GROOM LAW GROUP

April 8, 2016

Fiduciary Rule – Principal Transactions in Certain Assets

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 Principal Transactions Exemption. For an analytical summary of the Final Regulation, BIC Exemption, and other existing exemptions, please see our client alerts covering those subjects.

I. Executive Summary

The Principal Transactions Exemption provides relief from the prohibited transaction rules for a purchase or sale of certain assets in principal transactions and riskless principal transactions between a plan (including a participant or beneficiary account within a participant-directed plan) or IRA and a Financial Institution (as defined in Part II.C.), as a result of an Adviser's (as defined in Part II.C.) or Financial Institution's advice. The assets a plan or IRA may purchase under the Principal Transactions Exemption are limited to certain Debt Securities (as defined in Part II.B.), unit investment trusts, and certificates of deposit, but a plan or IRA may sell any security or other investment property under the Principal Transactions Exemption. The Adviser and Financial Institution must acknowledge fiduciary status, agree to follow

"Impartial Conduct Standards" as described below, and disclose information to the plan or IRA at the time of the covered transactions, annually, and upon request.

Below we describe the major changes to the Principal Transactions Exemption that were made since it was proposed and provide an overview of the Exemption in its final form.

II. Principal Transactions Exemption

A. Major Changes from Proposed Exemption

- Covered Assets. The Principal Transactions Exemption no longer provides relief for principal transactions in Debt Securities only. Now, the Exemption also provides relief for a covered advice recipient's purchase of unit investment trusts or certificates of deposit. Further, the Principal Transactions Exemption broadly permits *sales* of any "securities or other investment property."

- The Two-Quote Requirement. DOL has removed the requirement that the price of the covered security be at least as favorable to the plan or IRA as the contemporaneous price offered by two ready and willing counterparties that are not affiliates of the Financial Institution or Adviser. Some commented that this condition would not have been workable.

- Streamlined Contract and Disclosure Requirements. As with the BIC Exemption, DOL loosened some of the written contract requirements and information that must be disclosed. For example, DOL eliminated the written contract requirement for plans covered by Title I of ERISA, provided for the amendment of existing contracts with non-Title I plan and IRA clients through a "negative consent" process, and removed the proposed Principal Transactions Exemption's requirement that mark-ups and mark-downs be disclosed in connection with the principal transaction.

B. Covered Transactions and Relief Provided

The Principal Transactions Exemption would provide relief from the restrictions of sections 406(a)(1)(A) and (D), 406(b)(1) and (2), and Internal Revenue Code of 1986, as amended ("Code") sections 4975(c)(1)(A), (D), and (E) for the following:

- Purchases of "Debt Securities," unit investment trusts, and certificates of deposit by "Retirement Investors" from Financial Institutions in principal transactions in exchange for mark-ups, mark-downs, or other payments to Advisers or Financial Institutions or their Affiliates (as defined in Part II.D.), as a result of the Adviser's or Financial Institution's advice.
    - Covered Debt Securities include 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; "Asset Backed Securities" as defined in FINRA rule 6710(m) or its successor, guaranteed by an Agency as defined in FINRA rule 6710(k) or its successor, or a Government Sponsored Enterprise as defined in FINRA rule 6710(n) 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 also, for instance, structured notes.*

  - DOL also stated that investment advice fiduciaries may apply for individual prohibited transaction exemptions that would permit them to sell additional categories of investments in principal transactions to a plan or IRA.

- Sales of "securities or other investment property" from "Retirement Investors" to "Financial Institutions" in principal transactions.

- In addition to principal transactions, the Principal Transactions Exemption also covers purchases and sales of the above covered securities in "riskless principal transactions," which are defined as transactions where a Financial Institution purchases or sells assets to offset contemporaneous transactions with Retirement Investors. DOL noted in the preamble to the Principal Transactions Exemption that it intended to cover riskless principal transactions in the proposed exemption, but it was necessary to specify that riskless principal transactions are covered because they are functionally similar to agency transactions. References to "principal transactions" in this overview include "riskless principal transactions."

C. Covered Providers

The Principal Transactions Exemption distinguishes between individuals who provide advice and the institutions they represent:

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

- 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. *This definition does not include insurance companies.*

D. Covered Advice Recipient

Retirement Investors includes (i) a fiduciary of a non-participant directed plan, (ii) a participant or beneficiary of a plan who has the authority to direct the investment of his or her account, and (iii) the beneficial owner of an IRA acting on behalf of the IRA.

E. Exclusions

The Principal Transactions Exemption is not available if:

- The Adviser is a "discretionary" fiduciary.
- The plan is covered by Title I of ERISA, and either (i) the Adviser, Financial Institution, or an affiliate is the employer/plan sponsor; or (ii) 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 (i) is not the Adviser, Financial Institution, or an affiliate thereof; (ii) does not receive compensation from the Adviser, Financial Institution, or an affiliate in excess of 2% of its annual revenues; and (iii) does not have a relationship with or interest in the Adviser, Financial Institution, or an affiliate that might affect the exercise of the person's best judgment.

F. Conditions

- Existence and Terms of Contract. For transactions with IRAs and non-Title I plans, there must be a written contract with the Financial Institution. The contract must be entered into before engaging in principal transactions, but the contract may be executed after the advice to enter into the principal transaction is given, so long as the contract covers the advice retroactively. The contract must contain the following terms:
    - Affirmative statement that the Adviser and Financial Institution are "fiduciaries" with respect to investment recommendations regarding principal transactions.
    - Agreement by the Adviser and Financial Institution to comply with the following "Impartial Conduct Standards":
        - Provide investment advice that is, at the time of the recommendation, in the "best interest" of the IRAs or non-Title I plans;
        - Seek to obtain "best execution," which may include compliance with FINRA rules 2121 and 5310, if the Financial Institution is a FINRA member; and
        - Provide statements regarding the covered securities, fees, material conflicts of interest, principal transactions, and other matters that are not materially misleading at the time they are made.
    - Warranties by the Adviser and Financial Institution that:
        - 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;

    - 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;

    - The Financial Institution has adopted written policies and procedures to address how credit risk and liquidity assessments for covered Debt Securities will be made; and

    - 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 IRAs or non-Title I plan's "best interest".

    - The preamble to the Principal Transactions Exemption notes that if the Adviser or Financial Institution fails to comply with the warranties, the Principal Transactions Exemption will still be available, but IRAs and non-Title I plans will be able to sue the Adviser or Financial Institution for breach of contract.

  - Disclosures regarding principal transactions, including the circumstances under which principal transactions will be used and the types of compensation the Adviser and Financial Institution would receive, and identification and disclosure of material conflicts of interest associated with principal transactions.

  - For contracts executed after January 1, 2018, the IRA's or non-Title I plan's affirmative written consent. Financial Institutions may use negative consent with respect to existing clients.

  - A statement noting that the IRA's or non-Title I plan's consent is terminable at will by the Retirement Investor at any time by written notice, without penalty.

  - A statement that the IRA or non-Title I plan has the right to obtain, free of charge, (i) copies of the Financial Institution's written description of its policies and procedures adopted in connection with the Principal Transactions Exemption, (ii) information about the securities involved in the principal transactions, including their price, credit quality, yield, and duration, and (iii) model contractual disclosures or model notice of contractual terms, which are reviewed for accuracy on a quarterly basis;

  - A statement that the Financial Institution's written description of the policies and procedures adopted by the Financial Institution in connection with the Principal Transactions Exemption are maintained on the Financial Institution's website is required to maintain under the contract; and

- A statement describing whether the Financial Institution or Adviser will monitor the IRA's or non-Title I plan's investments and provide alerts on recommended changes, and, if so, the frequency with which the monitoring will occur and why the IRA or non-Title I plan would be alerted.

- Terms Prohibited in the Written Contract. 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 IRA or non-Title I plan waives or qualifies its right to bring or participate in class actions or representative actions *in court* in disputes with the Adviser or Financial Institution, although individual claims may be arbitrated**.**

- ERISA Plans. Financial Institutions are not required to enter into enforceable contracts with plans covered under Title I of ERISA. However, the Financial Institution would still be required to (i) provide a written statement affirming its fiduciary status, (ii) adhere to the same Impartial Conduct Standards, (iii) adopt and enforce the same policies and procedures, (iv) provide the same disclosures, and (v) refrain from including the same prohibited contract terms in its general services contract with the plan, all as described above.

- General Conditions on the Transactions

  - If the plan or IRA is purchasing, as opposed to selling, the Debt Security must not be issued by the Financial Institution or an affiliate; must not be purchased in an underwriting in which the Financial Institution or an affiliate is the underwriter or a member of the underwriting syndicate; and must possess no greater than "moderate credit risk" and be sufficiently liquid to permit sale at/near carrying value within a reasonably short period of time. *"Moderate credit risk" is not defined in the Principal Transactions Exemption. DOL states the Debt Security should have at least average credit-worthiness, and that the standard is similar to that of Rule 6a-5 under the Investment Company Act.*

  - The principal transaction must not be intended to evade compliance with ERISA or the Code or otherwise impact the value of the asset.

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

- Disclosure Requirements. The Principal Transactions Exemption requires Advisers and Financial Institutions to make several types of disclosures to Retirement Investors, including:

  - Pre-transaction disclosures: Prior to a principal transaction or at the time of execution, the Adviser or Financial Institution must provide to the Retirement Investor, orally or in writing, an explanation of the capacity in which the Financial Institution may act with respect to the transaction.

- Confirmations: The Financial Institution must provide written confirmations of the principal transactions, which may be satisfied by complying with Rule 10b-10 under the Securities Exchange Act.

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

  - A list identifying each principal transaction engaged in during that year, and the date and price at which the Debt Security was purchased or sold;

  - A statement that the consent of the Retirement Investor (see above discussion under "Existence and Terms of Contract") is terminable at will without penalty, upon written notice;

  - A statement that the Retirement Investor may obtain information about the securities that have been traded, free of charge; and

  - A statement that (i) the Financial Institution's model contractual disclosures or notice of model contractual terms, which must be reviewed for accuracy on a quarterly basis, and (ii) written description of its policies and procedures adopted in connection with the Principal Transactions Exemption, are available free of charge and on the Financial Institution's website.

- Upon-request disclosures: The Financial Institution must prepare a written description of its policies and procedures and make it available on its website, and additionally provide them to Retirement Investors, free of charge, upon request. The written description must summarize key terms of the policies and procedures as they relate to conflict-mitigation and incentive practices. In addition, as noted above, the Financial Institution must provide information about the securities involved in the principal transactions, and model contractual disclosures or model notice of contractual terms upon request.

- Inaccurate disclosures would not result in the loss of the Principal Transactions Exemption, if they are cured (i) within 7 days of discovery or reasonable discovery if the inaccurate statement is on the Financial Institution's website, or (ii) within 30 days of discovery or reasonable discovery for all other inaccurate disclosures.

- Recordkeeping Requirements. The Principal Transactions Exemption requires compliance with various record retention requirements, summarized as follows:

  - For six years from the date of each principal transaction, records necessary to enable (i) DOL or IRS representatives, (ii) plan or IRA fiduciaries (or their employees or representatives), (iii) employers of participants and beneficiaries

and employee organizations (or their employees or representatives), and (iv) plan participants or beneficiaries or IRA owners to determine whether the conditions of the Principal Transactions Exemption have been satisfied.

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

- 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 Internal Revenue Service representatives), as well as disclosures that would be prohibited under federal banking law, 12 U.S.C. 484.

- 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.

- DOL also noted that failure to retain required documentation would only cause the loss of the Principal Transactions Exemption with respect to those specific transactions for which documentation is missing.

G. Effective Date and Transition

All of the conditions of the Principal Transactions Exemption become applicable on January 1, 2018. Nonetheless, from April 10, 2017 to January 1, 2018, a transition period, during which limited conditions would be required, applies. To qualify for relief during the transitional exemption, the Adviser and Financial Institution would be required to comply with the Impartial Conduct Standards (as defined in Part II.E) and the Financial Institution would be required to provide a notice (electronically or by mail) to the Retirement Investor, at or before the time of execution of principal transactions, that:

- Affirmatively states the Financial Institution and Adviser's fiduciary status;

- Sets forth the Impartial Conduct Standards and affirmatively states the Financial Institution and Adviser will comply with such standards; and

- Identifies and discloses the circumstances in which principal transactions will be made and the material conflicts of interest associated with principal transactions.

The recordkeeping requirements described above would also apply.

III. Implications

DOL has made the Principal Transactions Exemption more useful than in its proposed form by broadening the categories of securities the Principal Transactions Exemption covers and by removing some burdensome requirements, such as obtaining contemporaneous quotes and

disclosing mark-ups and mark-downs. Nonetheless, a Financial Institution is not permitted under the Principal Transactions Exemption to sell securities it issues, or those it distributes as a member of an underwriting syndicate.