

April 8, 2016

Fiduciary Rule – Final Prohibited Transaction Exemptions (New and Amended)

On April 6, 2016, the U.S. Department of Labor (“DOL”) made available its much-anticipated final regulation on the definition of “fiduciary” under section 3(21)(a)(ii) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). The new rule will have a profound impact on the retirement system and how services are provided throughout the industry. The package of materials released by DOL includes the following:

- A final regulation re-defining who is a “fiduciary” by reason of providing investment advice to a plan or an IRA (the “Final Regulation”);
- Final versions of the Best Interest Contract Exemption (the “BIC Exemption”), related supplemental exemptions, and the new prohibited transaction class exemption for principal transactions in certain investments (the “Principal Transactions Exemption”); and
- Final amendments to several existing prohibited transaction class exemptions, including prohibited transaction class exemption (“PTE”) 84-24, currently the primary source of prohibited transaction exemptive relief for the sale of insurance and annuity products to plans and IRAs.

The Final Regulation, changes to existing class exemptions, and certain elements of the BIC Exemption will be effective 60 days from the date of their publication in the Federal Register (*i.e.*, June 7, 2016). Despite this relatively early effective date, the terms of the rules generally delay their applicability until April 10, 2017. In the case of the BIC Exemption, special transition relief further delays the applicability of most conditions until January 1, 2018.

This client alert provides an overview of the amendments to the existing class exemptions and a summary of the new class exemptions. For a summary of the Final Regulation or a more in-depth analysis of the BIC Exemption, PTE 84-28, or the Principal Transactions Exemption, please see our alerts covering those subjects.

I. DOL’s Exemption Initiative

In the Final Regulation, DOL purported to update the definition of fiduciary “advice” to account for “the advent of 401(k) plans and IRAs, the dramatic increase in rollovers, and other developments that have transformed the retirement plan landscape” since the original regulation was issued. The Final Regulation greatly expands the circumstances in which a person or a firm offering investment services or products to an ERISA plan or IRA will be considered a fiduciary, thus making critical the availability of exemptive relief based on readily understand conditions.

The linchpin of DOL’s initiative to “to mitigate the effects of harmful conflicts of interest associated with fiduciary investment advice” is the new BIC Exemption. In conjunction with the

issuance of the BIC Exemption, DOL has also adopted a number of changes to the scope of existing PTEs, including completely revoking the relief provided for some IRA transactions. DOL believes that the conditions of the BIC Exemption “better protect” the interests of plans and IRAs in particular than the existing exemptions.

DOL has approved final amendments to the following existing class exemptions:

- PTE 75-1, relating to certain principal and mutual fund transactions involving broker-dealers, reporting dealers and banks;
- PTE 77-4, relating to the purchase or sale of shares of proprietary mutual funds;
- PTE 84-24, relating to certain transactions involving insurance agents and brokers, pension consultants, insurance companies, investment companies and their principal underwriters;
- PTE 86-128, relating to a fiduciary’s use of affiliated brokerage;
- PTE 80-83, relating to the use of proceeds from the sale of securities to reduce or retire debt of the issuer; and
- PTE 83-1, relating to investments in mortgage pool investment trusts.

Many of the key changes in the existing exemptions have the effect, and indeed, were intended to, either foreclose specific types of transactions or drive them, particularly for IRAs, to the BIC Exemption as the exclusive source of relief. For example:

- Recommendations of variable and fixed indexed annuities to plans *and* IRAs are no longer covered by PTE 84-24, nor will mutual fund recommendations to IRAs be covered by that exemption. Fiduciary advisers must rely on the BIC Exemption for these recommendations.
- DOL revoked the section 406(b) relief previously available under Part II of PTE 75-1 for the purchase of mutual fund shares by a plan or IRA where the fiduciary with respect to the assets involved in the transaction is not affiliated with the mutual fund or its principal underwriter.
- PTE 86-128 is no longer available to an IRA fiduciary for receipt of commissions in connection with mutual fund purchases. Moreover, only a *discretionary* fiduciary of an IRA may rely on this exemption to cover commissions for effecting securities transactions and these transactions will now be subject to the full scope of that exemption’s considerable conditions. While DOL did add a new mutual fund relief to PTE 86-128 (similar to that revoked in PTE 75-1), it is not available to IRAs.

The scope of the “commissions” covered by PTE 86-128 and PTE 84-24 has been significantly narrowed, precluding the receipt of mutual fund revenue sharing, shareholder

servicing and similar insurance-related fees. This effectively eliminates relief for mutual fund advisory programs under these exemptions. Relief for the receipt of these types of less traditional compensation is available under the BIC Exemption.

The “Impartial Conduct Standards” condition found in the BIC Exemption has also been added to PTEs 84-24, 75-1 (Parts III, IV), 86-128, 77-4, 80-83, 83-1 as a condition of relief, but without the requirement that these standards be incorporated into a binding contract. Notably, these standards would not preclude a fiduciary from having a conflict of interest but would require that the conflict and fees be accurately 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...”

An additional complement to the expanded fiduciary advice definition is the Principal Transactions Exemption permitting fiduciary “Financial Institutions” and “Advisers” to recommend that a plan or IRA purchase certain debt securities, unit investment trusts, and certificates of deposit from the Financial Institution. The exemption would also allow the Financial Institution or Adviser to recommend the *sale* by the plan or IRA to the Financial Institution of any security or investment property. The exemption is subject to significant conditions.

In addition to these changes related to the broader scope of the investment advice definition, DOL has also adopted the following modifications to existing class exemptions:

- 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 relief available in PTE 86-128 for affiliated brokerage has been expanded in two ways: (1) it is now available to cover commissions paid not only to the fiduciary and affiliated broker-dealers but to “Related Entities,” defined as a person in whom the fiduciary may have an interest that could affect its best judgment, and (2) discretionary trustees are permitted to use the “recapture of profits” provision as an alternative to the section III(h) and (i) conditions.

DOL revoked the relief provided in Parts I(b) and I(c) of PTE 75-1 for the furnishing of services by broker-dealers, noting that it is duplicative of the statutory exemption under section 408(b)(2).

Importantly, as part of this package, DOL has not imposed 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). These exemptions 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.

II. Summaries of the Class Exemptions

Groom has prepared outlines summarizing the new BIC Exemption, the “Pre-Existing Transaction Exemption” (a supplemental exemption under the BIC Exemption), the “Insurance and Annuity Contract Exemption” (a supplemental exemption under the BIC Exemption), the new Principal Transactions Exemption, and the amended PTE 84-24. We have also prepared a chart summarizing the final amendments to the existing prohibited transaction class exemptions.