PRESENTATION

Inaugural Memphis Compliance Roundtable

The DOL's Proposed Change to the Definition of "Fiduciary Investment Advice"

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Points:

- “Investment Advice” and “Fiduciary” Status - What’s the Significance?
- Current Rules and Regulatory Regime
- Proposed Rule
- Impact

“Investment Advice” and “Fiduciary” Status What’s the Significance?

“Investment Advice” and Fiduciary Status:

Fiduciary status has two important implications.

- **First**, fiduciaries of ERISA-covered plans are required to carry out their duties with care, skill, prudence, and diligence. This is the highest duty under the law. ERISA fiduciaries who breach their duties are subject to personal liability for resulting losses.
- **Second**, fiduciaries’ dealings with plans or IRAs are restricted by prohibited transactions rules (ERISA § 406; Code § 4975), which prohibit fiduciaries from engaging in self-dealing or receiving compensation from third parties in connection with a transaction involving a covered plan or account.

The Department of Labor's Current Rules and Regulatory Regime

Current Rules and Regulatory Regime:

Statutory definition of “fiduciary” under ERISA and the Code includes:

1. Any person who exercises authority or control over management or disposition of plan assets.

2. Any person who does not exercise such authority or control but who “renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan.” *Such a person is often referred to as an Investment Advice Fiduciary (IAF)*.

Current Rules and Regulatory Regime: (continued)

In 1975, the DOL issued a regulation that defined the types of advice that would be viewed as fiduciary using a five-part test. Under this test, a person is an investment advice fiduciary if the person renders advice to a plan that:

1. is a **recommendation** on investing in, purchasing, or selling securities or other property, or advice as to their value;
2. is provided on a **regular basis**;
3. is provided pursuant to a **mutual agreement, arrangement, or understanding**, either written or otherwise;
4. will serve as a **primary basis** for investment decisions; and
5. is on an **individualized** basis.

The Department of Labor's Proposed Regulations

DOL Proposal:

The preamble to the proposed regulation offers two overarching reasons for changing the 1975 regulation.

First, the 1975 regulation departed from Congressional intent by narrowing the breadth of the statutory definition of “fiduciary investment advice.”

Second, changes have occurred in the retirement market since 1975 (particularly the growth of participant-directed plans and IRAs and the “increasingly complex financial marketplace”) that warrant revisiting the current definition of fiduciary and expanding it to cover a broader array of advice and communications.

DOL Proposal: (continued)

The DOL's proposed solution is to greatly expand the scope of what may constitute investment advice under ERISA (i.e., covered advice) and expanding the circumstances in which covered advice is considered fiduciary investment advice.

The proposal consists of **(i)** a delineation of categories of advice that could be considered investment advice, **(ii)** specific carve-outs from the definition of investment advice, and **(iii)** new and amended prohibited transaction class exemptions (PTEs).

DOL Proposal: (continued)

Expanded Scope of Covered Advice: Four types of advice that may make the provider of the advice an investment advice fiduciary:

1) a recommendation as to the advisability of buying, selling, holding, or exchanging a security, including a recommendation as to taking a distribution of benefits or rolling over benefits from a plan or IRA;

2) a recommendation as to the management of securities, including a recommendation as to taking a distribution of benefits or rolling over benefits from a plan or IRA;

3) an appraisal, fairness opinion, or similar oral or written statement concerning the value of a security if provided in the context of the acquisition, disposition, or exchange of such security; **OR**

4) a recommendation of a person who is also going to receive a fee or other compensation for providing any of the advice described in 1-3.

DOL Proposal: (continued)

“Recommendation” is defined expansively to mean:

- a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action.

DOL Proposal: (continued)

In order for advice to be covered advice, it must be provided to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner in exchange for a fee or other compensation, direct or indirect.

"fee or other compensation, direct or indirect" means:

- any fee or compensation for the advice received by the person (or by an affiliate) from any source and any fee or compensation incident to the transaction in which the investment advice has been rendered or will be rendered.

DOL Proposal: (continued)

Expanded Circumstances in which covered advice is considered fiduciary investment advice: A person who provides one of the foregoing types of advice will be an IAF if such person, directly or indirectly (e.g., through an affiliate), does either of the following:

1) Represents or acknowledges that he or she is "acting as a fiduciary" within the meaning of ERISA with respect to the advice; **OR**

2) Renders the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan of IRA.

DOL Proposal (continued)
Changes to Definition of Fiduciary Investment Advice:

Current Regulations	2015 Proposed Rule
"Regular basis" standard	One time advice/recommendation suffices
"Mutual agreement" standard	No "meeting of the minds" required
"A primary basis" for investment decision	No actual reliance or causal correlation required. The mere fact that advice was given for consideration is enough
Functional approach ("Whether or not an individual or entity is an ERISA fiduciary must be determined by focusing on the functions performed, rather than the title held." *Womack v. Orchids Paper Prods. Co*. 401(k) Sav. Plan (N.D. Okla. 2011).	Presumptive, maximalist approach

DOL Proposal (continued)
Changes to Definition of Fiduciary Investment Advice:

Current Regulations	2015 Proposed Rule
Discussing information related to IRAs and rollovers not deemed fiduciary investment advice	Discussing information related to IRAs and rollovers may now be deemed fiduciary investment advice.
Broad "participant investment education" protections under Interpretive Bulletin 96-1	Educational materials will confer fiduciary status if they include specific product or fund references or references to specific managers.
No defined or set lists of approved investments or products	Conditions and predicates to many PTEs operate within a defined universe of products (DOL calls them "common" investments)

DOL Proposal | The Carve-Outs:

Carve-Outs/Exceptions from definition of Investment Advice:

Acknowledging that the proposed categories of investment advice, standing alone, could sweep in certain relationships and advice that are not appropriately considered fiduciary in nature, the DOL included a number of specific carve-outs in the proposal.

Note: Persons who represent or acknowledge that they are acting as fiduciaries may not subsequently rely on any of the proposed carve-outs to IAF status.

DOL Proposal | The Carve-Outs (continued)

Carve-Outs/Exceptions from Definition of Investment Advice:

1. Counterparties – Statements or recommendations made to a "large plan investor with financial expertise" by a counterparty acting in an arm's length transaction. Does not apply to plans with fewer than 100 participants, unless the plan is managed by a fiduciary with more than $100 million of ERISA plan AUM. Doesn't apply to IRAs or individuals (individual plan participants).

2. Swaps – recommendations to enter into certain swap or security-based swap transactions under the Commodity Exchange Act or the Securities Exchange Act of 1934. Only applies to plans, not to IRAs or individual participants, and the plan must be represented by a fiduciary independent of the swap counterparty.

3. Employees – advice given to plan fiduciaries by employees of the plan's sponsor will not be fiduciary investment advice, unless the employee receives compensation for the advice beyond his/her regular pay.

DOL Proposal | The Carve-Outs (continued)

Carve-Outs/Exceptions from Definition of Investment Advice:

4. Platform Providers – Marketing a set of investment alternatives, where plan fiduciaries select the alternatives that will be made available to participants, will not be fiduciary investment advice, so long as the platform provider "discloses in writing to the plan fiduciary that [it] is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity."

5. Objective Advice on Selecting/Monitoring Alternatives – A platform provider will not be considered to be rendering fiduciary investment advice if it merely "identifies investment alternatives that satisfy objective criteria specified by the plan fiduciary" or "provides objective financial data and comparisons with independent benchmarks to the plan fiduciary." Again, this exception does not apply to IRAs.

DOL Proposal | The Carve-Outs (continued)

Carve-Outs/Exceptions from Definition of Investment Advice:

6. Financial Reports & Valuations – Although the new proposal would generally bring appraisals and fairness opinions relating to plan assets within the scope of fiduciary investment advice, this carve-out excludes reports that are provided to an ESOP, to a pooled investment fund that holds assets of unrelated plans, or to a plan, participant or IRA owner for the sole purpose of complying with reporting and disclosure requirements.

7. Investment Education – This exception would replace Interpretive Bulletin 96-1, which excludes general financial, investment and retirement information from the scope of investment advice. Major changes include extending "investment education" to certain information provided to plan fiduciaries and IRA owners, and excluding asset allocation models that refer to specific examples of investment products.

DOL Proposal | The PTEs

As previously noted, individuals providing fiduciary investment advice cannot accept any payments creating conflicts of interest unless their conduct fits within a **Prohibited Transaction Class Exemption (PTE)**.

In conjunction with broadening the types of advice relationships that give rise to fiduciary status, the DOL has proposed two new PTEs and amendments to existing PTEs that, *in theory*, will permit common compensation arrangements of broker-dealers, insurance agents, and other investment advice fiduciaries that otherwise would be prohibited under ERISA.

DOL Proposal | The PTEs
The Best Interest Contract Exemption:

Covers non-discretionary advice to **retail** investors (small non-participant directed plans, individual participants, and IRA owners) to buy, sell, or hold certain **assets**.

For purchases and sales of assets covered by the BIC exemption, Advisers, Financial Institutions, and their affiliates will be allowed to receive compensation that is ordinarily prohibited to fiduciaries (e.g., commissions, sales charges, 12b-1 fees, revenue sharing and other payments from third parties), provided that they:

> **(i)** contractually agree to adhere to Impartial Conduct Standards in rendering advice regarding [plan or IRA] Assets; **(ii)** warrant that they have adopted policies and procedures designed to mitigate the dangers posed by Material Conflicts of Interest; **(iii)** disclose important information relating to fees, compensation, and Material Conflicts of Interest; and **(iv)** retain documents and data relating to investment recommendations regarding Assets.

DOL Proposal | The PTEs
The Best Interest Contract Exemption:

Written contract requirements include:

- Acknowledge fiduciary status;
- Will comply with “Impartial conduct standards”;
- Warranties re policies and procedures taken to mitigate conflicts;
- Disclosures re conflicts of interest and cost of advice;
- Provision identifying address of webpage that discloses all compensation arrangements; and
- A notice informing investor of its right to obtain complete information about the fees associated with the assets in which it is invested.

DOL Proposal | The PTEs
The Best Interest Contract Exemption: (continued)

Required Disclosures Include:

- **Point of sale disclosure**: estimated costs to client of holding investment in a dollar amount if held for 1, 5 and 10 years.

- **Annual disclosure**: actual costs to plan or IRA and actual compensation received by firm and individual advisers in connection with account.

- **Public website**: compensation payable to financial institution and individual advisers in connection with each asset bought, sold or held in last 365 days, updated quarterly, including source of compensation.

- **DOL disclosure and recordkeeping requirements**: aggregated data regarding inflows, outflows, holdings and returns, including identity and amounts of revenue received. The DOL reserves the right to publicly disclose data received.

DOL Proposal | The PTEs
The Principal Transactions Exemption:

Would allow advisors to recommend certain fixed-income **debt securities** and sell them to an investor from the advisor's own inventory (i.e., a principal transaction) (e.g., U.S. Treasury securities). Would also permit advisors to receive a markup, markdown, or other payment for themselves or an affiliate in connection with a principal transaction.

Written Contract Requirements:

- Must sign contract with investor prior to engaging in first principal transaction acknowledging fiduciary status (terminable at will);
- Warranties, disclosures, and affirmative consent;
- Independent of the issuer (cannot be part of underwriting syndicate);
- Moderate credit risk;
- Sufficiently liquid (able to be sold at fair market value within reasonably short period);
- Cash transactions only. No in-kind transactions;
- Price must be at least as favorable as price outside a principal transaction, and at least as favorable as the contemporaneous price offered by two unaffiliated counterparties;
- Disclosures: prior to trades (oral/written), confirms, annual disclosures, and upon request; and
- Recordkeeping.

Potential Impact of Proposed Rule

Potential Impact of Proposed Rule:

If adopted as proposed, the rule will have a profound impact on:

- **How services are provided to ERISA Plans and IRAs.**
  - Retail brokerage
  - Institutional brokerage
  - Investment education and communications
  - Valuations and appraisals
  - Recordkeeping and platform providers
- **How all types of investment products and services are sold to ERISA Plans and IRAs.**
  - Registered funds/ETFs
  - Private funds
  - Managed accounts
  - Consulting
  - Insurance products
  - Futures and options
  - Brokerage windows
  - Etc.
- **What disclosures are provided to small Plan fiduciaries, Plan participants and IRAs.**
  - The new proposed PTEs would require extensive disclosure of investment-related compensation paid to financial institutions and their individual representatives.

Activities of Other Regulators

The Securities and Exchange Commission (SEC)

- Chairman White supported the DOL standard and announced the SEC will draft similar proposed rules for broker-dealers.

Financial Industry Regulatory Authority (FINRA)

- CEO Ketchum's Comments
  - SIFMA Conference March 2015 ("It does seem to me that this is the right time to move to a consistent, single standard that is focused on the best interest of the customer…it would be far preferable to have a single, consistent [fiduciary] standard that operates out of the SEC across all [investment] vehicles that exist for the individual investor…").
  - FINRA Annual Meeting May 2015 ("As many of you are aware, I have spoken out in support of a 'best interests of the customer' standard for a number of years. I continue to believe today that, for both investor protection and firm cultural reasons, a best interest standard for broker-dealers- under the securities laws - is the direction we must go.").
  - See also FINRA Regulatory Notices 13-23 (*Brokerage and Individual Retirement Account Fees*) and 13-45 (*FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers*).

Best Interest Contract Exemption

General

Intended to encourage access to advice for retail investors (e.g., small plan participants and IRA owners) who could benefit from such advice, but who may be particularly susceptible to the risk of receiving and acting on conflicted advice.

Subject to certain exclusions and conditions described below, the exemption would permit the following persons to receive compensation—including commissions, sales loads, 12b-1 fees, and revenue sharing payments—for services rendered in connection with any purchase, sale or holding of an asset[1] by a retirement investor[2] acting upon the recommendation of an investment advice fiduciary:

- the individual acting as the fiduciary with respect to the retirement investor (the Adviser);
- the RIA, bank, insurance company or BD that employs the Adviser or retains the Adviser as an independent contractor, agent or registered representative (the Financial Institution); and
- any affiliate of the Adviser or Financial Institution or other related party.

For purchases and sales of assets covered by the BIC exemption, Advisers, Financial Institutions, and their affiliates will be allowed to receive compensation that is ordinarily prohibited to fiduciaries (*e.g.*, commissions, sales charges, 12b-1 fees, revenue sharing and other payments from third parties), provided that they:

> contractually agree to adhere to Impartial Conduct Standards in rendering advice regarding [plan or IRA] Assets; warrant that they have adopted policies and procedures designed to mitigate the dangers posed by Material Conflicts of Interest; disclose important information relating to fees, compensation, and Material Conflicts of Interest; and retain documents and data relating to investment recommendations regarding Assets.

These conditions (further detailed below) in large measure require the Adviser, Financial Institution, and any affiliates to abide by the same standards as an ERISA fiduciary, whether or not he/she/it would otherwise have that status.

Excluded Transactions

The BIC exemption would not apply to any transaction involving a Plan for which the Adviser, Financial Institution or any affiliate is (i) an employer of employees covered under the Plan or (ii) a named fiduciary or plan administrator with respect to the Plan, unless the Adviser and Financial Institution were selected to provide investment advice by an independent Plan fiduciary. Nor would the exemption apply to any transaction where the Adviser exercises authority or control over the management or disposition of the Plan or IRA assets involved in the transaction.

The exemption also would not apply to the receipt of compensation in connection with a transaction in which the Adviser is acting for its own account or for the account of the Financial Institution or any affiliate, or any transaction that results from "robo advice" generated by an interactive website using computer software-based models or applications.

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[1] An "asset" is defined here to include **only** the following investment products: bank deposits and certificates of deposit; insurance contracts, annuity contracts and guaranteed investment contracts; interests in registered investment companies, bank collective funds, insurance company separate accounts, exchange-traded REITs and exchange-traded funds; corporate bonds offered pursuant to a registration statement under the Securities Act of 1933; U.S. treasury securities and U.S. agency debt securities; and exchange-traded equity securities (other than a security future or a put, call, straddle or other option to buy or sell an equity security).

[2] A "retirement investor" is defined for purposes of the exemption as (i) a participant or beneficiary of a Plan that provides for participant-directed investments; (ii) the beneficial owner of an IRA; and (iii) the sponsor (or any employee, officer or director thereof) of a non-participant-directed Plan with fewer than 100 participants, provided the sponsor has the authority to make investment decisions for the Plan.

Conditions

The BIC exemption would apply to the receipt of compensation by an Adviser, a Financial Institution or any affiliate or other related party in connection with a non-excluded transaction, provided the following conditions are satisfied:

- Financial Institution notifies EBSA of its intent to rely on exemption;
- Adviser & Financial Institution enter into a written contract with the retirement investor (before making any recommendations) that contains the provisions described below; and
- Adviser & Financial Institution comply with disclosure/recordkeeping requirements (see below).

Additional conditions apply if the Financial Institution makes only a limited range of assets available to an Adviser for purchase, sale or holding by the retirement investors.

Condition 1: Required Contract Provisions

Under the exemption, the contract among the Adviser, Financial Institution, and retirement investor must contain:

- a statement that the Adviser & Financial Institution are fiduciaries under ERISA or the Internal Revenue Code, or both, re any investment recommendation to the retirement investor;
- an agreement by Adviser & Financial Institution to comply with Impartial Conduct Standards (described below) when providing investment advice to the retirement investor;
- warranties by Adviser & Financial Institution re compliance with applicable federal & state laws and adoption of written policies/procedures designed to mitigate impact of conflicts of interest;
- disclosures identifying material conflicts of interest applicable to the Adviser & Financial Institution and any compensation to be received from third parties;
- a provision identifying the address of a webpage that discloses the compensation arrangements entered into by the Adviser & Financial Institution, as described below; and
- a notice informing the retirement investor of its right to obtain complete information about the fees currently associated with the assets in which it is invested.

In addition, the contract cannot include any exculpatory provisions that limit the liability of the Adviser or Financial Institution for a violation of the contracts terms, or any provisions waving or qualifying the retirement investor's (or related Plan or IRA's) right to bring or participate in a class action.

Condition 2: Impartial Conduct Standards

Under the exemption, the Adviser and Financial Institution must agree to comply with the following Impartial Conduct Standards when providing investment advice to a retirement investor:

- Adviser & Financial Institution will provide advice that is in best interest of retirement investor;
- the Adviser & Financial Institution will not recommend to a retirement investor that it purchase, sell or hold an asset if the total amount of compensation the Adviser, Financial Institution, their affiliates and related parties expect to receive as a result of the transaction would exceed reasonable comp; and
- the Adviser & Financial Institution will not make any misleading statements about assets, fees, material conflicts of interest or any other matters relevant to retirement investor's investment decisions.

Investment advice will be in the best interest of a retirement investor if the advice is furnished in a manner consistent with the duty of loyalty and duty of care imposed on fiduciaries under ERISA. Accordingly, the investment advice must be prudent and must be determined without regard to any financial or other interests the Adviser, the Financial Institution or any Related Parties may have in the transaction. The Impartial Conduct Standards would therefore extend to IRAs some of the fiduciary protections available to Plans under ERISA. Failing to comply with these Impartial Conduct Standards undoubtedly will result in different claims and remedies against Advisers, Financial Institutions, and affiliates depending upon whether the contract is with an ERISA plan or an IRA.

If the contract is with an ERISA plan, federal courts would have exclusive jurisdiction over any claim for violation of these standards and any resulting non-exempt prohibited transaction, and any state law breach of contract claims should be preempted by ERISA § 514(a). For an ERISA plan adviser that acknowledges fiduciary status, the effect of the Impartial Conduct Standards would be to shift the burden to the adviser to prove in any lawsuit brought under ERISA that it acted prudently and without regard to its own interests in providing the advice covered by the exemption. Although the DOL suggests in the preamble that ERISA plans and their participants could seek to enforce the Impartial Conduct Standards in "an action based on breach of the agreement," any such action would have to be brought under ERISA. In the event of a breach, the Secretary of Labor, a plan fiduciary or a participant would be allowed to seek only those remedies available under ERISA § 502(a), and there should be no right to a trial by jury.

If, however, the contract is with an IRA, the IRA holder would have a state law breach of contract claim against the Adviser, Financial Institution, and affiliates that could be brought in state court and tried by jury. Whether the contract is with an IRA or ERISA plan, the Adviser & Financial Institution would be exposed to excise tax under IRC § 4975 for prudence violations.

Condition 3: Disclosure and Recordkeeping Requirements

The exemption requires the Adviser and Financial Institution to make the following disclosures:

- prior to executing a purchase of assets on behalf of a retirement investor, the Adviser is required to furnish to the retirement investor a chart that provides, with respect to each asset recommended, the total cost to the retirement investor for one-, five- and 10-year investment periods, assuming an investment of the dollar amount recommended by the Adviser and an investment performance based on reasonable assumptions that are disclosed;

- within 45 days after the end of each year, the Adviser or Financial Institution is required to furnish to the retirement investor a disclosure identifying each asset purchased or sold during the preceding year, the sale or purchase price for each asset, the total amount of fees and expenses paid by the retirement investor with respect to each asset, and the total amount of compensation received by the Adviser and Financial Institution as a result of the retirement investor's purchase, holding or sale of each asset; and

- the Financial Institution is required to main a webpage that is freely accessible to the public which displays (i) the direct and indirect compensation payable to the Adviser, the Financial Institution and any affiliate for services provided in connection with each asset or class of assets currently available to purchase, hold or sell through the Adviser or Financial Institution (or that have been purchased, held or sold by retirement investors during the preceding year), (ii) the source of the compensation and (iii) how the compensation varies within and among classes.

The DOL has published a model transaction disclosure chart and a model website disclosure. A copy is attached.

In addition to the disclosure requirements, the BIC exemption requires a Financial Institution to maintain, for a period of six years, the records necessary for representatives of the DOL, the IRS, and any retirement investor (including any Plan sponsor, fiduciary, representative or beneficiary, and any IRA owner) to determine whether the conditions have been met. Subject to certain restrictions on access to privileged information, the Financial Institution is required to make the records unconditionally available at its customary location for examination by such representatives during normal business hours.

Comparison of Definitions of Investment Advice Fiduciary
Under DOL's Current Regulations and Proposed Regulations

Conditions for Adviser to Become a Fiduciary Under **Current Regulations**	Conditions for Adviser to Become a Fiduciary Under **Proposed Regulations**
A person without discretionary authority or control with respect to the purchase or sale of securities must:	**Provision of the following advice in exchange for a fee or other direct or indirect compensation:**
(i) Render advice as to the value of securities or make recommendations as to the advisability of investing in, purchasing or selling securities (ii) on a regular basis (iii) pursuant to a mutual agreement, arrangement or understanding with the plan or plan fiduciary (iv) that the advice will serve as a primary basis for investment decisions of the plan's assets and (v) the advice is individualized and particularized for the plan.	(i) A recommendation as to the advisability of acquiring, holding, disposing of or exchanging securities or other property, including to take a distribution of benefits, or as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA; (ii) A recommendation as to the management of securities or other property, including securities or other property to be rolled over or otherwise distributed from the plan or IRA; (iii) An appraisal, fairness opinion, or similar oral or written statement concerning the value of securities or other property provided in connection with a specific transaction(s) involving the acquisition, disposition, or exchange of such securities or other property by the plan or IRA; or (iv) A recommendation of a person who will receive a fee or other compensation for providing any of the types of advice described in (i) through (iii) above; **AND**
	Such person directly or indirectly (e.g., through or together with any affiliate) does either of the following:
	(i) Represents or acknowledges that such person is acting as a fiduciary with respect to the advice described above; **OR** (ii) Renders the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized or specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA.

Principal Transactions Exemption

General

Subject to certain exclusions and conditions described below, the Principal Transactions Exemption would permit an Adviser or related Financial Institution to enter into principal transactions[1] in debt securities[2] with retirement investors.[3] The exemption would also permit the Adviser or Financial Institution to receive a markup, markdown or other payment for themselves or any affiliate in connection with a principal transaction.

As proposed, the exemption would only apply to purchases and sales of debt securities as defined (*see* footnote 2). In the preamble to the Principal Transactions Exemption, the DOL explained its decision to limit relief to purchases and sales of certain debt securities, noting that principal transactions between a fiduciary and a Plan or IRA involve a potentially severe conflict of interest on the part of the fiduciary. However, because particular bond issues might be sold by a limited number of financial institutions, the DOL determined that Plans and IRAs may face reduced choices in the market for debt securities without an exemption. In contrast, the DOL noted that equity securities were widely available through agency transactions that did not present the same conflict-of-interest issues associated with principal transactions.

Excluded Transactions

The Principal Transactions Exemption would not apply to principal transactions involving a Plan for which the Adviser, the Financial Institution or any affiliate is (i) an employer of employees covered under the Plan or (ii) a named fiduciary or plan administrator with respect to the Plan, unless the Adviser and Financial Institution were selected to provide investment advice by an independent Plan fiduciary. Nor would the exemption apply to principal transactions where the Adviser has authority or control over the management or disposition of the Plan or IRA assets involved in the transaction.

Conditions

In order for the Principal Transactions Exemption to apply to a principal transaction, the following conditions would need to be satisfied:

Condition 1: Contractual Obligations

(i) Adviser and Financial Institution must enter into written contract with retirement investor before engaging in a principal transaction in debt securities;

(ii) The contract may be part of a master agreement and need not be executed prior to each principal transaction

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[1] A "principal transaction" is defined for purposes of the exemption as a purchase or sale of a debt security where an Adviser or Financial Institution is purchasing from or selling to the plan, participant or beneficiary account, or IRA on behalf of the account of the Financial Institution or the account of any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with the Financial Institution.

[2] A "debt security" is defined for purposes of the exemption by reference to Rule 10b-10(d)(4) under the Securities Exchange Act of 1934. The categories of covered debt securities include securities that are (i) U.S. dollar-denominated securities issued by a U.S. corporation and offered pursuant to a registration statement under the Securities Act, (ii) U.S. agency securities or (iii) U.S. Treasury securities. The definition excludes debt issued by the Financial Institution and underwritten by the Financial Institution (unless in the case of underwriting, the debt security is sold in a secondary offering). The debt security must not carry greater than moderate credit risk and be sufficiently liquid that it could be sold at or near its fair market value within a reasonably short period of time.

[3] A "retirement investor" is defined for purposes of the exemption as (i) a participant or beneficiary of a Plan that provides for participant-directed investments; (ii) the beneficial owner of an IRA; and (iii) the sponsor (or any employee, officer or director thereof) of a non-participant-directed Plan with fewer than 100 participants, provided the sponsor has the authority to make investment decisions for the Plan.

(iii) The contract must contain the following elements:

- Adviser and Financial Institution must affirmatively acknowledge fiduciary status
- Adviser and Financial Institution must affirmatively commit to Impartial Conduct Standards (i.e., prudence and loyalty), reasonable compensation and non-misleading statements
- Agreement that the Adviser and Financial Institution will not enter into a principal transaction if the purchase or sales price of the debt security (including the mark-up or mark-down) is unreasonable under the circumstances
- Agreement not to make misleading statements about the debt securities, fees, material conflicts of interest and other matters relevant to a retirement investor's investment decision
- Warranty of compliance with applicable federal and state laws regarding the rendering of investment advice and the purchase and sale of debt securities
- Warranty that Financial Institution has adopted written policies and procedures reasonably designed to mitigate impact of material conflicts of interest that exist re the provision of investment advice to retirement investors
    - Warranty that Financial Institution specifically identified material conflicts of interest and adopted measures to prevent them from causing violations of the Impartial Conduct Standards
    - Warranty that neither the Financial Institution nor its Affiliates will use quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differentiated compensation or other actions or incentives if they would encourage recommendations that are not in the best interest of retirement investors
- Contractual disclosures:
    - Circumstances under which the Adviser and Financial Institution may engage in principal transactions with the plan, participant or beneficiary account, or IRA
    - Material conflicts of interest associated with principal transactions
    - Document the retirement investor's affirmative written consent, on a prospective basis, to the principal transactions
    - Inform the retirement investor (i) that the consent to principal transactions is terminable at will by the retirement investor at any time, without penalty and (ii) of the right to obtain complete information about all fees and other payments currently associated with its investment transactions with the Adviser or Financial Institution

(iv) The contract must not contain any of the following elements:

- Exculpatory provisions disclaiming or limiting liability for Adviser or Financial Institution's violations of the contract terms
- Requirement that the retirement investor agree to waive its right to bring or participate in a class action or other representative action in court or a contract dispute with the Financial Institution or Adviser

Condition 2: General Conditions Applicable to Each Transaction

(i) The principal transaction may not be part of an agreement, arrangement, or understanding devised to evade compliance with ERISA or the Code or to otherwise impact the value of the debt security

(ii) The purchase or sale of the debt security must be for no consideration other than for cash (not available for transactions done on an "in-kind" basis)

(iii) The purchase or sale of the debt security must be executed at a price that the Adviser and Financial Institution reasonably believe is at least as favorable to the retirement investor as the price available to the retirement investor in a transaction that is not a principal transaction

(iv) The purchase or sale of the debt security must be at least as favorable to the plan, participant or beneficiary account, or IRA as the contemporaneous price for the debt security, or a similar security if a price is not available with respect to the same debt security, offered by two ready and willing counterparties that are not Affiliates in agency transactions

Condition 3: Disclosure Requirements

(i) Prior to engaging in a principal transaction, the Adviser or Financial Institution must provide a pre-transaction disclosure to the retirement investor, either orally or in writing:

- Notifying the retirement investor that the purchase or sale of the debt security will be executed as a principal transaction
- Providing the retirement investor with any available pricing information regarding the debt security, including two quotes obtained from unaffiliated parties, including mark-up or mark-down

(ii) Written confirmation of the principal transaction, including the mark-up or mark-down or other payment to the Adviser, Financial Institution or Affiliate

(iii) Annual Statement:

- Including a list of the principal transactions entered into during the year, including the prevailing market price at which the debt security was purchased or sold, and the mark-up or mark-down for each security
- Including a reminder that the retirement investor may withdraw its consent to principal transactions at any time, without penalty

(iv) Upon reasonable request, the Financial Institution or Adviser must provide the retirement investor with additional information regarding the debt security and the transaction for any principal transaction that has occurred within the 6 years preceding the date of the request

Condition 4: Recordkeeping Requirements

For 6 years following the date of each principal transaction, records must be kept that would allow the DOL or IRS, plan or IRA fiduciaries, employers of participants and beneficiaries and plan participants and beneficiaries to determine whether the conditions of the exemption have been satisfied. The documents must be generally available for examination during normal business hours.