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INVESTMENT FUNDS & ADVISERS REGULATORY ALERT

Department of Labor Fiduciary Rule to Take Effect June 9, 2017

The U.S. Department of Labor ("DOL") regulation that expands the definition of "investment advice fiduciary" (the "Fiduciary Rule") becomes applicable June 9, 2017, and will affect discretionary investment managers.

Immediate Consequences of the Fiduciary Rule

By June 9, 2017, SEC and state registered investment advisers with retirement plan and account investors must either: (1) comply with the Fiduciary Rule's Best Interest Contract Exemption ("BIC Exemption") or (2) not provide any investment advice to retirement plans and accounts, unless those plans and accounts meet the standards for the Seller's Exception, described below. For the transition period of June 9, 2017 through January 1, 2018, registered advisers may comply with the BIC Exemption simply by complying with the Impartial Conduct Standards, discussed below. SEC and state exempt reporting advisers are not eligible to comply with the BIC Exemption and should not provide investment advice to retirement plans and accounts that do not qualify for the Seller's Exception after June 9, 2017.

Additional changes to the Fiduciary Rule may occur later this year in conjunction with the DOL's reexamination of the Fiduciary Rule requested by President Trump; however, the DOL expects investment advisers to work diligently and in good faith on complying with the Fiduciary Rule in the meantime.

Overview of the Rule

As noted in our last post on the Fiduciary Rule, this rule expands the types of activities that will be considered "investment advice" of a nature that causes the adviser to be an "advice fiduciary" to retirement plans and accounts. The plans and accounts covered by the Fiduciary Rule are plan fiduciaries, IRA owners and beneficiaries, plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA") or to the prohibited transaction excise tax rules of section 4975 of the Internal Revenue Code (generally private sector plans) and participants in such plans (collectively, "Retirement Plan Investors").

Under the Fiduciary Rule, various marketing activities and investment "recommendations" that previously were not regarded as investment advice will now be treated as such. Advisers that engage in these activities will be considered advice fiduciaries of the Retirement Plan Investors to which they direct such communications. An investment "recommendation" is 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. These communications include not only specific recommendations regarding securities investments and the selection of other investment advisers, but also communications that suggest action but are not the primary basis for an investment decision, such as those about (1) investment policies, (2) portfolio composition, (3) different types of investment account arrangements (such as brokerage vs. separate account vs. private fund), and (4) transfers, distributions and rollovers to or from a plan or IRA.

For example, if an adviser in a “hire me” pitch offers multiple account types (including different types of ownership interests in one or more funds) with different categories of fees and recommends one particular kind to a Retirement Plan Investor, the adviser will have made an investment recommendation. Depending on content, some advisers’ periodic newsletters could also be viewed as "recommendations" to remain invested in a fund or continue a separately managed account arrangement. Several categories of communications will not be treated as recommendations, such as certain kinds of factual educational materials describing investment options, and communications with independent fiduciaries who meet the standards for the Seller’s Exception.

The Fiduciary Rule does not apply to transactions executed before June 9, 2017; however, if a Retirement Plan Investor makes another investment transaction, such as a supplemental subscription, after June 9, 2017, stemming from investment advice provided after or before June 9, 2017, the supplemental subscription would likely not be grandfathered under the Fiduciary Rule and the investment adviser would be an advice fiduciary with respect to that supplemental subscription. An investment adviser is not an advice fiduciary for investment advice provided without direct or indirect compensation.

Seller’s Exception

The Seller’s Exception allows an adviser to engage in communications that would otherwise fall within the scope of the Fiduciary Rule without being deemed an advice fiduciary, if certain conditions are met. The Seller’s Exception requires that the communications be with an independent fiduciary with financial expertise acting on behalf of a Retirement Plan Investor in an arms’ length transaction, and the independent fiduciary must be either a bank, insurance company, registered adviser, broker-dealer or independent plan fiduciary that manages total assets of at least $50 million. Self-directed IRA owners are not independent fiduciaries.

The Seller’s Exception also requires that, before entering into the transaction at issue, the adviser must: (1) know or reasonably believe that the independent fiduciary is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investments; (2) fairly inform the independent fiduciary that it is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with the transaction; (3) fairly inform the independent fiduciary of the existence and nature of any financial interests in the transaction; and (4) know or reasonably believe that the independent fiduciary is a fiduciary under ERISA or the Internal Revenue Code with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction. The adviser may not receive a fee or other compensation directly from the Retirement Plan Investor for the provision of investment advice (as opposed to receiving an indirect fee for other services, such as acting as managing a private fund in which the Retirement Plan Investor invests).

The BIC Exemption

A registered adviser that cannot rely on the Seller's Exception and that makes recommendations to Retirement Plan Investors that cause it to be an "advice fiduciary" may avail itself of the BIC Exemption to avoid being subject to certain prohibited transaction restrictions on compensation that otherwise apply to advice fiduciaries. There are two forms of the BIC Exemption: the streamlined (or "level fee") BIC Exemption, where compensation is based solely on a flat fee or a fixed percentage of the value of the assets (such as a management fee), and the full BIC Exemption, where compensation is non-level (such as a commission or transaction-based fee). "Level fee" compensation structures likely include those with performance allocations; although, there is still some uncertainty based on the DOL guidance provided to date as to whether certain compensation structures will qualify as "level fee." An exempt reporting adviser is not eligible to rely on either form of the BIC Exemption.

Each form of the BIC Exemption requires that the advice fiduciary comply with the "Impartial Conduct Standards" (described below) and, depending on which BIC Exemption form applies, make certain written disclosures and representations in investor contracts and communications. This Regulatory Alert does not address the required content of the written disclosures, which is complex and may change later this year. There are significantly fewer requirements for advice fiduciaries relying on the "level fee" BIC Exemption than for advice fiduciaries relying on the full BIC Exemption. The DOL has delayed the applicability date of these written disclosure and contract requirements until January 1, 2018. Until then, advice fiduciaries relying on either form of the BIC Exemption only need to comply with the Impartial Conduct Standards, beginning June 9, 2017.

The Impartial Conduct Standards require fiduciaries to: (1) provide advice that is in the Retirement Plan Investor's best interest (recommendations that are prudent and without regard to the adviser's financial interests), (2) not make materially misleading statements, and (3) charge no more than reasonable compensation for services. We recommend that registered advisers that solicit or have Retirement Plan Investors as clients or investors contact us to discuss updating their compliance policies and procedures to incorporate the Impartial Conduct Standards.

Consequences of Non-Compliance

An advice fiduciary that fails to comply with the Fiduciary Rule and engages in a prohibited transaction may be required to refund all fees earned from the transaction and pay an annual Internal Revenue Code excise tax of 15% on such fees until all fees have been repaid. Additionally, for a prohibited transaction involving a Retirement Plan Investor subject to ERISA, the adviser may be required to pay civil penalties and be liable for losses or improper profits.

On May 22, 2017, the DOL released a Field Assistance Bulletin and additional Fiduciary Rule FAQs, which state the DOL and the Internal Revenue Service would temporarily not pursue claims of prohibited transactions as a result of the Fiduciary Rule against advisers who are working diligently and in good faith to comply with the Fiduciary Rule. This temporary non-enforcement policy ends on January 1, 2018, when the additional written requirements for compliance with the BIC Exemption become effective.

Compliance Considerations

SEC and state exempt reporting advisers and registered investment advisers that do not want to comply with either form of the BIC Exemption may either (1) not provide Retirement Plan Investors with investment advice, or (2) limit their dealings with Retirement Plan Investors to those that qualify for the Seller's Exception. In practice, effecting these changes for some investment advisers may mean that the adviser does not engage in any future transactions with current Retirement Plan Investors and no longer accepts funds from new Retirement Plan Investors, while others may prefer to revise subscription documents and policies and procedures to require Retirement Plan Investors to qualify for the Seller's Exception.

SEC or state registered advisers that will rely on either form of the BIC Exemption (including most discretionary separate account managers) should (1) update their policies and procedures to require adherence to the Impartial Conduct Standards when advising Retirement Plan Investors and (2) monitor developments concerning the Fiduciary Rule and the BIC Exemption in advance of January 1, 2018, when the additional BIC Exemption requirements are scheduled to become applicable. Advisers who will become advice fiduciaries due to the Fiduciary Rule may also want to review their errors and omissions insurance policy regarding coverage of fiduciary breaches with respect to Retirement Plan Investors.

Paid solicitors that solicit Retirement Plan Investors can become fiduciaries under the Fiduciary Rule. If a solicitor makes an investment recommendation to a Retirement Plan Investor subject to ERISA but does not comply with the conditions of the BIC Exemption, the adviser may be liable for that solicitor's non-compliance. Thus, an adviser with relationships with solicitors that solicit Retirement Plan Investors should revise its solicitation agreements to require solicitors to comply, if needed, with the BIC Exemption and to indemnify the adviser for the solicitor's failure to do so.

Because of the complex nature of the Fiduciary Rule and the fact that DOL guidance on the Fiduciary Rule addresses a limited number of scenarios, there are a few compliance questions that have not yet been resolved. Advisers should reach out to legal counsel to discuss appropriate compliance measures and should understand that additional changes in their compliance measures may be required once the DOL provides further clarity on these issues later this year.

If you have any questions, please contact one of the attorneys in the Investment Funds & Advisers Group at Shartsis Friese LLP: John Broadhurst, Geoffrey Haynes, Carolyn Reiser, Neil Koren, Jim Frolik, Christina Hamilton, Joan Grant, Lyn Roberts, Anthony Caldwell, David Suozzi or Kathryn Miller.

Previous letters to our investment advisory clients and friends and discussions of other topics relevant to private fund managers, investment advisers and private investment funds can be found at our insights page: www.sflaw.com/blog/investment-funds-advisers-insights.