GROOM LAW GROUP

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Proposed Exemption for Principal Transactions in Debt Securities

1) Rationale for Exemption

a. DOL is concerned with conflicts of interest inherent to principal transactions, such as a Financial Institution's incentive to "dump" unwanted securities. Nonetheless, certain issues of debt securities may only be available from a limited number of Financial Institutions, some of whom may provide fiduciary advice under the new proposed regulation. Without this new exemption, ERISA plans, participants, beneficiary accounts, or IRAs would face reduced choices in the market for the covered debt securities.

b. DOL did not propose exemptions for principal transactions in securities for asset classes other than debt securities on the basis that the danger of conflicts of interest in those principal transactions outweighs the reduced choices for plans. For example, equity securities are widely available to plans and IRAs in agency transactions. But DOL requested public input and comments on whether there are additional commonly held assets that are commonly sold in principal transactions.

2) Covered Transactions and Relief Provided

The exemption would provide relief from the restrictions of sections 406(a)(1)(A) and (D), 406(b)(1) and (2), and Code sections 4975(c)(1)(A), (D) and (E) for the following:

a. Purchases or sales of certain "debt securities" by "Advisers" or "Financial Institutions" from or to "Retirement Investors" in principal transactions in exchange for mark-ups, mark-downs, or other payments for such Advisers or Financial Institutions or their Affiliates, as a result of the Adviser's or Financial Institution's advice.

b. Covered debt securities those defined in Rule 10b-10(d)(4) of the Securities Exchange Act of 1934 that are: U.S. dollar-denominated, issued by a U.S. corporation and offered pursuant to registration statements under the Securities Act of 1933; U.S. agency debt securities as defined in FINRA Rule 6710(I) or its successor; or U.S. treasury securities as defined in FINRA Rule 6710(p) or its successor. *The Rule 10b-10(d)(4) definition is fairly broad and may include not only traditional debt but, for instance, structured notes.*

3) Covered Providers

The exemption distinguishes between individuals who provide advice and the institutions they represent:

a. Advisers: Individual fiduciaries of ERISA plans, qualified plans and IRAs, solely by reason of providing investment advice, who are employees, independent contractors, agents, or registered representatives of "Financial Institutions" (defined below).

b. Financial Institutions: Registered investment advisers at the state or federal level; banks or similar institutions; and registered brokers or dealers that (i) employ Advisers and (ii) customarily purchase or sell debt securities for their own account in the ordinary course of

business. *Does not include insurance companies.*

4) Exclusions

The exemption is not available if:

a. The Adviser is a "discretionary" fiduciary.

b. The plan is covered by Title I of ERISA, and either (1) the Adviser, Financial Institution, or an affiliate is the employer/plan sponsor; or (2) the Adviser or Financial Institution is a named fiduciary or administrator of the plan or an affiliate thereof that was selected to provide investment advice to the plan by a fiduciary who is not "independent."

For this purpose, "independent" means that the person (1) is not the Adviser, Financial Institution, or an affiliate thereof; (2) does not receive compensation from the Adviser, Financial Institution, or affiliate; and (3) does not have a relationship with or interest in the Adviser, Financial Institution, or affiliate that might affect the exercise of the person's best judgment.

5) Conditions

a. Existence and Terms of Contract. There must be a written contract between the Financial Institution, Adviser and Retirement Investor, containing the following terms, entered into before engaging in principal transactions:

i. Affirmative statement that the Adviser and Financial Institution are "fiduciaries" under ERISA, the Code, or both, with respect to investment recommendations regarding principal transactions.

ii. Agreement by the Adviser and Financial Institution to comply with the following:

1. Provide investment advice in the "best interest" of the Retirement Investor;

2. Not enter into principal transactions if doing so is unreasonable under the circumstances; and

3. Provide statements regarding the debt securities, fees, material conflicts of interest, principal transactions, and other matters that are not misleading.

iii. Warranties by the Adviser and Financial Institution that:

1. They will comply with applicable laws regarding rendering investment advice and the purchase and sale of debt securities;

2. The Financial Institution has adopted written policies and procedures designed to mitigate the impact of material conflicts of interest and ensure that Advisers adhere to the above-described standards of conduct;

3. The Financial Institution has specifically identified material conflicts of interest and has adopted measures to prevent them from causing violations of the above-described standards of conduct; and

4. Neither the Financial Institution or its affiliates uses quotas, appraisals, bonuses, etc. if doing so would encourage the Advisers to make recommendations regarding principal transactions that are not in the Retirement Investor's "best interest".

5. The Preamble to the exemption notes that if the Adviser or Financial fails to comply with the warranties, the exemption will still be available, but Retirement Investors will be able to sue the Adviser or Financial Institution for breach of contract.

iv. Disclosures regarding principal transactions, including the circumstances under which principal transactions will be used; and identification and disclosure of material conflicts of interest associated with principal transactions.

v. The Retirement Investor's affirmative written consent. *Note: many financial institutions typically rely on "negative consent" for IRA account changes.*

vi. A statement noting that such consent is terminable at will by the Retirement Investor at any time, without penalty.

vii. A statement that the Retirement Investor has the right to complete information about fees and other payments associated with its investments.

b. <u>Terms Prohibited in the Written Contract</u>. The written contract must not contain exculpatory terms disclaiming or limiting the Adviser's or Financial Institution's liability for violating the terms of the contract or provisions by which the Retirement Investor waives or qualifies its right to bring or participate in class actions or representative actions <u>in court</u> in disputes with the Adviser or Financial Institution.

c. <u>General Conditions on the Transactions</u>

i. The debt securities are not issued by the Financial Institution or an affiliate; are not purchased in an IPO in which the Financial Institution or an affiliate is the underwriter or a member of the underwriting syndicate; have no greater than "moderate credit risk" *[Note: "moderate credit risk" is not defined in the exemption.]*; and are sufficiently liquid to permit sale at/near fair market value within a reasonably short period of time.

ii. The principal transaction is not intended to evade compliance with ERISA or the Code or otherwise impact the value of the debt security.

iii. Only cash purchase or sale transactions are permitted; in-kind transactions are prohibited.

iv. Certain pricing protections must apply, i.e., a purchase or sale must be executed at a price that:

1. The Adviser or Financial Institution reasonably believes is at least as favorable to the plan as the price available outside of a principal transaction; and

2. Is at least as favorable to the plan as the contemporaneous price for the debt security (or a similar security if a price is not available for the same debt security) offered by two ready and willing counterparties that are not affiliates of the Financial Institution or Adviser. *Note: The idea that there are at least two other counterparties is somewhat inconsistent with the stated rationale of the exemption. More importantly, compliance with this condition may increase costs and narrow the universe of securities for which the exemption is available.*

d. Disclosure Requirements. The exemption requires Advisers and Financial Institutions to make several types of disclosures to Retirement Investors, including:

i. Pre-transaction disclosures: Prior to a principal transaction, the Adviser or Financial Institution must provide to the Retirement Investor, orally or in writing:

1. A statement that the purchase or sale of a debt security will be executed as a principal transaction between the Adviser or Financial Institution and the plan, participant, or beneficiary account, or IRA; and

2. Available pricing information regarding the debt security, including the pricing quotes discussed under "General Conditions," above, and the mark-up, mark-down, or other payment that will be charged.

ii. Confirmations: The Financial Institution must provide written confirmations of the principal transactions in accordance with Rule 10b-10 under the Securities Exchange Act, including disclosures of mark-ups, mark-downs, or other payments in connection with the principal transaction.

iii. Annual disclosures: Within 45 days of the end of the applicable year, the Adviser or Financial Institution must provide, in a single disclosure:

1. A list identifying each principal transaction engaged in during that year, the market price at which the debt security was purchased or sold, and the applicable mark-up, mark-down or other payment for each debt security; and

2. A statement that the consent of the Retirement Investor (see above discussion under "Existence and terms of contract") is terminable at will without penalty.

iv. Upon-request disclosures: The client must receive at any time within six years, upon reasonable request, additional information regarding the debt security and its purchase or sale. *Note: Exactly what additional information, not already provided, must be saved for six years is not clear.*

e. Recordkeeping Requirements. The exemption requires compliance with various record retention requirements, summarized as follows:

i. For six years from the date of each principal transaction, records necessary to enable (1) DOL or IRS representatives, (2) plan or IRA fiduciaries (or their employees or representatives), (3) employers of participants and beneficiaries and employee organizations (or their employees or representatives), and (4) plan participants or beneficiaries or IRA owners to determine whether the conditions of the exemption have been satisfied.

ii. Such records must be generally available unconditionally at their customary location for examination during normal business hours by the individuals identified above.

iii. There is a carve-out for trade-secrets/privileged and confidential information with respect to examinations by the individual identified above (other than DOL or IRS representatives).

iv. If the Financial Institution refuses to disclose information claiming that it is exempt from disclosure, the Financial Institution must, within 30 days of the information request, notify the requestor of the reasons for such refusal and that the DOL may request such information.