

Publications

DOL Proposes to Significantly Tighten Prohibited Transaction Exemption Procedures

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Over the decades since the enactment of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), many plan sponsors, service providers, and industry groups have applied for, and been granted, prohibited transaction exemptions permitting a variety of transactions involving employee benefit plans and IRAs. However, the process for obtaining an exemption may soon become substantially more difficult.

On March 15, 2022, the Department of Labor (“DOL”) published proposed amendments to its regulations governing the procedures for the filing and processing of individual and class exemption applications. These proposed amendments, if finalized in their current form, would impose significant new requirements on exemption applicants and other entities who may be involved in exemptions (*e.g.*, independent fiduciaries and appraisers) and could significantly limit the availability of exemptive relief.

The changes would apply prospectively 90 days following the final adoption of the amendments in the Federal Register but would not apply to those who have submitted exemption applications prior to that date. Comments on the proposed amendments are due by April 14, 2022.

I. Background

ERISA and the Internal Revenue Code of 1986, as amended (the “Code”), prohibit a wide array of transactions involving employee benefit plans and IRAs, including transactions that are necessary or advantageous for the operation of plans and IRAs. Congress understood this and established a framework to exempt transactions otherwise prohibited by ERISA and the Code. The statute itself contains a number of exemptions, such as those that allow the payment of reasonable compensation to service providers. In addition, Congress provided DOL the authority to grant exemptions on a class or individual basis provided three conditions are met. Specifically, DOL must determine that the exemption is administratively feasible, in the interests of participants and beneficiaries, and protective of the rights of participants and beneficiaries.

DOL has long-standing regulations setting forth the procedures for its consideration of a request for an exemption. These regulations require applicants to submit detailed information to DOL, notify those who may be affected by the exemption so as to allow them to comment on a proposed exemption, and provide that documents submitted to DOL in connection with an exemption request will be available to the public upon request.

Plan sponsors and financial institutions have applied for, and been granted, hundreds of prohibited transaction exemptions over the years. At one time, it was common for DOL to grant dozens of exemptions every year. For example, in the five-year period from 1997 to 2001, DOL issued an average of approximately 90 exemptions per year. However, DOL has granted fewer and fewer exemptions in recent years. Over the last five year period (2017 to 2021), DOL granted fewer than 10 exemptions per year (and only 3 exemptions were granted in 2021). The exemption application process has also taken longer and become considerably more costly.

II. Overview of Proposed Amendments

DOL is proposing significant changes to the exemption application regulation. The proposal would codify some of DOL's existing policy positions that have already been applied in the course of some exemption requests but would also add a number of important new requirements. Below, we summarize the changes.

A. Pre-Submission

Prior to going through the time and expense of completing a formal application, exemption applicants often seek a meeting with DOL exemption staff to discuss whether DOL would be willing to entertain the applicant's proposed exemption. Plan sponsors and service providers might also approach and consult with DOL where they believe that they do not need to request an exemption (*i.e.*, because under the factual circumstances, no prohibited transaction would occur, or because another exemption is available to cover the transaction), but seek confirmation DOL would not conclude otherwise. The proposed amendments provide that communications with DOL become part of the administrative record of the exemption that the public can obtain on request and further prohibit a prospective applicant from approaching DOL on an anonymous or "no names" basis to discuss specific factual patterns, even if the purpose of the conference is not to discuss a potential exemption but to seek confirmation that an exemption is not needed.^[1]

B. Independent Fiduciaries and Appraisers

Exemptions often include conditions that require an independent fiduciary with no conflict of interest in the transaction to represent the interests of the plan^[2] and, if relevant, an independent appraiser to establish that the plan will pay no more or receive no less than the fair market value of an asset in a transaction. The proposed amendments would impose new terms and conditions with respect to independent fiduciaries and appraisers, including:

- The exemption procedure regulations describe when a fiduciary or appraiser will be considered "independent." The regulations currently include a percentage of revenue test, providing that a fiduciary or appraiser is deemed independent if less than 2% of its revenue is derived from parties involved in the transaction but state the fiduciary or appraiser may nonetheless be independent if the revenue is less than 5%. The amendments would make the 2% of revenue standard stricter, and would require the calculation to incorporate both the fiduciary's or appraiser's total revenue from the prior tax year and a projection of total revenue in the current year. DOL's focus on a 2% of revenue standard of independence is notable both because it will be harder for exemption applicants to meet and because DOL has previously issued guidance concluding that a party may be considered independent of another entity if less than 5% of its revenue is derived from the other party. *See, e.g.*, DOL Adv. Op. 2001-09 (Dec. 14, 2001).
- The amendments would impose a new requirement that an appraiser must also be independent of the independent fiduciary, not merely the applicant.
- The amendments also state that an entity may not be considered independent if it has an interest in the subject transaction or future transactions of the same nature or type. In the preamble to the proposed amendments, DOL stated that it has concerned that certain independent fiduciaries may have a "business interest" in allowing an exemption transaction to proceed where doing so would promote its independent fiduciary services to other clients, or would promote a relationship with a third party, such as an investment advisor or bank. This statement appears to be targeted toward certain firms that specialize in providing independent fiduciary services to plans and could potentially limit the availability of independent fiduciaries in the context of a DOL exemption.

- The amendments would set certain standards for a plan’s contract with an independent fiduciary or appraiser. The contract could not include indemnification for breach of contract or violations of applicable law, or a waiver of the plan’s claims under applicable law, including ERISA. This provision would codify DOL’s informal approach to appraisers in the context of exemptions.
- An independent fiduciary would be required to maintain fiduciary liability insurance in an amount that is sufficient to indemnify the plan for damages resulting from a breach by the independent fiduciary of either (a) ERISA, the Code, or any other Federal or state law; or (b) its agreement with the plan. The insurance may not contain an exclusion for actions brought by DOL or any other federal or state regulator, the plan, or plan participants or beneficiaries. For very large transactions, this may make the cost of fiduciary insurance prohibitively high, if it is even available.
- An independent appraiser would need to certify under penalty of perjury that, to the best of its knowledge all of the representations made in its appraisal report are true and correct.
- The amendments would require the provision of more information regarding independent fiduciaries and appraisers in the application for the exemption, including:
 - A description of the diligence process leading to the selection of the independent fiduciary or appraiser, including the number of candidates reviewed and references contacted;
 - With respect to independent appraisers, a description of any past engagements the plan or any party involved with the exemption transaction has had with the appraiser; and
 - With respect to independent fiduciaries, (a) either (i) a statement that, within the last five years, the independent fiduciary has not been under any regulatory investigation, examination, or litigation, or (ii) a description of such regulatory investigation, examination, or litigation; and (b) either (i) a statement that, within the last 13 years, the independent fiduciary has not been either convicted or released from imprisonment for certain felonies, including under foreign law, or (ii) a description of such conviction and the circumstances that lead to such conviction.
- The proposed amendments would also provide DOL with the right to a conference with the independent fiduciary or appraiser without the participation of the exemption applicant. This is not uncommon in DOL’s current process, though it is not specified in regulations.

C. Impartial Conduct Standards

Under the proposed amendments to the exemption procedure regulations, DOL would presume that the impartial conduct standards based upon PTE 2020-02 should be applied to every new exemption. The impartial conduct standards are:

- The transaction is in the “best interest” of the plan and its participants and beneficiaries, meaning the fiduciary causing the plan to enter into the transaction determines, with the care, skill, prudence, and diligence under the circumstances then prevailing, that a prudent person acting in a like capacity and familiar with such matters would, in the conduct of an enterprise of a like character and with like aims, enter into the exemption transaction based on the circumstances and needs of the plan, and that such fiduciary shall not place the financial or other interests of itself, a party to the exemption transaction, or any affiliate ahead of the interests of the plan, or subordinate the plan’s interests to any party or affiliate;
- All compensation received, directly or indirectly, by a party involved in the exemption transaction does not exceed reasonable compensation; and
- All of the statements to DOL, the plan, or, if applicable, the independent fiduciary or appraiser about the exemption transaction and other relevant matters are not, at the time the statements are made, materially misleading.

The burden would be on an exemption applicant to explain why these impartial conduct standards should not apply to its requested exemption. This is a significant expansion of DOL’s policy and would create a fiduciary standard for exemptions covering IRAs that are exempt from ERISA’s fiduciary standard of care.

D. Information to Be Reported by Applicants

The current exemption procedure regulations already require significant information to be included in an application for an exemption, but the proposed amendments would require more information, including:

- A description of material benefits non-plan parties would receive as a result of the transactions the exemption would permit.
- The costs and benefits (quantified if possible) of the transaction to plans, participants, and beneficiaries. However, many applicants would not have the internal resources to complete a cost/benefit analysis that is similar to what would be required of a federal governmental agency's regulatory impact analysis.
- A detailed description of potential alternatives to engaging in a prohibited transaction requiring a new exemption from DOL, and why those alternatives were not pursued.
- A description of each conflict of interest or potential instance of self-dealing that would be permitted if the exemption is granted.
- With respect to applications for individual exemptions, the applicant would need to report foreign (in addition to United States) criminal convictions and any prior transaction between (i) the plan or plan sponsor and (ii) a party involved in the exemption transaction. DOL explained in the preamble to the proposed amendments that the requirement to report prior transactions is intended to allow DOL to determine whether the transaction the exemption is requested for fits into a larger pattern or practice.

E. Ongoing Reporting to DOL after Grant of Exemption

The current version of the exemption procedure regulations requires, as stated above, that applicants update DOL if any material fact or representation provided to DOL changes or becomes inaccurate while the application for the exemption is pending with DOL. An example of a material fact that would necessitate reporting that DOL pointed to in the preamble to the proposed amendments is the identity of an independent fiduciary.

F. Other Changes

In addition, the proposed amendments to the exemption procedure regulations would:

- Codify DOL's view that an applicant is not entitled to an exemption solely because DOL has granted the same or a substantially similar exemption in the past. This policy can have controversial results. For example, service providers who have been granted an individual exemption allowing them to provide a particular type of service may have a competitive advantage over other service providers who cannot obtain the same type of exemption.
- Prohibit the costs of notifying interested persons of the exemption, as well as commissions, fees, or costs associated with the exemption transaction, from being charged to plan assets, unless there are compelling circumstances necessitating otherwise.
- Impose requirements with respect to a "party involved in the exemption," including that the independent fiduciary and appraiser must be independent from such parties, and information regarding the relationship between such parties and the independent fiduciary and appraiser, the plan, and the applicant and its affiliates must be reported to DOL. A "party involved in the exemption," includes all service providers to the plan and certain of their affiliates.
- Facilitate DOL's ability to deny an exemption application before providing the applicant with an opportunity to conference with DOL and respond to issues identified by DOL.

III. Observations

The proposed amendments to the exemption procedures would undoubtedly make it more difficult to apply for, and receive, a prohibited transaction exemption. This result is reflective of a shift in DOL's relationship with the regulated community that has been underway for some time. DOL used to routinely grant exemptions requested by plan sponsors, financial institutions and industry groups to facilitate transactions beneficial to plan participants. However, if finalized, the changes make it more difficult for potential applicants to obtain a workable exemption. Further, the proposed amendments effectively discourage the regulated community from proactive, informal communication with DOL.

It is also possible that DOL could attempt to apply the new substantive obligations and restrictions outside the context of prohibited transaction exemption applications. For example, the role of the independent fiduciary and appraiser in an exemption context is similar to the role of an independent trustee and financial advisor in the context of employee stock ownership plans, and DOL might seek to impose similar requirements in the context of investigations or enforcement actions regarding these types of transactions.

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Despite the scope and potential impact of the proposed amendments, DOL has provided a relatively short comment period. Consequently, stakeholders should be prepared to submit comments on or before the April 14, 2022 deadline.