SHARTSIS FRIESE LLP
INVESTMENT FUNDS & ADVISERS REGULATORY ALERT

The Department of Labor Fiduciary Rule's Effect on Investment Adviser Marketing Practices and Rollover Recommendations

On April 10, 2017, the U.S. Department of Labor ("DOL") final regulation (the "Final Regulation") that redefines what constitutes "investment advice" that makes the advice provider (including an investment advisory firm) a "fiduciary" to plans, plan participants and IRA owners ("Retirement Plan Investors") under the Employee Retirement Income Security Act of 1974 ("ERISA") and the prohibited transaction excise tax rules of Internal Revenue Code section 4975, is scheduled to become applicable. Although the Final Regulation was designed to limit conflicts of interest at retail-level investment advisers and broker-dealers, unless an exception applies, the Final Regulation will confer fiduciary status on advisers, such as separate account managers, who (1) solicit Retirement Plan Investors with a pitch that is coupled with an investment recommendation or (2) make a recommendation to roll over plan holdings to an individual retirement account ("IRA").

There is some uncertainty regarding the application of the Final Regulation to advisers to private funds, but as noted our previous post on the Final Regulation, we believe that the new rule generally should not apply to investment advisers to a private investment fund, even if the fund is a "plan assets" fund, if the investment adviser only manages the fund's portfolio on a discretionary basis and does not provide any advice to the investors in the fund. In addition, an adviser will not be a fiduciary if it limits its interactions with Retirement Plan Investors to only clients who either are independent fiduciaries with financial expertise that control at least $50 million in assets or otherwise qualify under the ERISA "seller's exception."

However, if an adviser becomes a fiduciary under the Final Regulation, it may still receive compensation from clients and avoid prohibited transactions if it either satisfies the "Best Interest Contract" exemption (the "BIC exemption"), which sets certain criteria aimed at ensuring the advice is in the client's best interest, or if it satisfies the more streamlined "level fee" BIC exemption, which is only available to advisers who receive compensation based on a set fee or fixed percentage of the value of managed assets.

DOL Final Regulation FAQs

The DOL recently issued its first set of FAQs on the Final Regulation and the related prohibited transaction exemptions. Among the points made in the FAQs were the following regarding how such solicitations or recommendations can comply with the new rules:

- A "hire me" pitch to a Retirement Plan Investor will be investment advice that confers fiduciary status on the adviser if it is coupled with an investment recommendation, such as recommending (1) a specific investment, product or program, (2) whether or not to roll over assets from a plan to an IRA or (3) whether to switch to or from a commission-based account. In that event, the "hire me" bid will need to comply with an exemption, in order for the resulting receipt of compensation to be permissible.

- A person who makes an investment recommendation in connection with a "hire me" pitch, but who does not receive any resulting compensation, will not become a fiduciary by virtue of making the recommendation.

- Because a rollover recommendation is "investment advice" under the Final Regulation, the receipt of compensation related to that recommendation must comply with the conditions of either the full BIC exemption (for advisers who receive transaction-based compensation) or the BIC "level fee" exemption. Exemptive relief is available even if the adviser will manage the rolled-over funds on a discretionary basis. In addition to satisfying the general exemption conditions, the adviser must document the specific reasons why the recommendation was considered to be in the Retirement Plan Investor's best interest:

    1. For a recommended rollover from a plan to an IRA, the documentation must include consideration of the alternatives to a rollover, the comparative fees and expenses associated with the plan and IRA, whether the employer pays for some or all of the plan's expenses and the different levels of services available under each option. The FAQS explain that, to satisfy this requirement, the adviser (or other financial institution) must make diligent and prudent efforts to obtain information on the existing plan (which should be should be readily available as a result of other DOL regulations that mandate disclosure of salient information to plan participants). If, despite prudent efforts, the adviser is unable to obtain the necessary information or if the Retirement Plan Investor is unwilling to provide the information, even after fair disclosure of its significance, the adviser could rely on alternative data sources, such as the most recent Form 5500 or reliable benchmarks on typical fees and expenses for the type and size of plan at issue. If the adviser relies on such alternative data, it should explain the data's limitations and the written documentation should also include an explanation of how the adviser determined that the benchmark or other data were reasonable.

    2. For a recommendation to roll over from one IRA to another, or to switch from a commission-based account to a level fee account, the documentation must include the reasons that the arrangement is considered to be in the best interest of the investor, including specification of the services that will be provided.

<u>Compliance Considerations</u>

To guard against a 'hire me" pitch to a Retirement Plan Investor triggering fiduciary status, an adviser may decide to adopt policies and procedures that would prevent the adviser from providing specific advice about or identifying what investments or programs the adviser may recommend with respect to any retirement assets that the potential client may hold. Instead, the adviser may wish to limit that part of its potential client proposal to subjects such as the adviser's credentials and experience. If the proposal identifies what the recommended or discretionary investments or programs for those retirement assets will be if hired, the policies should set out the steps to achieving compliance with an applicable exemption mentioned above. For rollover recommendations, adherence to the documentation process set out in the FAQ is paramount.

In the alternative, an adviser may desire to revise its policies and procedures, subscription documents and/or investment management agreements to include language that would limit the adviser's dealings to Retirement Plan Investors who either are independent fiduciaries with financial expertise that control at least $50 million in assets or otherwise qualify under the ERISA "seller's exception."

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

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