Proskauer

Private Investment Fund Managers and Other Investment Advisers May Be Affected by the U.S. Department of Labor's New Fiduciary Rules

July 20, 2016

On April 6, 2016, the U.S. Department of Labor (DOL) issued its highly anticipated final rule addressing when a person is considered to be a fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (Code) as a result of providing investment advice. As discussed below, the final rule's definition of fiduciary investment advice significantly expands the group of people who would be considered fiduciaries under ERISA and the Code, and might cover certain marketing and other related activities common to the investment management industry (including the private investment fund industry).[1]

The following is a high-level executive summary followed by a more detailed summary of certain material aspects of the final rule as it relates to private investment fund managers and other investment advisers. To review a more fulsome summary of the final rule, please see our client alert (available here).

Executive Summary

- Investment advisers providing discretionary or other advisory investment management services to ERISA plans, individual retirement accounts (IRAs), IRA owners and/or entities holding "plan assets" may already be considered "fiduciaries" under ERISA or the Code. Nonetheless, the final rule may still impact their marketing and other related activities involving ERISA plan and/or IRA investors, prospective investors, clients and/or prospective clients (Targeted ERISA/IRA Parties).

    - Certain common marketing or offering activities for private investment funds and separately managed accounts involving ERISA plans and/or IRAs may be considered "investment advice" under the final rule, potentially constituting "conflicted" advice offered in a fiduciary capacity that could result in a

violation of fiduciary duty and/or a prohibited transaction absent an exemption.

- Discussions with Targeted ERISA/IRA Parties may be considered "investment advice" and fiduciary in nature if they are considered tantamount to a "recommendation" to invest (or maintain an investment) in the fund or establish (or maintain) a separately managed account arrangement, even though, in the case of a prospective investor or client, a fee will not be charged until after the investor invests in the fund or the separately managed account is established.

- However, when dealing with most ERISA-covered pension plan investors and clients, fund managers and other investment advisers might be able to avail themselves of an "expert fiduciary exclusion."

- Further, a request to "hire me" to provide investment management services which is not combined with a "recommendation" on how to invest or manage ERISA plan or IRA assets might not constitute "investment advice." Unfortunately, it may not always (or ever) be clear whether an adviser's "hire me" request in connection with its solicitation of a Targeted ERISA/IRA Party's investment in the adviser's fund or establishment of a separately managed account with the adviser will constitute a "recommendation" on how to invest or manage ERISA plan or IRA assets, especially when the potential investment opportunity involves the purchase of a security in a particular product.

- A "recommendation" to invest in a fund may be considered "investment advice" even if the fund is not considered to be holding "plan assets" under ERISA or the Code.

- The new rule's constraints on marketing activities to IRAs and "small plans" might lead to a reduction in opportunities to invest in private investment funds and/or to establish separately managed account arrangements given that the "expert fiduciary exclusion" is not available for advice given to IRAs and small plans that are not separately managed by expert fiduciaries. Although the BICE (or another exemption) may be available in certain cases to exempt certain forms of advice provided to IRAs and small plans from constituting a "prohibited transaction", compliance with the BICE (or such other exemption) may prove too complicated

and burdensome for most fund managers, other investment advisers and brokers in this context. Compliance with the BICE (to the extent available) (i) with respect to ERISA-covered plans, does not exempt the adviser from "fiduciary" status under Title I of ERISA (it only exempts the conflicted investment advice and the receipt of the related compensation from constituting a "prohibited transaction") and (ii) with respect to IRAs, may require contractual adoption of a "best interests" standard that may expose the adviser to potential new liabilities that would not have otherwise existed.

- Currently, the only guidance available to analyze the issues covered by the new rule is the new rule itself. We expect that analysis and compliance strategies will continue to evolve over the coming months, and it is possible that the DOL may issue additional guidance prior to the effective date of the new rule.

- The final rule is not applicable until April 10, 2017.

Background

ERISA provides that "a person is a fiduciary with respect to a plan to the extent . . . he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so." ERISA § 3(21)(A)(ii). Pursuant to a 1975 regulation, in order for a person to be held to ERISA's fiduciary standards with respect to investment advice for a fee, such person must: (i) make recommendations as to investing in, purchasing or selling securities or other property, or give advice as to their value, (ii) on a regular basis, (iii) pursuant to a mutual understanding that the advice, (iv) will serve as a primary basis for investment decisions with respect to plan assets, and (v) will be individualized to the particular needs of the plan.

In October 2010, the DOL proposed changes to the 1975 regulation that it believed were necessary to adequately protect plans, participants, beneficiaries, and, in particular, IRA owners (to which ERISA's current fiduciary rules regarding prudence and loyalty do not apply) from conflicts of interest, imprudence and disloyalty.

Following significant public comment and debate, the DOL withdrew its 2010 proposal and published a new proposal in April 2015. After another round of comment and debate, the DOL published a final rule that significantly expands the scope of service providers that might be considered to be "fiduciaries" by way of providing "investment advice".

Although the final rule will not apply until April 10, 2017, private investment fund managers and other investment advisers should review their current marketing and other related activities relating to Targeted ERISA/IRA Parties prior to the applicability date to determine whether such activities will result in fiduciary status and to begin preparation of their plan for compliance or avoidance of such status (as applicable).

The Final Rule

The final rule details the types of "recommendations" provided to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner, which, when provided for a fee or other compensation, directly or indirectly, and given under certain circumstances (discussed below), would be considered "investment advice" and thus subject the advice provider to fiduciary standards and certain prohibited transaction rules intended to address conflicts of interest. The final rule also describes certain types of communications and situations that are specifically not intended to constitute "recommendations" or otherwise result in the provision of fiduciary "investment advice". Summaries of these concepts are provided below.

(a) *Investment Advice*

1. ***What* "*Recommendations*" *Are Covered For This Purpose***?
   Recommendations as to how ERISA plan or IRA assets should be invested or managed (as more specifically described below) generally will fall within the types of recommendations that the DOL was looking to capture:

   1. "*A recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property or a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA.*"

   2. "*A recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services; selection of investment account arrangements (e.g., brokerage versus advisory); or recommendations with respect to rollovers, transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer or distribution*

should be made."

The DOL stated in the preamble to the final rule that a person or firm can tout the quality of his, her or its advisory or investment management services and recommend that an ERISA plan or IRA investor enter into an advisory relationship with the adviser (i.e., asking a potential client to "hire me") ***without*** necessarily triggering fiduciary obligations. However, when a recommendation to "***hire me***" effectively includes a "recommendation" on how to invest or manage ERISA plan or IRA assets, that recommendation could trigger fiduciary obligations. For example, pitching a particular fund may be treated as a "recommendation" that triggers fiduciary status.

2. ***Fee Or Other Compensation.*** In order to be considered "investment advice" under the final rule, the covered "recommendations" must be provided for a "fee or other compensation, direct or indirect." The final rule defines this phrase to mean "*any explicit fee or compensation for the advice received by the person (or by an affiliate) from any source, and any other fee or compensation received from any source in connection with or as a result of the purchase or sale of a security or the provision of investment advice services, including though not limited to, commissions, loads, finder's fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, underwriting compensation, payments to brokerage firms in return for shelf space, recruitment compensation paid in connection with transfers of accounts to a registered representative's new broker-dealer firm, gifts and gratuities, and expense reimbursements. A fee or compensation is paid 'in connection with or as a result of' such transaction or service if the fee or compensation would not have been paid but for the transaction or service or if eligibility for or the amount of the fee or compensation is based in whole or in part on the transaction or service.*" Importantly, recommendations made before an adviser is even hired can count as "investment advice", even though the compensation is contingent on actually getting hired and will not be received until later. (As noted above, there is a "hire me" exception, but the exception does not cover specific recommendations.)

3. ***The Circumstances Under Which Advice Is Provided.*** In order for a "recommendation" to be covered under the final rule, the recommendation must be made either directly or indirectly (*e.g.*, through or together with any affiliate) by a person who:

    1. Represents or acknowledges that he or she is acting as a fiduciary within the meaning of ERISA or the Code with respect to the advice being

provided (*i.e.*, once you acknowledge that you are acting as a fiduciary, you cannot later argue that advice was not fiduciary in nature);

2. Renders the advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the advice recipient; or

3. Directs the advice to a specific advice recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the ERISA plan or IRA.

Significantly, the final rule does not require a meeting of the minds as to the extent to which the recipient will actually rely on the advice, but the parties must agree or understand that the advice is individualized or "specifically directed" to the particular advice recipient for consideration in making investment decisions. There is no requirement that the advice be specific to the needs of the ERISA plan, participant or beneficiary or IRA owner; rather, the advice need only be specifically directed to such recipient. There is no requirement that the advice be provided on a regular basis or that the advice be a significant factor in the recipient's final decision.

(b) *What Is A "Recommendation" For This Purpose?*

1. ***Communications and Activities That Constitute "Recommendations".*** A "recommendation" means "*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. The determination of whether a 'recommendation' has been made is an objective, rather than subjective inquiry. In addition, the more individually tailored the communication is to a specific advice recipient or recipients about, for example, a security, investment property, or investment strategy, the more likely the communication will be viewed as a recommendation. Providing a selective list of securities to a particular advice recipient as appropriate for that investor would be a recommendation as to the advisability of acquiring securities even if no recommendation is made with respect to any one security. Furthermore, a series of actions, directly or indirectly (e.g., through or together with any affiliate), that may not constitute a recommendation when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software*

program."

2. ***General Communications Do Not Constitute "Recommendations"***. A recommendation does not include the furnishing of "general communications" that a reasonable person would not view as an investment recommendation, including general circulation newsletters, television, radio, and public media talk show commentary, and remarks in widely attended speeches and conferences; research reports prepared for general distribution, general marketing materials, general market data, including data on market performance, market indices, or trading volumes, price quotes, performance reports, or prospectuses. But customizing communications for particular targets or adding commentary like this investment is good "for you" can trigger fiduciary responsibility.

3. ***Investment Education.*** Furnishing or making available educational information and materials to an ERISA plan, plan fiduciary, participant or beneficiary or IRA owner will not constitute a recommendation and therefore will not be considered the provision of investment advice, regardless of who provides the information (*e.g.*, plan sponsor, fiduciary or service provider), the frequency with which the information is shared, the form in which it is provided (*e.g.*, on an individual or group basis, in writing or orally, via a call center, or by way of video or computer software), and whether an identified category of information and materials is provided or made available alone or in combination with other categories identified, or the type of plan or IRA involved.

Investment-related educational information and materials include, but are not limited, to: (a) general financial, investment and retirement information (such as effects of inflation and historic differences in rates of return between different asset classes) that do not address specific investment products; (b) asset allocation models; and (c) interactive investment materials (that, for example, provide a means to estimate future retirement income). Models and interactive materials will generally cross the line from education to advice if they include investments that are available under the recipient's IRA. (But models and interactive materials for ERISA-covered plans that have investment fiduciaries are not subject to this restriction.)

(c) *Persons Not Deemed Investment Advice Fiduciaries*

The final rule provides that certain communications and activities shall not be deemed to result in the provision of fiduciary investment advice, including certain transactions with independent plan fiduciaries with financial expertise and the execution of securities transactions.

1. ***Transactions with Independent Plan Fiduciaries with Financial Expertise.*** Fiduciary status does not attach to advice and recommendations made to an expert plan fiduciary (including a manager of or adviser to an entity that holds plan assets) in an arm's-length sale, purchase, loan, exchange, or other transaction where there is no expectation of fiduciary investment advice, if, prior to entering the transaction the person providing the advice satisfies the following requirements:

    1. The person knows or reasonably believes that the independent fiduciary is: (A) a regulated and supervised bank; (B) an insurance carrier which is qualified under the laws of more than one state to perform the services of managing, acquiring or disposing of assets of a plan; (C) a registered investment adviser; (D) a registered broker-dealer; or (E) any other person acting as an independent fiduciary that holds, or has under management or control, total assets of at least $50 million. The person may rely on written representations from the plan or independent fiduciary to satisfy this condition;

    2. The person knows or reasonably believes that the independent fiduciary is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies. The person may rely on written representations from the plan or independent fiduciary to satisfy this condition;

    3. The person fairly informs the independent plan fiduciary that the person is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with the transaction and must fairly inform the independent plan fiduciary of the existence and nature of the person's financial interests in the transaction;

    4. The person knows or reasonably believes that the independent fiduciary is a fiduciary under ERISA or the Code, or both, with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction. The person may rely on written representations

from the plan or independent fiduciary to satisfy this requirement; and

5. The person does not receive a fee or other compensation directly from the plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner for the provision of the advice (as opposed to other services) in connection with the transaction.

This "expert fiduciary exclusion" is not available for recommendations to "retail investors", including IRA owners, small plan fiduciaries and plan participants and beneficiaries. The DOL noted that it believes that recommendations to retail investors generally are not "arm's-length" and are presented routinely as advice, consulting, or financial planning services.

2. ***Execution of Securities Transactions.*** Generally, a broker, dealer or bank will not be deemed to be a fiduciary with respect to an ERISA plan or IRA solely because such person executes transactions for the purchase or sale of securities on behalf of such plan or IRA in the ordinary course of its business as a broker, dealer, or bank, pursuant to instructions of a fiduciary with respect to such plan or IRA, and provided certain other conditions are met.

Practical Impacts

Discretionary Investment Managers of, and Other Investment Advisers to, ERISA Plans, IRAs or Entities Holding "Plan Assets" May Already Be "Fiduciaries"

- If you are already acting as a discretionary investment manager of "plan assets" of a pension plan subject to ERISA or an IRA subject to Section 4975 of the Code or considered to be providing "investment advice" for a fee with respect to such "plan assets" under the current regulatory scheme (i.e., the 1975 regulation), then you are already a "fiduciary" subject to the fiduciary duties and prohibited transaction restrictions of ERISA and/or Section 4975 of the Code.

- Nonetheless, as noted below, these new rules may still impact your activities.

Certain Ordinary Marketing Activities Involving ERISA Plans and/or IRAs May Be Considered "Investment Advice"

- It may not be entirely clear whether a particular fund manager's or other investment adviser's marketing materials (e.g., offering memorandum and/or pitch

book) together with its "pitch" practices effectively would be considered "recommendations" to invest in its funds or establish a separately managed account arrangement with it, or would simply be considered a "hire me" request to provide investment management services and not a "recommendation."

- If merely considered a request to "hire me", such request in and of itself should not result in fiduciary status under the final rule.

- Similarly, it may not be entirely clear whether a particular fund manager's or other investment adviser's periodic "newsletter" or other similar materials could be viewed as a "recommendation" to remain invested in a fund or continue a separately managed account arrangement.

- If such marketing materials, pitch practices and/or periodic distributions are considered a "recommendation", such as a recommendation to purchase or hold a security (e.g., an equity interest in a private investment fund) or continue a separately managed account arrangement, then the investment adviser would most likely be considered to be providing fiduciary "investment advice" to Targeted ERISA/IRA Parties to purchase or continue to hold an interest in the adviser's own funds and/or establish or continue a separately managed account arrangement with the adviser (and to pay any related management or other fees), as the case may be, potentially constituting "conflicted" investment advice that could result in a violation of fiduciary duty and/or a prohibited transaction absent an exemption.

- When dealing with most ERISA-covered plans, fund managers and other investment advisers might be able to avail themselves of the "expert fiduciary exclusion". However, such exclusion is likely not available for recommendations provided to an IRA owner that is not being separately advised by an independent expert fiduciary in connection with the fund investment or separately managed account arrangement. (The exclusion, however, may be available with respect to IRAs managed by "qualified professional asset managers" or "QPAMs" or other expert fiduciaries meeting the requirements of the exclusion.)

- If the fund manager or other investment adviser is considered to be providing fiduciary "investment advice" to Targeted ERISA/IRA Parties, a prohibited transaction exemption for the conflicted investment advice and the receipt of the related compensation (e.g., the BICE) may be available in certain cases, but compliance may be somewhat complicated and burdensome (particularly in regards to the BICE). Although the DOL expanded the coverage of the BICE to

include non-traded, illiquid investments, the DOL stated that "the fact that the exemption was broadened does not mean the [DOL] is no longer concerned about some of the attributes of the investments that were not initially included . . . such as unusual complexity, illiquidity, risk, lack of transparency, high fees or commissions or tax benefits that are generally unnecessary in these tax preferred accounts." The DOL noted that "Financial Institutions must ensure that Advisers are provided with information and training to fully understand all investment products being sold to ensure that customers are fully advised of the risks" and "[w]ithout an accompanying agreement to monitor certain recommended investments, at least a recommendation that the Retirement Investor arrange for ongoing monitoring, the Adviser may be unable to satisfy the exemption's Best Interest obligation with respect to such investments." In addition, the "sale" of an interest in a fund through interaction with the investment manager of the fund (or an affiliate) may be considered a "principal transaction" not covered by the BICE. Further, it is important to note that compliance with the BICE (to the extent available) (i) with respect to ERISA-covered plans, does not exempt the adviser from "fiduciary" status under Title I of ERISA (it only exempts the conflicted investment advice and the receipt of the related compensation from constituting a "prohibited transaction") and (ii) with respect to IRAs, may require contractual adoption of a "best interests" standard that may expose the adviser to potential new liabilities that would not have otherwise existed.

- Accordingly, fund managers and other investment advisers should consider revising their fund or account documents and marketing and offering materials before the new rule goes into effect (for new funds or existing funds that may accept new investments following the effective date of the new rule and separately managed accounts to be established on or after such date). For example, fund managers and other investment advisers may want to require each Targeted ERISA/IRA Party to provide representations consistent with the fund manager's or investment adviser's desire to avoid being treated as a fiduciary in connection with such Targeted ERISA/IRA Party's investment in the fund or separately managed account arrangement with the adviser to the extent such investment may be made or such separately managed account arrangement may be established on or after the effective date of the new rule.

IRAs and Small Plans May See a Reduction in Opportunities to Invest in Private Investment Funds or Establish Separately Managed Account Arrangements

- Private investment fund managers and other investment advisers may determine that their marketing activities would (or could) be treated as "investment advice" under the final rule and, given the lack of an "expert fiduciary exclusion" for advice

given to IRAs and small plans that are not separately managed by expert fiduciaries, determine simply not to pitch their products to IRAs or such plans.

- Although an existing or new exemption (e.g., the BICE or a streamlined version of the BICE) might be available in certain cases to permit the "conflicted advice" to invest in a fund manager's funds or establish a separately managed account with the adviser, compliance may prove too complicated or impractical.

- The complexity and additional burdens of complying with the BICE and/or the DOL's expression of concern over certain types of investments may dissuade brokers and other advisors from suggesting private fund investments or other investment management services to IRA and small plan clients.

The Final Rule is Not Applicable Until April 10, 2017

- Although these rules are not applicable until April 2017, you should consider reviewing your current marketing and other related activities (and corresponding compensation practices) relating to ERISA plans and IRAs to determine whether such activities will result in fiduciary status and begin preparing and implementing a plan for compliance or avoidance of such status (as applicable).

- Based on informal comments from DOL officials, it is expected that the DOL will issue additional guidance on the new rule prior to the effective date.

[1] Recognizing that the new rules would expand the definition of "fiduciaries" who would be subject to prohibited transaction restrictions under ERISA and/or the Code (and cause a number of common forms of compensation arrangements to violate such rules), the DOL also finalized a new Best Interest Contract Exemption (BICE), a new Principal Transactions Exemption and amended other prohibited transaction class exemptions that would allow certain broker-dealers, insurance agents and others who provide investment advice to continue to engage in certain transactions and to receive common forms of compensation that otherwise would be prohibited as conflicts of interest under the final rule. Our client alerts summarizing the BICE and the new Principal Transactions Exemption and other amended prohibited transaction class exemptions are forthcoming.

Related Professionals

- **Adam W. Scoll**
  Partner
- **Ira G. Bogner**
  Managing Partner
- **Seth J. Safra**
  Partner