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DOL Proposes Tougher Prohibited Transaction Exemption Procedures

By Wayne Miller, Stephen P. Wilkes, and Mark Greenstein[*]
Wagner Law Group
Boston, MA

LAW

The Employee Retirement Income Security Act of 1974, as amended (ERISA), was enacted in part to protect the retirement savings of participants in their employers' retirement plans and IRA owners and beneficiaries in their IRAs from losses due to transactions with persons with specified relationships to the plan. This includes broad prohibitions against self-dealing by fiduciaries and specified transactions with ''parties in interest'' defined in ERISA and ''disqualified persons'' under the Internal Revenue Code (the code). As a consequence, ERISA prohibits certain self-dealing and other potentially abusive transactions (prohibited transactions) by fiduciaries and parties in interest with respect to employee benefit plans and IRAs. Parallel provisions of the Code impose excise tax penalties for engaging in prohibited transactions.

However, because of the breadth of these rules, Congress provided for three kinds of possible exemptions from the prohibited transaction prohibitions: statutory exemptions, class exemptions and individual exemptions (granted to individual applicants). The Department of Labor (DOL) has long had regulations setting forth the procedures for applying for class and private exemptions and has granted many such exemptions over the last 48 years. Now, however, the DOL is proposing changes to its procedures that would significantly modify the process and create additional burdens on applicants and independent fiduciaries covered by the exemption.

BACKGROUND

On March 15, 2022, the DOL published proposed amendments to its regulations specifying the procedures for applying for class and individual exemptions and the processing of such applications.[1] If finalized as recently proposed, these changes would impose significant new requirements on applicants and other actors (such as appraisers and independent fiduciaries) who are involved in transactions that require an exemption.

Comments to the DOL were originally due by April 14, 2022, but the time was extended to May 29, 2022. If adopted, the amendments will apply prospectively (excluding exemption applications already submitted) 90 days following publication of the adoption of the amendments in the Federal Register.

Pursuant to §408 of ERISA, Code §4975(c)(2), and the DOL's existing regulations governing the granting

[*] Wayne Miller has been practicing employee benefits and executive compensation law since 1981, specializing in ERISA, tax and labor law. He advises clients on a wide variety of tax-qualified retirement plan issues, including plan design, drafting and implementation, required governmental reporting, and employee communications.

Stephen P. Wilkes, a partner in the firm, heads the firm's Investment Management Law practice. He also is a Practice Group leader for the firm's ERISA Fiduciary Compliance and Independent Fiduciary practices.

Mark Greenstein is a seasoned ERISA attorney who worked for nearly 25 years in the Office of Policy and Research at the Department of Labor's (DOL) Employee Benefits Security Administration (EBSA). During his tenure at the DOL, Mark analyzed complex legal issues arising under Title I of ERISA, including those arising under legislation, as well under Organization for Economic Co-operation and Development (OECD) and Government Accountability Office (GAO) reports.

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[1] Procedures Governing the Filing and Processing of Prohibited Transaction Exemption Applications, RIN 1210–ACO5, 87 Fed. Reg. 14,722 (Mar. 15, 2022).

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of exemptions, three conditions must be met: the DOL must determine that the exemption is (1) administratively feasible, (2) in the interests of participants and beneficiaries, and (3) protective of the rights of participants and beneficiaries. These regulations further require applicants to (1) submit detailed information to the DOL (and update it as required to keep it materially accurate) and (2) notify those who may be affected by the exemption so as to allow them to comment on a proposed exemption, and the regulations provide that documents submitted to the DOL in connection with an exemption request will be available to the public upon request.

Over the past two decades, the DOL has reduced its rate of granting exemptions from dozens per year to just three in 2021, and the exemption process has taken longer, become more complicated and become more costly. The number of applications for exemptions, however, is not known to have decreased proportionately. The proposed amendments do not appear likely to improve these trends, or ultimately to enable plans and participants to benefit from prudently issued exemptions. In fact, they may force applicants to choose less beneficial transactions or avoid the transactions altogether, a lost opportunity for the plan and its participants.

SUMMARY OF PROPOSED AMENDMENTS

The proposed amendments to the exemption application regulations include some of the DOL's existing policy positions that are already being applied to exemption requests and would also add a number of significant new requirements. These are summarized below.

Before Submission

Under the proposed amendments, all communications with the DOL regarding a requested exemption will become part of the administrative record that the public can obtain on request. They also would prohibit asking the DOL on an anonymous basis about specific factual patterns, even if the purpose of the discussion is not with respect to a potential exemption but to seek confirmation that an exemption is not needed.

These changes would preempt the common practice of seeking a meeting with the DOL's exemption staff to discuss what the staff's attitude would be toward a requested exemption before a would-be applicant incurs the time and expense of preparing a formal application. They may prevent plan sponsors and service providers from consulting the DOL to request informal views that they do not need to request an exemption because, for example, under their facts no prohibited transaction would occur or because another exemption is available.

Impartial Conduct Standards

The proposed amendments provide that the DOL will presume that the impartial conduct standards of the DOL's fiduciary advice class exemption (PTE 2020-02) will be applied to each new exemption. The impartial conduct standards are:

- The transaction is in the "best interest" of the plan and its participants and beneficiaries, meaning the fiduciary causing the plan to enter into the transaction determines, with the care, skill, prudence, and diligence under the circumstances then prevailing, that a prudent person acting in a like capacity and familiar with such matters would, in the conduct of an enterprise of a like character and with like aims, enter into the transaction based on the circumstances and needs of the plan, and that such fiduciary shall not place the financial or other interests of itself, a party to the transaction, or any affiliate ahead of the interests of the plan, or subordinate the plan's interests to any party or affiliate;
- All compensation received, directly or indirectly, by a party involved in the transaction does not exceed reasonable compensation; and
- All of the statements to the DOL, the plan, or, if applicable, the independent fiduciary or appraiser about the transaction and other relevant matters are not, at the time the statements are made, materially misleading.

Observation: An exemption applicant who could not (or did not wish to) meet these impartial conduct standards would bear the burden of establishing why the standards should not apply to its requested exemption. This would be a significant expansion of the DOL's policy regarding impartiality.

Since these rules also apply to exemptions for IRA transactions, it would create a fiduciary standard for exemptions covering IRAs that are otherwise not subject to ERISA's fiduciary standard of care. This could be argued to be inconsistent with the reasoning of the Fifth Circuit's decision to vacate the DOL fiduciary regulations.[2]

Independent Fiduciaries and Appraisers

Exemptions often impose requirements that an independent fiduciary with no conflict of interest in-

[2] *See Chamber of Commerce of U.S. v. U.S. Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018).

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volving the transaction be appointed to represent the interests of the plan and, if relevant, an independent appraiser to establish that the plan will pay no more for or receive no less than the fair market value of an asset in a transaction. The proposed amendments would impose new requirements for independent fiduciaries and appraisers, including:

- When a fiduciary or appraiser will be considered "independent:"
  - o The current regulations include a percentage of revenue test: a fiduciary or appraiser is:
    - deemed independent if less than 2% of its revenue is derived from parties involved in the transaction but;
    - based on the facts and circumstances, the fiduciary or appraiser may nonetheless be independent if the revenue is less than 5%.
  - o The amendments would:
    - Make the 2% of revenue limit the sole standard (subject to the DOL's sole discretion to determine otherwise), and
    - would require the calculation to incorporate both the fiduciary's or appraiser's total revenue from the prior tax year and a projection of total revenue in the current year.

Observation: The new 2% of revenue standard of independence will be harder for exemption applicants to meet and could reduce competition, by narrowing down the field of smaller firms. It could impact smaller entities by limiting the amount of work they do for any one client and allow a larger entity to negotiate a larger fee by virtue of its overall revenue characteristics. Will this affect what is considered reasonable compensation if fees increase due to reduced competition? Why reduce competition by providing for a different standard for exemption purposes than what the DOL has previously allowed as appropriate for determining when a party may be considered independent of another entity: if less than 5% of its revenue is derived from the other entity:[3]

- The proposed amendments impose a new requirement that an appraiser must also be independent of the independent fiduciary, not merely the applicant;
- The amendments also state that an entity may not be considered independent if it has an interest in the subject transaction **or future transactions of the same nature or type.**

Observation: In the preamble to the proposed amendments, the DOL stated that it is concerned that certain independent fiduciaries may have a "business interest" in facilitating an exemption transaction, such as to promote its independent fiduciary services to other clients, or to promote a relationship with a third party, such as an investment advisor or bank. The uncertainly inherent in this standard will likely reduce the number of entities willing to serve as independent fiduciaries, reduce competition and increase fees;

- The amendments would set certain standards for a plan's contract with an independent fiduciary or appraiser:
  - o The contract could not include indemnification for breach of contract or violations of applicable law, or a waiver of the plan's claims under applicable law, including ERISA.

Observation: This provision would formalize the DOL's current informal approach for prohibited transaction exemptions. Instead, the department should consider a more flexible approach such as requiring that the arrangement be commercially reasonable considering available alternatives:

- An independent fiduciary would be required to maintain fiduciary liability insurance in an amount that is sufficient to indemnify the plan for damages resulting from a breach by the independent fiduciary of either (a) ERISA, the Code, or any other federal or state law, or (b) its agreement with the plan. The insurance may not contain an exclusion for actions brought by the DOL or any other federal or state regulator, the plan, or plan participants or beneficiaries.

Observation: For very large transactions, this may make fiduciary insurance unavailable or at least prohibitively expensive. The cost of such insurance would presumably include a profit margin and a margin for asymmetric information which will be borne, at least in part, by plans by making the terms less favorable. The only positive could be a screening or oversight function that would make claims less likely. As the department notes, many and perhaps most independent fiduciaries have an interest in future business and can more accurately assess risk as they have more complete information. This interest appears to duplicate the only positive from insurance since any claim resulting in a payout would materially damage the ability to obtain future business. Therefore, the expense of insurance would represent a cost with no commensurate benefit in most cases:

- An independent appraiser would need to certify under penalty of perjury that, to the best of its knowledge, all of the representations made in its appraisal report are true and correct.
- Compared to the current exemption procedures regulations, the amendments would require the

[3] *See, e.g.,* DOL Adv. Op. 2001-09 (Dec. 14, 2001).

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provision of more information regarding independent fiduciaries and appraisers in the application, including:

- o A description of the diligence process leading to the selection of the independent fiduciary or appraiser, including the number of candidates reviewed and references contacted;
- o With respect to independent appraisers, a description of any past engagements the plan or any party involved with the exemption transaction has had with the appraiser; and
- o With respect to independent fiduciaries, (a) either (i) a statement that, within the last five years, the independent fiduciary has not been under any regulatory investigation, examination, or litigation, or (ii) a description of such regulatory investigation, examination, or litigation; and (b) either (i) a statement that, within the last 13 years, the independent fiduciary has not been either convicted or released from imprisonment for certain felonies, including under foreign law, or (ii) a description of such conviction and the circumstances that led to such conviction.

- Finally, the proposed amendments would also provide the DOL with the right to a conference with the independent fiduciary or appraiser without the participation of the exemption applicant.

Observation: This conference right of the DOL is only a formalization of the DOL's current practice.

Information to be Included in Applications

The proposed amendments would require even more information from the applicant than the voluminous amount already required, including:

- A description of material benefits non-plan parties would receive as a result of the transactions the exemption would permit;
- The costs and benefits (quantified if possible) of the transaction to plans, participants, and beneficiaries;
- A detailed description of potential alternatives to engaging in the prohibited transaction (if an exemption is granted), and why those alternatives were not pursued;
- A description of each conflict of interest or potential instance of self-dealing that would be permitted if the exemption is granted; and
- With respect to applications for individual exemptions, the applicant would need to report:
  - o foreign (in addition to domestic) criminal convictions and
  - o any prior transaction between (i) the plan or plan sponsor and (ii) a party involved in the transaction.

Observation: The cost of this requirement would eliminate transactions that would otherwise be commercially favorable for plans, and consequently reduce plan investment returns. Further, many applicants would not have the resources to perform or pay for a cost/benefit analysis that is similar to what would be required of a federal agency's regulatory impact analysis.

The DOL explained in the preamble to the proposed amendments that the requirement to report prior transactions is intended to allow the DOL to determine whether the proposed transaction fits into a larger pattern or practice.

Ongoing Reporting to DOL Until Grant of Exemption

In addition to the current requirement to update the DOL if any material fact or representation in the application changes or becomes inaccurate prior to final action of the DOL, the proposed amendments provide that if, at any time during the pendency of an exemption application, the applicant or any other party participating in the transaction becomes the subject of an investigation or enforcement action by the DOL, the IRS, the Justice Department, the Pension Benefit Guaranty Corporation, the Federal Retirement Thrift Investment Board, or any other federal or state governmental entity involving compliance with provisions of ERISA, provisions of the Code relating to employee benefit plans, or provisions of the Federal Employees' Retirement System Act of 1986 (FERSA) relating to the Federal Thrift Savings Fund, the applicant must promptly notify the DOL.

Other Changes

The proposed amendments would:

- Formalize the DOL's current position that an applicant is not entitled to an exemption solely because the DOL has granted the same or a substantially similar exemption in the past.
- Prohibit the costs of notifying interested persons of the exemption, as well as commissions, fees, or costs associated with the exemption transaction, from being charged to plan assets, unless there are compelling circumstances necessitating otherwise.
- Impose requirements with respect to a ''party involved in the exemption:''

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- o including that the independent fiduciary and appraiser must be independent from such parties; and
  - o that information regarding the relationship between such parties and the independent fiduciary and appraiser, the plan, and the applicant and its affiliates must be reported to DOL (Parties involved in the transaction include service providers and their affiliates).
- Enhance the DOL's right to deny an exemption application before providing the applicant with an opportunity for a conference with the DOL and respond to issues identified by the DOL.
- Require a statement that every proposed exemption either will be in the best interest of the plan and its participants and beneficiaries or a statement as to why this standard should not be applicable to the exemption transaction.
- Require a higher level of scrutiny for retroactive exemption applications.
- Make substantive revisions to several existing definitions and add new definitions, such as affiliate, control, independent fiduciary, and qualified independent appraiser, which now includes a review of the appraiser's and fiduciary's projected revenues relating to the proposed exemption.
- State that the DOL will generally not consider any applications if the transaction or a party in interest is being investigated under any federal or state laws.
- Warn that any information provided by the applicant cannot be deemed confidential and would be made available to the public.

ADDITIONAL CONSIDERATIONS

Although many of the terms of the proposed amendments to the exemption procedures only formalize current unwritten positions and requirements that the DOL now imposes on applications for exemptions, the proposed amendments would obviously make it more difficult and expensive to apply for a prohibited transaction exemption and put the success of an application in more doubt. As indicated by the diminishing number of exemptions granted in the past two decades, this tightening of the requirements reflects a continuation of the hardening in the DOL's position with respect to the benefits community that has been underway for at least that long. If finalized, the changes will restrict the ability of the benefits community to obtain exemptions for transactions that facilitate efficient plan administration, and provide for favorable investments, to the detriment of plans. Further, the proposed amendments effectively discourage the benefits community from proactive, informal communication with the DOL and reduce the department's understanding of current issues and transactions and reduce the public's understanding of the DOL's views.

The DOL could also move to apply the new substantive obligations and restrictions outside the context of prohibited transaction exemption applications. For example, the DOL might seek to impose similar requirements on an independent trustee and an independent appraiser involved in an employee stock ownership plan transaction in the context of investigations or enforcement actions regarding the transaction.

Concerned stakeholders were asked to submit comments to the DOL by May 29, 2022. We expect and hope the DOL to carefully consider the input from commenters and to use this input to formulate a procedure which benefits plans, participants and beneficiaries.

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