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INVESTMENT MANAGEMENT AND
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DEPARTMENT OF LABOR ISSUES FINAL RULES EXPANDING THE SCOPE OF ADVISORS WHO ARE CONSIDERED ERISA FIDUCIARIES

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On April 6, 2016, the U.S. Department of Labor ("DOL") issued new regulations that significantly expand the definition of a fiduciary for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA"). While tempered down from rules first proposed in 2010 and then reissued in April 2015, the final rules — which generally become effective April 10, 2017 — will turn many advisors into ERISA-covered fiduciaries. The following discussion summarizes the new rules (collectively, the "Fiduciary Rule"), as well as two important exemptions to the Fiduciary Rule known as the Best Interest Contract exemption and the Principal Transactions exemption.

The Fiduciary Rule

Prior to the Fiduciary Rule, the DOL applied a long-standing five-part test to determine if an advisor is a fiduciary under ERISA. Under that test, an advisor is considered a fiduciary if the advisor makes investment recommendations on a regular basis pursuant to a mutual understanding that the advice will serve as a primary basis for investment decisions and be individualized to the particular needs of the plan.

Under the new Fiduciary Rule, a person will be treated as an ERISA fiduciary if the person recommends investments or provides certain other investment advice for a fee (direct or indirect) to a plan, plan fiduciary, participant, or beneficiary, or to an individual retirement account ("IRA") or IRA owner.

A "recommendation," for purposes of the Fiduciary Rule, is defined as "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 objective rather than subjective. 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.

The following are types of recommendations that will or will not constitute fiduciary advice under the Fiduciary Rule:

Recommendations that Constitute Fiduciary Advice	Recommendations that Do Not Constitute Fiduciary Advice
Making a recommendation as to the advisability of acquiring, holding, disposing of, or exchanging securities or other investment property.	Providing a platform or similar mechanism to a plan fiduciary for making and monitoring plan investments, provided there is disclosure that the service provider is not acting in a fiduciary capacity.
Making a recommendation as to how securities should be invested after the securities are rolled over, transferred, or distributed from a plan or IRA.	Providing certain fund investment selection and monitoring assistance to a plan fiduciary by providing objective financial data and benchmark comparisons.
Making a recommendation on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, and/or selection of investment account arrangements (e.g., brokerage versus advisory).	Providing certain general communications (such as newsletters, television commentary speeches, research and reports for general distribution, general marketing materials, and general market data, including performance numbers, trading volumes, price quotes, and prospectuses) under circumstances such that a reasonable person would not view it as an investment recommendation.
Making a recommendation with respect to rollovers, distributions, or transfers 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.	Providing certain "investment education" information within certain specified limits, including plan information, general financial investment and retirement information, asset allocation models, and interactive investment materials such as questionnaires, worksheets, software, or other similar materials.

The following types of communications are exempt from being considered investment advice subject to the Fiduciary Rule, so long as the provider does not otherwise acknowledge fiduciary status:

- Advice provided in an arm's-length transaction with certain plan fiduciaries who are licensed financial professionals (broker-dealers, registered investment advisors, banks, insurance companies, etc.) or with plan fiduciaries who have at least $50 million under management;
- Advice provided in connection with certain swap and securities-based transactions; and
- Advice provided by employees or independent contractors of plan sponsors, employee benefit plans, or plan fiduciaries, so long as they don't receive special compensation in connection with such advice.

The fiduciary status of an advisor is generally limited to the scope of the services provided and does not cover assets or aspects of a plan or IRA with respect to which the advisor does not have discretionary authority or otherwise exercise authority or control, or does not render advice for a fee and does not have the authority or responsibility to render such advice.

Best Interest Contract Exemption

Those treated as fiduciaries under the Fiduciary Rule are subject to the prohibited transaction restrictions of ERISA and the Internal Revenue Code, which generally prohibit fiduciaries from receiving compensation that varies based on their investment advice. Similarly, fiduciaries may not receive compensation from third parties in connection with their investment advice where such compensation could present a conflict of interest. Investment professionals often receive compensation for services to retirement investors in the retail market through a variety of arrangements which might violate the prohibited transaction rules applicable to plan fiduciaries. These include commissions paid by the plan, participant, beneficiary, IRA, commissions, sales loads, 12b-1 fees, revenue sharing, and other payments from third parties that provide investment products. A fiduciary's receipt of such payments would generally violate the prohibited transaction provisions, unless such payments meet the requirements of an exemption.

The DOL has previously granted several exemptions that generally focus on specific advice arrangements and provide relief for narrow categories of fiduciary and advisory compensation. In contrast to these earlier exemptions, the new Best Interest Contract ("BIC") exemption, which was issued in association with the Fiduciary Rule, allows advisors to receive compensation with respect to retail retirement investors under circumstances where the advice rendered may impact their fees, provided they give advice that is in their customers' best interest and certain basic protections are implemented regarding conflicts of interest. A retail retirement investor for purposes of the BIC exemption includes participants and IRA owners that can self-direct the investment of their accounts, as well as plans and IRAs managed by fiduciaries that are not banks, insurance companies, registered investment advisors or broker-dealers or that have less than $50 million in assets under management. In particular, to rely on the BIC exemption, advisors (or their employees, contractors, agents, representatives, affiliated entities, etc.) generally must:

- Acknowledge fiduciary status with respect to investment advice to certain retirement investors;
- Adhere to "Impartial Conduct Standards" requiring them to:
  - Provide advice that is in the retirement investor's best interest (i.e., prudent advice based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor, without regard to financial or other interests of the advisor, financial institution, or their affiliates, related entities, or other parties);
  - Charge no more than reasonable compensation; and
  - Make no misleading statements about investment transactions, compensation, and conflicts of interest;
- Implement policies and procedures reasonably and prudently designed to prevent violations of the Impartial Conduct Standards;
- Notify the DOL of reliance on the BIC exemption;
- Refrain from giving or using incentives for advisors to act contrary to the customer's best interest; and
- Fairly disclose the fees, compensation, and material conflicts of interest associated with their recommendations.

With respect to IRAs and other plans not covered by ERISA (but which are subject to similar rules under the Internal Revenue Code), financial institutions must execute a written contract agreeing to comply with the BIC exemption provisions that is enforceable by the retirement investor. A BIC exemption contract is not required at a first meeting with a retirement investor, but may be signed (with a retroactive effect) after a decision has been made to open an account along with other account-opening documents. With respect to existing clients, the written contract can be agreed to via "negative consent."

Class Exemption for Principal Transactions

In connection with the Fiduciary Rule, the DOL also issued a class exemption that permits a fiduciary to engage in certain transactions with a retirement investor from its own account (principal transactions) subject to certain basic protections. To rely on the exemption, financial institutions must:

- Acknowledge fiduciary status with respect to any investment advice regarding principal transactions or riskless principal transactions;
- Adhere to Impartial Conduct Standards, as discussed above with respect to the BIC exemption;
- Seek to obtain the best execution reasonably available under the circumstances with respect to the transaction;
- Make no misleading statements about investment transactions, compensation, and conflicts of interest;
- Implement policies and procedures reasonably and prudently designed to prevent violations of the Impartial Conduct Standards;
- Refrain from giving or using incentives for advisors to act contrary to the retirement investor's best interest; and
- Make certain additional disclosures.

Advisors relying on the exemption must comply with the Impartial Conduct Standards when making investment recommendations regarding principal transactions and riskless principal transactions.

Impact of the Fiduciary Rule and BIC Exemption On:

Investment Advisors. While investment advisors to ERISA plans were already considered fiduciaries to their client plans, they will need to consider the impact of the Fiduciary Rule to individual plan participants and beneficiaries, as well as to IRA owners, and adjust their contracts and procedures accordingly. They may also need to adjust the manner in which their fees are determined.

Brokers. Many brokers will now find themselves subject to a fiduciary standard, rather than a suitability standard, in their dealings with retirement investors. In such cases, commissions, 12b-1 payments, and other variable compensation must comply with the fiduciary standard and will generally need to rely upon an exemption such as the BIC exemption. The requirements for the BIC exemption should be examined carefully and procedures and contracts reviewed and revised to meet its requirements.

Private Equity and Hedge Funds. A typical investor solicitation by a private equity or hedge fund would not appear to cause the fund or its principals to be fiduciaries under the Fiduciary Rule to investing plans or IRAs because the mere solicitation should not be a recommendation. Indeed, subscription agreements and private placement memoranda used by private equity and hedge funds typically disclaim that the fund managers are making any recommendation regarding investments in the fund. However, private equity and hedge funds that hold "plan assets" under ERISA and accept retail retirement investors should review their compensation practices and fund documents in light of the Fiduciary Rule and the BIC exemption to determine whether and to what extent changes in documentation and procedures should be made. Generally speaking, a fund does not hold "plan assets" for ERISA purposes if (i) benefit plan investors (e.g., nongovernmental U.S. pension plans, IRAs, and certain pooled investment vehicles that are considered to have plan assets) own less than 25% of the value of any class of equity interests in the fund, or (ii) the fund qualifies as a venture capital operating company (VCOC). That is, if a fund qualifies as a VCOC or if benefit plan investors stay below the aforementioned 25% ERISA threshold, the fund's managers will not be treated as ERISA fiduciaries with respect to benefit plan investors who invest in the fund.

Effective Date

The Fiduciary Rule generally becomes effective April 10, 2017. The BIC and Principal Transactions exemptions also become effective April 10, 2017, but with a transition period that will delay full implementation of all requirements of the exemptions until January 1, 2018.

A Final Word

The Fiduciary Rule represents a welcome easing of the scope of earlier versions of the rule proposed by the DOL. However, the Fiduciary Rule will cause many advisors to be tagged with ERISA fiduciary status. Advisors will need to understand what that means for them and navigate their new status cautiously. Advisors will undoubtedly need to review their advisory agreements, including their revenue streams as well as their disclosures to and representations received from clients/investors, compliance programs, and onboarding procedures.

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