

2019 NEW YORK INVESTMENT MANAGEMENT CONFERENCE

## Regulatory Updates

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# ERISA Updates



# TOPICS

- Distribution Through Consulting/OCIO Firms
- Socially Responsible/ESG Investing
- Multiple Employer Plans (MEPs)





# Distribution Through Consulting/OCIO Firms

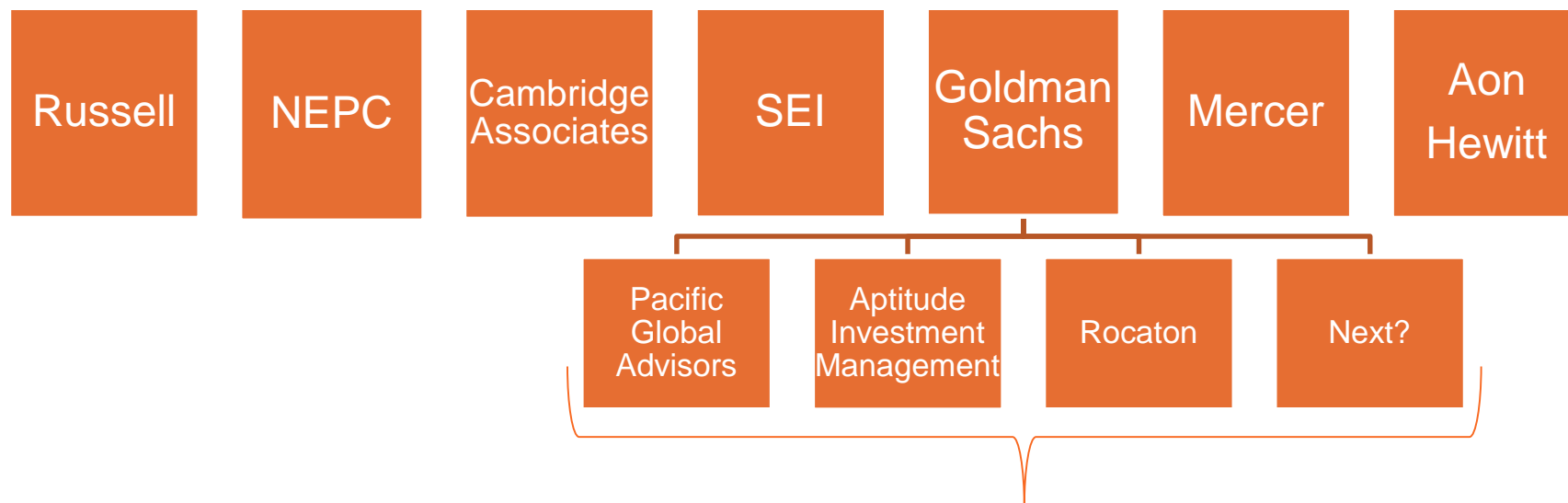


## OCIO FIRMS

“Outsourced chief investment officers” or “OCIOs” are advisory firms that help institutional investors, such as endowments, foundations, and pension plans, select investment managers and make other investment-related decisions, such as asset allocation and rebalancing decisions



# LARGE FIRMS; INDUSTRY CONSOLIDATION



OCIO-oriented firms acquired  
in the last 3-4 years by Goldman Sachs



## OUTSOURCING TREND

- According to data from *Pensions & Investments*, OCIO managers reported a 23% surge to \$1.74 trillion in assets managed worldwide for institutions in the fiscal year ended March 31, 2018
- Top three OCIO firms: Mercer (\$212 billion under management, up 34.6% from last year); Russell (\$163.8 billion, up 32.4%); and Aon Hewitt (\$151.8 billion, up 47.5%)
- Goldman Sachs Asset Management broke into the top five ranking, moving up from seventh place, due in part to the acquisition of the strategic partnership outsourcing business of Verus Investors, Seattle, in July of 2017



# DIFFERENT SERVICE OFFERINGS

## Advisory (non-fiduciary)

- Consultant advises the plan
- Plan's internal fiduciary (e.g., retirement committee) considers the advice when making decisions
- Contract provides that consultant is not a fiduciary

## Advisory (fiduciary)

- Consultant advises the plan and serves as a co-fiduciary with the plan's internal fiduciary
- Most common arrangement
- Sometimes referred to as "3(21) services"

## Discretionary (fiduciary)

- Consultant makes all decisions for the plan and may sign documents on the plan's behalf
- Sometimes referred to as "3(38) services"
- "True" OCIO





## LEGAL AND REGULATORY CONSIDERATIONS

- Investment managers should consider the legal and regulatory implications of marketing to ERISA clients (over \$10T in assets) through this channel
- Considerations include:
  - Potential ERISA “prohibited transactions”
  - Potential implications for the investment manager’s duty of prudence



# PROHIBITED TRANSACTIONS

## Prohibited Transactions

When managing ERISA money, investment managers are subject to ERISA's prohibited transaction rules

An investment manager may need to avoid certain service providers to ensure it complies with a prohibited transaction exemption (e.g., the QPAM exemption)

For example, an investment manager may not be able to execute trades with a broker that is affiliated with the OCIO firm or clear swaps through a clearing member that is affiliated with the OCIO firm

The OCIO firm may seek to impose contractual restrictions



# DUTY OF PRUDENCE

## Duty of Prudence

An investment manager may be precluded from (a) using the OCIO firm and its affiliates in connection with providing services to the plan and (b) causing the plan to purchase securities issued by the OCIO firm and its affiliates

The investment manager should consider whether such restrictions impact its ability to meet its duty of prudence to the ERISA client

For example, (a) Can the manager comply with its best execution policy, if it is precluded from using a major broker-dealer? (b) Can the manager prudently manage the strategy if it is precluded from purchasing certain bonds?



## COMMON QUESTIONS

- Can I agree to restrict my trading and service providers?
- Do I need a different client contract?
- What is the impact on due diligence?
- Can I provide fee breaks/tiering based on all of the OCIO's clients
- What are the issues associated with managing a portion of an OCIO's pooled investment structure?

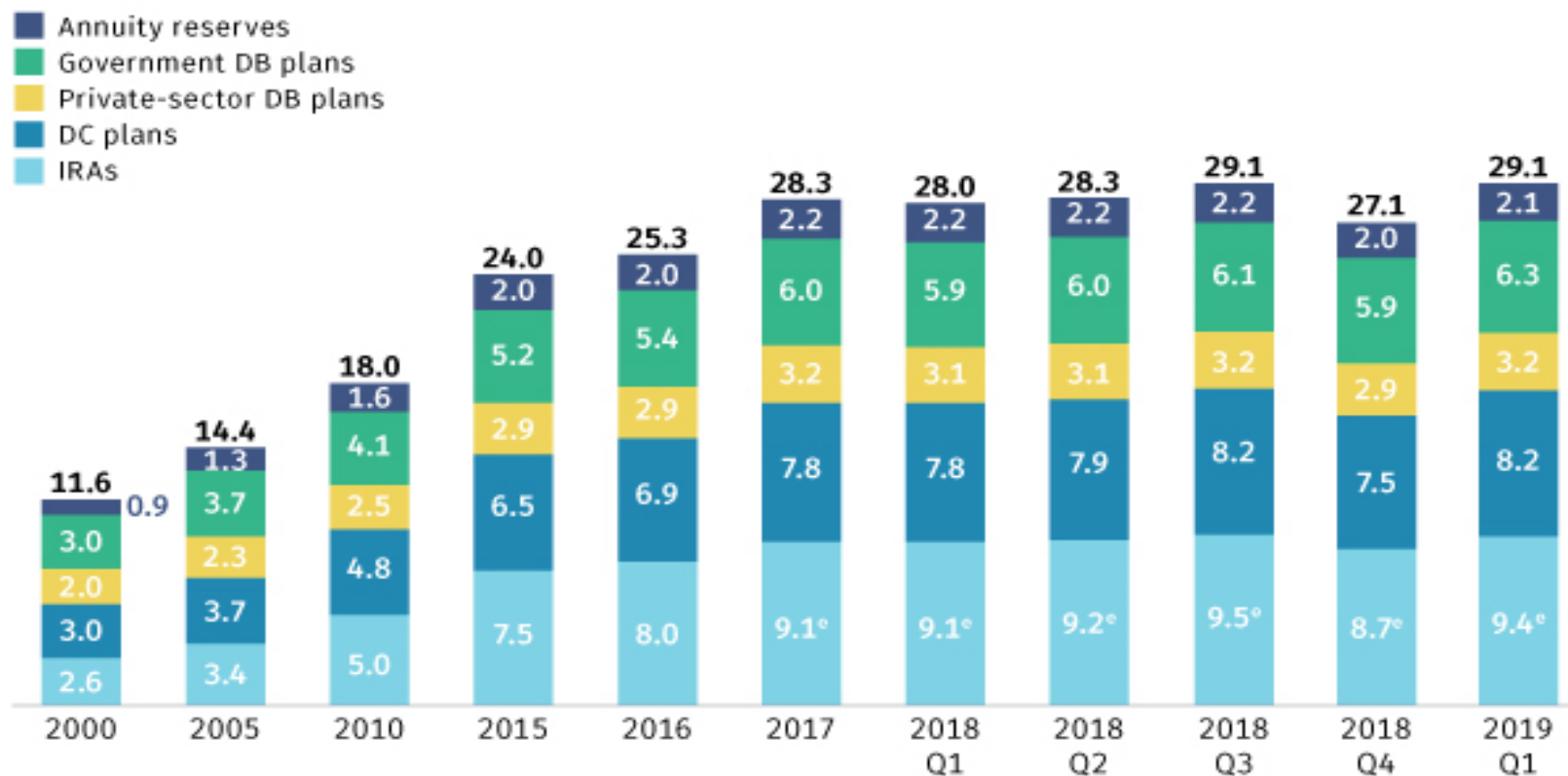




# Socially Responsible/ESG Investing



# ERISA INVESTORS ARE LARGE ASSET OWNERS



Source: Investment Company Institute, “Retirement Assets Total \$29.1 Trillion in First Quarter 2019”.

[https://www.ici.org/research/stats/retirement/ret\\_19\\_q1](https://www.ici.org/research/stats/retirement/ret_19_q1)



# NAVIGATE ERISA CONSIDERATIONS

- The Department of Labor (“DOL”) has a longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater risks as a means of promoting collateral social policy goals
- Series of DOL guidance.
- Most recent guidance issued in April (Field Assistance Bulletin 2018-01).
  - Clarification or warning bell?
  - ERISA fiduciaries must not too readily treat ESG factors as economically relevant; rather, an evaluation of an investment opportunity should be focused on financial factors that have a material effect on return and risk.

## COMMON QUESTIONS

- Can ESG-themed investments be included in a 401(k) investment lineup?
- Can ESG-themed investments be a default investment option?
- Can a target date fund allocate to ESG-themed investments?
- What should an investment policy statement say about ESG factors?
- What process should a fiduciary follow in considering ESG factors?
- Does the DOL's guidance apply to IRAs? Public plans?
- Are there any specific considerations for defined benefit plans?





# Multiple Employer Plans



## WHAT IS A MEP?

- Single retirement plan utilized by two or more employers
- Different from a multi-employer plan (union)
- Traditionally offered by trade associations and professional employee organizations and used by smaller employers
- Pros & cons
  - Risk reduction
  - Cost
  - Customization
  - Administrative tasks (plan audit, Form 5500, hiring and monitoring service providers)

## LEGISLATIVE AND REGULATORY ACTIVITY

- 2018 Executive Order – Supportive of MEPs; calls for the DOL and IRS to consider guidance that would expand usage
- SECURE Act – Bipartisan bill that would expand access to “open MEPs” (addresses the “bad apple rule”)
- IRS Regulations – Public hearing in December on proposed regulations regarding the rules for the qualification of a plan maintained by more than one employer

## COMMON QUESTIONS

- How will MEPs impact my business?
- What are the implications for the U.S. retirement system?
- What roles can I play?
  - Plan sponsor
  - Service provider to plan sponsor
  - Consultant
  - Investment manager





# Financial Professional Standards for Broker Dealers and Investment Advisers



## BACKGROUND

- On June 5, 2019, the SEC formally adopted four measures for the protection of retail investors:
  1. Form CRS
  2. Regulation Best Interest (“Regulation BI”)
  3. Interpretation of investment advisers’ (“IAs”) fiduciary duties
  4. Interpretation of the “solely incidental” prong of the broker-dealer exclusion from definition of “investment adviser” under the Investment Advisers Act of 1940

## BACKGROUND

## *CONTINUED*

- Compliance Dates:
  - Regulation BI and Form CRS: June 30, 2020
  - Interpretations reflect restatements of existing SEC views, and were effective July 12, 2019 upon publication in the Federal Register





# Regulation BI





# REGULATION BI

## General obligations

- Broker-dealers and their natural person associated persons (e.g., registered representatives), when recommending securities and investment strategies to a retail customer, must act in the “best interest” of the customer, and not place their own interest ahead
  - “Retail customer” = a natural person (or legal representative) who receives and uses a recommendation primarily for personal, family, or household purposes (note that this includes family office/family trust, etc.)
    - No exceptions based on wealth, experience, etc.
  - “Recommendation” = account recommendations, such as recommendations to roll over / transfer assets from one account to another, IRAs, retirement annuities, education accounts, etc.

## REGULATION BI

## *CONTINUED*

General Obligation is met by satisfying four key obligations:

1. Disclosure
2. Care
3. Conflicts
4. Compliance





# Type of Broker-Dealers – *Does Regulation BI Apply?*



## TYPES OF BROKER-DEALERS – *DOES REGULATION BI APPLY?*

- Whether Regulation BI applies depends on:
  - Whether the Broker-Dealer makes a recommendation; and
  - Whether the Recommendation is made to a Retail Customer?
- Let's talk about the roles that different types of broker-dealers play



# TYPES OF BROKER-DEALERS

Does Regulation BI Apply?

## 1. Retail Brokerage Business

- Regulation BI applies to registered sales professionals who solicit orders, recommend securities/investment strategies with respect to retail customers.

## 2. Execution-Only Business

- Regulation BI doesn't apply to firms that:
  - Engage solely in an discount brokerage/execution-only business
  - Execute customer's request contrary to a previous recommendation
  - Form CRS obligations may apply



## TYPES OF BROKER-DEALERS *CONTINUED*

### 3. Alternative Trading Systems (ATS)

- If institutional customers only, then Regulation BI will not apply.
- If retail investors are permitted, whether Regulation BI applies will depend on how the ATS interacts with them.

### 4. Clearing Firm

- Regulation BI may apply to self-clearing firms if they make recommendations to retail customers.
- Regulation BI will not apply to clearing firms that perform purely back-office functions on a fully disclosed/omnibus basis.



## TYPES OF BROKER-DEALERS *CONTINUED*

### 5. Institutional Business

- Regulation BI does not apply to firms that engage in an institutional-only business.
- Important to confirm that entities typically considered “institutions” do not constitute “retail customers” under Regulation BI.

### 6. Wholesale Business

- Regulation BI does not apply firms that conduct wholesale business unless the firms make recommendations of securities/investment strategies to retail customers.

### 7. Fund Principal Underwriter

- Regulation BI does not apply to broker-dealers who passively act as a fund’s principal underwriters or distributors.



## TYPES OF BROKER-DEALERS *CONTINUED*

### 8. Placement Agent Business

- Whether Regulation BI applies to a placement agent depends on the types of investors eligible to invest in an unregistered offering; and
- The conduct of the BD in communicating with potential investors.

### 9. Dual Registrant

- Employees need to be aware of the capacity they are acting in.
- Regulation BI applies to dual registrants that make recommendations to retail customers through brokerage accounts.
- Regulation BI doesn't apply to dual registrants acting in advisory capacity.





# TYPES OF BROKER-DEALERS *CONTINUED*

## 10. Wrap Business

- Wrap account is presumably an investment strategy.
- Regulation BI may apply to broker-dealers who recommend a “wrap account” to retail customers.

## 11. Financial Planning Business

- Regulation BI applies to firms that provide financial planning services to retail investors.

## 12. Funding Portal

- Regulation BI does not apply to funding portals because they are not permitted to make recommendations.



## TYPES OF BROKER-DEALERS *CONTINUED*

### 13. Research Provider

- The SEC has taken the position that the delivery of research is a “solicitation.”
- Institutional research to non-natural persons would not trigger Regulation BI.
- Research to natural persons for the purpose of executing securities transaction could be deemed a “recommendation.”





# Regulation BI Litigation



# REGULATION BI LITIGATION

State of New York, State of California, State of Connecticut, State of Delaware, District of Columbia, State of Maine, State of New Mexico, State of Oregon v. United States Securities and Exchange Commission and Walter “Jay” Clayton III, in his official capacity as Chairman of the United States Securities and Exchange Commission, 1:19-cv-08365, Sept. 9, 2019

- Eight Attorneys General of states and the District of Columbia (“DC”) sued the SEC to block the implementation of Regulation BI.
- The States and DC claimed that Regulation BI does not comply with Section 913(g) of the Dodd-Frank Act.
- The States and DC asserted that the retirement savings of their constituents would decrease because of purportedly conflicted investment advice, which would, in turn, lower tax revenues.

## REGULATION BI LITIGATION *CONTINUED*

XY Planning Network, LLC and Ford Financial Solutions, LLC v. United States Securities and Exchange Commission and Walter “Jay” Clayton III, in his official capacity as Chairman of the United States Securities and Exchange Commission, 1:19-cv-08415, Sept. 10, 2019

- An investment adviser and an association of investment advisers also filed suit against the SEC claiming that Regulation BI gives brokers a competitive advantage over investment advisers and exceeds the agency’s rulemaking authority.
- Plaintiffs in the state case and the investment adviser case sought appellate review supported by the SEC. The SDNY consolidated both cases and dismissed them pending review by the Second Circuit.



# Form CRS



## FORM CRS

- IAs and BDs will be required to provide relationship summaries on Form CRS to retail investors, and to post Form CRS on websites
  - Firms will have to file Form CRS with the SEC through Web CRD or IARD (both if dually registered)
  - Forms must be updated within 30 days of information becoming outdated or inaccurate. Must communicate changes to investors within 60 days
  - Forms will be in a uniform, machine-readable format in order to assist with comparisons



## FORM CRS

## CONTINUED

Forms must include descriptions of services, standards of conduct, summaries of conflicts, and discussions of fees

- Must list examples of the most common fees and costs applicable to retail investors (e.g., custody, account maintenance, fees related to mutual funds and variable annuities, and other transactional / product-level fees)
- Required for all BDs and IAs who provide services to retail investors, regardless of whether they provide recommendations







# Interpretation of Investment Adviser's Fiduciary Duty



## SEC FINAL INTERPRETATION

- On June 5, 2019, the SEC adopted a final interpretation (the “Interpretation”) of the standard of conduct applicable to IAs
- Does not purport to modify existing IA standard of conduct



# INVESTMENT ADVISER'S FIDUCIARY DUTY

- Principles-based
- Enforceable under the anti-fraud provisions of the Investment Advisers Act of 1940
- IA's fiduciary duty includes:
  - Duty of care
  - Duty of loyalty



## NO WAIVER OF FIDUCIARY DUTY

- The Interpretation reaffirms the SEC's belief that an IA's fiduciary duty may not be **waived**
  - But may be **shaped and altered** by the underlying advisory agreement
- The Interpretation withdraws the *Heitman* no-action letter
- The Interpretation also discusses “hedge clauses”
  - Retail v. institutional clients

## FIDUCIARY DUTY – DUTY OF CARE

- The Interpretation states that duty of care includes:
  1. The duty to provide advice that is in the client's best interest;
  2. The duty to seek best execution; and
  3. The duty to provide advice and monitoring over the course of the relationship



## PRACTICAL CONSIDERATIONS

- Thinking about the fiduciary duty based on the type of client
  - Duty of care
    - Retail
    - Institutional
  - Duty of loyalty
    - Retail
    - Institutional
- Thinking about the fiduciary duty for dual registrants (both an IA and a BD)



## PRACTICAL CONSIDERATIONS *CONTINUED*

- Other general considerations for IAs
  - Reviewing and updating existing policies and procedures
  - Adopting new policies and procedures
  - Reviewing and updating Form ADV disclosures
  - Reviewing and updating template investment advisory agreements





# Interpretation of the “Solely Incidental” Prong of the Broker-Dealer Exclusion





## SOLELY INCIDENTAL INTERPRETATION

- A BD whose advisory services are “solely incidental” to its BD business and that does not receive special compensation is not deemed to be an IA
  - Account discretion that is limited in time, scope, or other manner (time / price discretion, infrequent or isolated discretion, or discretion to purchase any bond with a specified credit rating and maturity) and not comprehensive and continuous would be “solely incidental”



# SOLELY INCIDENTAL INTERPRETATION *CONTINUED*

- Account monitoring would not automatically fail the “solely incidental” prong, but agreements to monitor would result in a recommendation to buy, sell, or hold each time monitoring occurs and would be covered by Regulation BI. Consider account monitoring policies and procedures that are tailored to registration status of personnel





# Washington, DC - CFTC Regulatory Update





# Questions?



K&L GATES