GROOM LAW GROUP

April 16, 2015

Overview of DOL's 2015 Proposed Revisions to Existing Class Exemptions and Introduction of New Class Exemptions

On April 14, 2015, the U.S. Department of Labor ("DOL") made available its long-awaited re-proposed regulation on the definition of "fiduciary" under section 3(21) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The package of materials proposed by the DOL included:

- A regulation re-defining who is a "fiduciary" by reason of providing investment advice to a plan or an IRA (the "2015 Proposed Regulation");
- Two new prohibited transaction class exemptions; and
- Amendments to several existing prohibited transaction class exemptions.

This client alert prepared by Groom Law Group provides an overview of the proposed revisions to existing class exemptions and introduction of new class exemptions. For information regarding the 2015 Proposed Regulation and a summary of the DOL's regulatory impact analysis, please see our client alerts covering those subjects.

I. Executive Summary

The proposed new prohibited transaction class exemptions and amendments to existing class exemptions would require significant changes to the current service delivery and compensation models of many registered investment advisers, brokers, banks, insurance companies and consultants. Many current compensation practices will simply not work under the modifications to the current class exemptions and limitations of the newly proposed class exemptions. Where current compensation practices can be preserved, the ability to receive such compensation will be accompanied by taking on significant contractual, recordkeeping, and reporting obligations not currently required.

II. Overview of Class Exemption Proposals

The 2010 Proposed Regulation was roundly criticized for, among other things, not addressing needed prohibited transaction relief for dealing with the conflicts that would have resulted from re-characterizing many non-fiduciary activities as fiduciary in nature. The new proposal attempts to address this deficiency. The DOL has drafted a new class exemption designed for use by any person providing non-discretionary investment advice to so-called "Retirement Investors" (individual ERISA plan participants, IRAs or the plan sponsor of a non-participant-directed plan with under 100 participants) who wishes to receive and retain third-party compensation in connection with its fiduciary recommendations. All other fiduciary advisers in need of relief will be required to rely on some other exemption. In this regard, the DOL has also proposed a new exemption for the purchase and sale of certain debt securities and amendments to six existing class exemptions.

Recognizing that plan participants, IRAs and small plan sponsors may be in need of special protections, the DOL crafted an exemption with safeguards designed especially for them. In general, any person providing non-discretionary investment advice to Retirement Investors who

wishes to receive and retain third-party compensation in connection with its fiduciary recommendations will be required to comply with the new "Best Interest Contract Exemption" (or an existing individual or statutory exemption); all other fiduciary advisers in need of relief will be required to rely on some other exemption. Unfortunately, the primary exemptions on which many providers rely (e.g., 75-1, 86-128, 84-24) may be withdrawn or significantly modified so that the exemptions, even when used in combination, may no longer support current delivery and compensation models.

Given that the DOL generally does not have authority to enforce prohibited transaction rules against IRA fiduciaries, and the IRS does not have the resources, the DOL has come up with a novel approach that requires, as a condition of relief under the Best Interest Contact Exemption, various fiduciary representations and warranties to be included in all advisory contracts, which would be enforceable in state courts for IRAs or federal courts for ERISA plans. Arbitration clauses would be allowed, but as under existing FINRA rules customers could not be prohibited from participating in class action suits. Moreover, the new standards are sufficiently vague in many respects as to potentially make such suits a constant threat; we believe this vagueness was intentional. Of course, ERISA section 408(b)(14), the statutory exemption for level-fee or computer-model programs, remains available as an alternative to the new exemption; however, for various reasons that exemption has not proven to be very popular.

With the exception of Part I of class PTE 75-1 relating to non-fiduciary securities transaction services and recommendations (which would be eliminated as unnecessary in light of section 408(b)(2)) and Part II(2) of the same PTE (which would be revoked and moved in a severely modified form and with many new conditions, to PTE 86-128), none of the primary existing class exemption would be eliminated. These existing exemptions (PTEs 77-4, 75-1, 86-128, 84-24) – as modified (see below) – generally would remain available for (1) discretionary management of all types of plans and IRAs (including Retirement Investors); and (2) non-discretionary advice to plans *other than* Retirement Investors. Key changes in the existing exemptions include –

- Narrowing the definition of "commissions" covered by PTE 86-128 (excluding all forms of mutual fund revenue sharing) and submitting IRAs to the full scope of that exemption's considerable conditions, which might be unpalatable to many brokers. Similar changes are proposed for PTE 84-24, which also will no longer cover purchases of variable annuity contracts and mutual funds.
- Imposing an "impartial conduct standard" on fiduciaries as a condition of each of the exemptions including some form of "best interest" requirement on advisers to IRAs. Notably, that standard would not preclude a fiduciary from having a conflict of interest but would require that the conflict and fees be disclosed and that the fiduciary act in the "best interest" of its client "without regard the financial or other interests of the fiduciary or any other party..."
- The relief for extensions of credit by party-in-interest brokers to plan customers in PTE 75-1, Part V was expanded to permit a fiduciary broker to provide credit and be compensated for it if the loan was required to avoid a failed trade.

The modifications to the mutual fund exemption in Part II(2) of PTE 75-1 (which would be moved to PTE 86-128) could have a major impact on the market. Many financial institutions

have long relied on the exemption to permit the receipt of 12b-1 fees, sub-TA fees, shareholder services fees and revenue sharing in connection with the selection of mutual funds in discretionary management programs (*e.g.*, managed accounts). The modified exemption arguably permits the receipt and retention of a front-end sales load only, and only by a dealer acting as principal. The end result is that while the Best Interest Contract Exemption allows non-discretionary advisers to recommend third-party mutual funds and receive 12b-1 and other fees, *no comparable relief would be available for discretionary managers*. Consequently, managed account programs offering third-party mutual funds would have few options but "fee leveling," arguably putting them at a competitive disadvantage over advisory programs or discretionary programs using only proprietary mutual funds or other investment options.

A new class PTE for non-discretionary "principal" sales of certain non-proprietary debt was also proposed as a complement to the Best Interest Contract Exemption.

Importantly, as part of this package, the DOL has not proposed imposing new disclosure or other conditions on existing statutory exemptions, such as ERISA section 408(b)(4) (bank deposits) or 408(b)(8) (collective trusts and pooled separate accounts), which also provide relief for the receipt of compensation in connection with the sale of proprietary investments. Nor has it modified key strategies for *avoiding* a prohibited transaction, such as the SunAmerica advisory opinion or fee leveling.

III. Additional Class Exemption Summary Materials

In order to provide a more in-depth summary of the class exemption materials, Groom has prepared:

- An outline of each of the proposed new prohibited transaction class exemptions, including:
  - The proposed "Best Interest Contract Exemption"
    - The proposed "Pre-Existing Transaction Exemption" (a supplemental exemption under the Best Interest Contract Exemption)
    - The proposed "Insurance and Annuity Contract Exemption" (a supplemental exemption under the Best Interest Contract Exemption)
  - The proposed Exemption for Principal Transactions in Debt Securities
- A chart outlining the proposed revisions to existing prohibited transaction class exemptions