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DoL Offers Help

Exemption for use of proprietary mutual funds

RECENTLY, the Department of Labor (DoL) published a proposed exemption for the Principal Financial Group (Principal). The proposed exemption is important because it modifies or clarifies existing relief afforded by class Prohibited Transaction Exemption (PTE) 77-4 and permits Principal to invest client plan assets into proprietary mutual funds through target-date funds or other insurance company pooled separate accounts.

In exchange for relief from ERISA section 406, fiduciaries relying on PTE 77-4 must abide by certain conditions imposed by the exemption: (1) the prohibition against payment of sales commissions by a plan in connection with the purchase or sale of mutual fund shares; (2) the prohibition against the receipt of "double" investment advisory fees by the fiduciary or its affiliates, with respect to the investment of shares for the period of the investment; (3) the limitation of redemption fees payable by the plan; (4) the requirement that certain disclosures are sent to a second fiduciary, named fiduciary or t rustee of the plan that must approve the purchase or sale of the mutual fund shares; and (5) the approval, in writing, by the plan fiduciary of any change in the rate of fees to be applied to the plan.

The proposed Principal exemption provides similar relief for the investment or recommendation by Principal, as fiduciary, into proprietary mutual funds, directly or indirectly through Principal's Collective Funds and clarifies, updates and improves some of the requirements of PTE 77-4:

- Unlike PTE 77-4, which requires a waiver of, or offset against, all plan-level fiduciary fees, it would permit Principal to retain plan-level fees for asset allocation services, broadly defined to include (i) the selection of appropriate asset classes or target-date glide paths; (ii) the selection of Collective Funds or mutual funds to "populate" those asset classes; and (iii) the allocation of the plan's assets among those funds. We think this is a significant improvement, basically recognizing that asset allocation services are distinct from portfolio management.
- The proposed Principal exemption clarifies that the relief is available regardless of whether Principal is acting as a discretionary or non-discretionary fiduciary with respect to the investment (there has long been debate over whether PTE 77-4 covers non-discretionary advice).
- The proposed exemption permits the use of "negative consent" for future mutual fund fee changes based on 30 days advance notice. Fee changes may be implemented sooner than 30 days, provided that the plan receives a credit in the interim. It permits the use of "negative consent" when Principal seeks to add a new mutual fund as an investment vehicle underlying a Collective Fund.
- It permits the use of e-mails for all disclosures, subject to client consent.
- It clarifies that the exemption would permit (subject to disclosure) the use of Principal broker/dealer affiliates to execute trades for the proprietary mutual funds.

In exchange for many of these beneficial updates and clarifications to PTE 77-4, the DoL imposed several additional conditions to the proposed Principal exemption:

- In the case of an "indirect" investment in a proprietary mutual fund through a Collective Fund, only one "level" of asset management fees (plan-level, Collective Fund-level, or mutual fund-level) may be charged (via waiver or offset), even with respect to those plan assets invested in a Collective Fund but not invested in proprietary mutual funds.
- Certain new advance and annual disclosures are required.
- An independent (second) fiduciary for each client plan must receive a termination form at the time it approves the use of negative consent and annually thereafter.
- All fees must be "reasonable" within the meaning of ERISA section 408(b)(2).

Based on our discussions with DoL staff, we believe that this proposed exemption is intended to serve as a new "model" for fiduciaries who seek to invest client plan assets in proprietary mutual funds.

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