



K&L GATES

2016 INVESTMENT MANAGEMENT CONFERENCE

## ERISA Developments: DOL Conflict of Interest Regulation

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## TOPICS

- Common Misconceptions
- Background
- Selling/Promotional Activities



The image features a blue bokeh background with a central orange banner. The bokeh consists of numerous out-of-focus light spots in various shades of blue and white, creating a shimmering effect. The orange banner is a solid, horizontal band that spans the width of the image, positioned in the middle. The text "Common Misconceptions" is centered within this banner in a white, sans-serif font.

# Common Misconceptions

## COMMON MISCONCEPTIONS

- I'm already an ERISA fiduciary so the new regulation does not impact me
- I do not have to deal with ERISA because none of my funds are ERISA plan asset funds (e.g., ERISA investors are below 25%; mutual funds)
- My sales people do not provide investment advice



The image features a blue bokeh background with a central orange band. The word "Background" is written in white text on the orange band.

Background

## ERISA FIDUCIARIES

- Must navigate many complexities
- Are subject to strict:
  - Duties of prudence and loyalty
  - Prohibited transaction restrictions
- Cannot avoid conflicts of interest through disclosure

## HOW DOES ONE BECOME AN ERISA FIDUCIARY?

- ***Discretionary Fiduciaries:*** By exercising discretionary authority or discretionary control with respect to the management of an employee benefit plan covered by ERISA (e.g., 401(k) plans) or an IRA
- ***Investment Advice Fiduciaries:*** By rendering investment advice to such a plan for a fee or other compensation or having any responsibility to do so; regulations define the scope

## NEW REGULATION

- In April 2016, the Department of Labor issued a new regulation that re-defines “investment advice fiduciary” and brings radical change to many aspects of the U.S. retirement industry
- The regulation greatly expands the group of market participants to be deemed ERISA fiduciaries and alters key “prohibited transaction” exemptions





## UNDER THE NEW REGULATION

- Investment advice includes certain “recommendations”
- “Recommendations” broadly include statements that would reasonably be viewed as **suggestions** to take or refrain from taking a particular course of action (no mutuality requirement); for example, “you should invest in my fund” is a recommendation
- Content, context and presentation inform the determination
- The more individually tailored the communication, the more likely it is a recommendation
- Investment advice could include selling/promotional activity



# Selling/Promotional Activities

## TWO PHASES TO CONSIDER

Phase 1

Selling/Promotional

Hired

Phase 2

Providing Advice/  
Exercising  
Discretion



## WHEN DOES FIDUCIARY STATUS ATTACH?

- Historically managers avoided ERISA fiduciary status when selling products and services (phase 1) by making sure there is no “mutual understanding” that the manager is providing investment advice
  - Disclaimers on marketing materials
  - Representations in subscription agreements and IMAs
- The new regulation may cause a manager to become an ERISA fiduciary during phase 1, even if the manager is selling a non-plan asset fund



## CONSEQUENCES

- If the manager becomes an ERISA fiduciary during the selling/promotional phase, getting hired (and paid) is a “prohibited transaction”
  - Substantial excise tax penalty
  - Restore losses
  - Disgorge profits



## POSSIBLE APPROACHES

- Avoid providing a recommendation:
  - “Hire me” concept
  - Investment education
  - General communications
- Exclusions & Exemptions
  - Sophisticated fiduciary
  - Best interest contract exemption



## RECOMMENDATION? “HIRE ME” CONCEPT

- **Rule:** Can have a “hire me” discussion with a prospective client touting the quality of the firm without becoming a fiduciary
- **Limitation:** Combining a “hire me” discussion with a recommendation of a particular product or investment program is fiduciary investment advice

## RECOMMENDATION? INVESTMENT EDUCATION

- **Rule:** It is not fiduciary investment advice to furnish certain types of investment-related information and materials to a plan, plan fiduciary, plan participant or IRA
- **Limitation:** With limited exceptions, the information and materials cannot include recommendations with respect to
  - Specific investment products
  - Specific plan or IRA alternatives
  - Investment or management of particular securities or other investment property



## RECOMMENDATION? GENERAL COMMUNICATIONS

- **Rule:** It is not fiduciary investment advice to furnish or make available general communications that a reasonable person would not view as an investment recommendation
- **Examples:**

- General circulation newsletters
- Commentary in publicly broadcast talk shows
- Remarks and presentations in widely attended speeches and conferences
- Research or news 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
- Prospectuses

## EXCLUSION: SOPHISTICATED FIDUCIARY

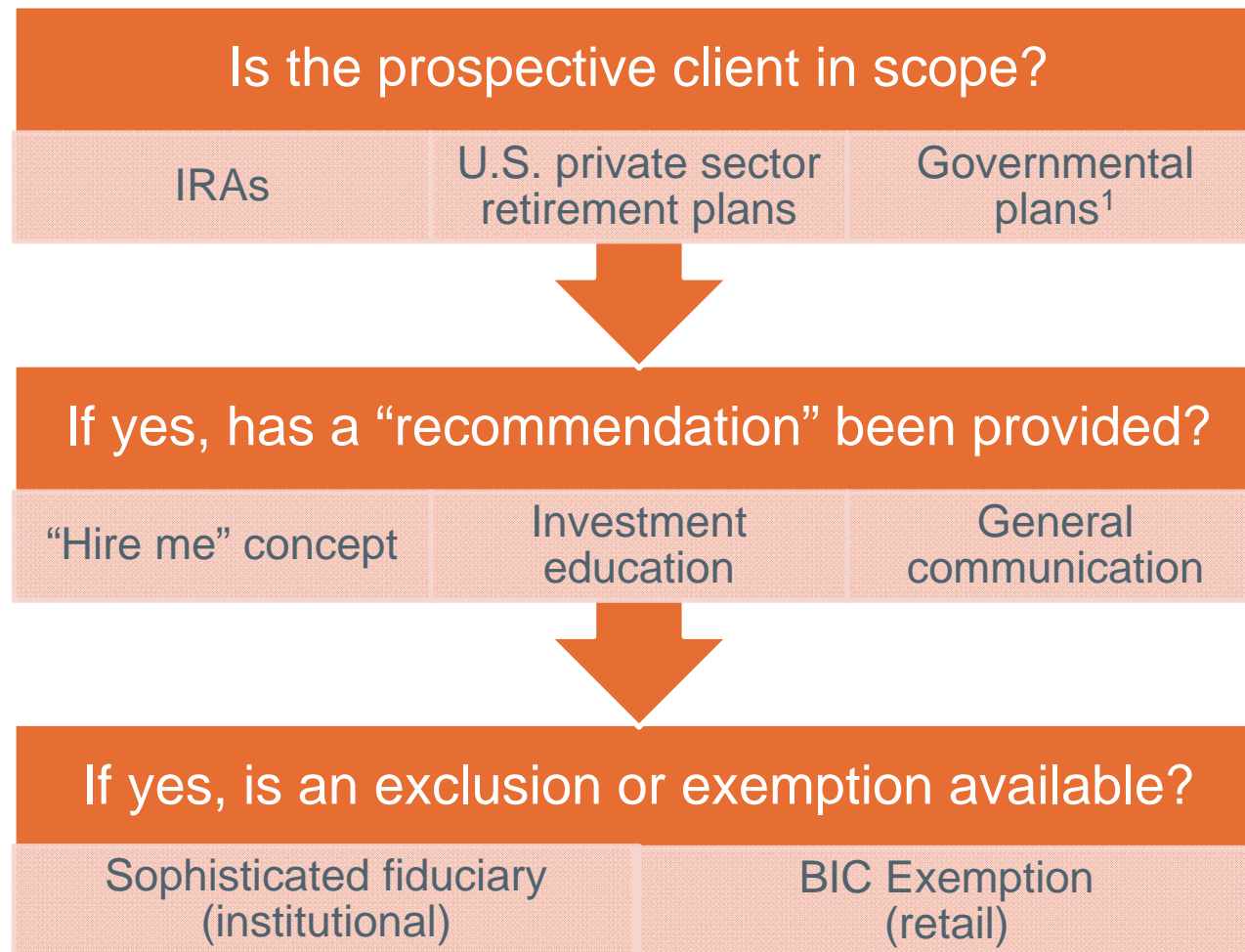
- **Rule:** It is not fiduciary investment advice for a manager to communicate with a sophisticated independent fiduciary acting on behalf of a retirement investor where there is no expectation of reliance
  
- **Requirements include:**
  - Any advice (e.g., a recommendation to invest in a fund) is made to a fiduciary acting on behalf of the investor that is independent of the manager
  - The manager knows or reasonably believes the fiduciary is a: (i) bank, (ii) insurance company, (iii) RIA, (iv) broker-dealer or (v) party that holds or has under management or control at least \$50M in assets
  - The manager informs the fiduciary that the manager is not providing impartial investment advice or giving advice in a fiduciary capacity
  - The manager knows or reasonably believes the fiduciary is a fiduciary under ERISA and/or the Internal Revenue Code with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction
  - The manager knows or reasonably believes the fiduciary is capable of evaluating investment risks independently, both in general and with regard to the particular investment

## EXEMPTION: BEST INTEREST CONTRACT

- Allows otherwise impermissible compensation
  - 12b-1 fees
  - Commissions
  - Sales loads
  - Revenue-sharing payments
  - But, fees to sales people are limited
- Compliance burdens: Many, including
  - Compliance with “impartial conduct standards”
  - Policies and procedures
  - Disclosures
- Streamlined requirements for “level fee fiduciaries”



# ANALYSIS OVERVIEW



<sup>1</sup> Some governmental plans are subject to state and local laws that incorporate ERISA concepts or seek to be treated as ERISA investors contractually

## ACTION STEPS

- Determine preferred approach or approaches
- Develop and implement a process to promote adherence
  - Sales training
  - Written procedures
  - Expanded compliance review of marketing materials and practices
  - Additional investor representations to fund documents and IMAs
  - Due diligence on the client's fiduciary



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