasing the leverage that participants, fiduciaries and the DOL have in any dispute over whether the adviser acted prudently.

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Questions about the proposed regulation redefining the term "fiduciary," the new proposed exemptions and the proposed amendments to existing exemptions may be directed to Melanie Nussdorf at +1 202 429 3009, Eric Serron at +1 202 429 6470, Patrick Menasco at +1 202 429 6215, Joni Andrioff at +1 202 429 8064, or Tom Veal at +1 312 577 1234.

APPENDIX I FINANCIAL INSTITUTION ABC—WEB SITE DISCLOSURE MODEL FORM

Type of investment	Provider, name, sub-type	Transactional			Ongoing			Affiliate	Special rules
		Charges to investor	Compensation to firm	Compensation to adviser	Charges to investor	Compensation to firm	Compensation to adviser		
Non-Proprietary Mutual Fund (Load Fund).	XYZ MF Large Cap Fund, Class A Class B Class C.	[•]% sales load as applicable.	[•]% dealer concession.	[•]% of transactional fee Extent considered in annual bonus.	[•]% expense ratio.	[•]% 12b–1 fee, revenue sharing (paid by fund/affiliate).	[•]% of ongoing fees. Extent considered in annual bonus.	N/A	Breakpoints (as applicable) Contingent deferred shares charge (as applicable)
Proprietary Mutual Fund (No load).	ABC MF Large Cap Fund.	No upfront charge.	N/A	N/A	[•]% expense ratio.	[•]% asset-based annual fee for shareholder servicing (paid by fund/affiliate).	[•]% of ongoing fees Extent considered in annual bonus.	[•]% asset-based investment advisory fee paid by fund to affiliate of Financial Institution.	N/A
Equities, ETFs, Fixed Income.		$[•] commission per transaction.	$[•] commission per transaction.	[•]% of commission Extent considered in annual bonus.	N/A	N/A	N/A Extent considered in annual bonus.	N/A	N/A
Annuities (Fixed and Variable).	Insurance Company A.	No upfront charge on amount invested.	$[•] commission (paid by insurer).	[•]% of commission Extent considered in annual bonus.	[•]% M&E fee [•]% underlying expense ratio.	$[•] Ongoing trailing commission (paid by underlying investment providers).	[•]% of ongoing fees Extent considered in annual bonus.	N/A	Surrender charge

APPENDIX II FINANCIAL INSTITUTION XZY—TRANSACTION DISCLOSURE MODEL CHART

	Your investment	Total cost of your investment if held for:		
		1 year	5 years	10 years
Asset 1				
Asset 2				
Asset 3				
Account fees				
Total				

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DEPARTMENT OF LABOR

Employee Benefits Security Administration

29 CFR Part 2550

[Application Number D–11713]

ZRIN 1210–ZA25

Proposed Class Exemption for Principal Transactions in Certain Debt Securities between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs

AGENCY: Employee Benefits Security Administration (EBSA), U.S. Department of Labor.

ACTION: Notice of Proposed Class Exemption.

SUMMARY: This document contains a notice of pendency before the U.S. Department of Labor of a proposed exemption from certain prohibited transactions provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (the Code). The provisions at issue generally prohibit fiduciaries with respect to employee benefit plans and individual retirement accounts (IRAs) from purchasing and selling securities when the fiduciaries are acting on behalf of their own accounts (principal transactions). The exemption proposed in this notice would permit principal transactions in certain debt securities between a plan, plan participant or beneficiary account, or an IRA, and a fiduciary that provides investment advice to the plan or IRA, under conditions to safeguard the interests of these investors. The proposed exemption would affect participants and beneficiaries of plans, IRA owners, and fiduciaries with respect to such plans and IRAs.

DATES: *Comments:* Written comments concerning the proposed class exemption must be received by the Department on or before July 6, 2015.

Applicability: The Department proposes to make this exemption available eight months after publication of the final exemption in the **Federal Register**.

ADDRESSES: All written comments concerning the proposed class exemption should be sent to the Office of Exemption Determinations by any of the following methods, identified by ZRIN: 1210–ZA25:

Federal eRulemaking Portal: http://www.regulations.gov at Docket ID number: EBSA–EBSA–2014–0016. Follow the instructions for submitting comments.

Email to: e-OED@dol.gov.

Fax to: (202) 693–8474.

Mail: Office of Exemption Determinations, Employee Benefits Security Administration, (Attention: D–11713), U.S. Department of Labor, 200 Constitution Avenue NW., Suite 400, Washington, DC 20210.

Hand Delivery/Courier: Office of Exemption Determinations, Employee Benefits Security Administration, (Attention: D–11713), U.S. Department of Labor, 122 C St. NW., Suite 400, Washington, DC 20001.

Instructions. All comments must be received by the end of the comment period. The comments received will be available for public inspection in the Public Disclosure Room of the Employee Benefits Security Administration, U.S. Department of Labor, Room N–1513, 200 Constitution Avenue NW., Washington, DC 20210. Comments will also be available online at *www.regulations.gov,* at Docket ID number: EBSA–2014–0016 and *www.dol.gov/ebsa,* at no charge.