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The Final Fiduciary Rule: Impact on Investment Managers

On April 8, 2016, the Department of Labor ("**DOL**") published a long-awaited new regulation (the "**Fiduciary Rule**") that greatly expands the types of communications that may be considered "investment advice" and the circumstances under which furnishing investment advice to an employee benefit plan or IRA investor (each, a "**benefit plan investor**") will cause the advice provider to be considered a fiduciary under the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**"), or the prohibited transaction excise tax provisions of the Internal Revenue Code of 1986, as amended (the "**Code**"). Along with the expanded definition, the Fiduciary Rule introduces a number of nuanced exceptions from fiduciary status that will require changes to existing policies, contracts and practices. This article describes the potential impact of the Fiduciary Rule on investment managers and the exceptions under the rule upon which investment managers may seek to rely in order to avoid triggering fiduciary status in connection with their marketing activities.

Although the biggest impact of the Fiduciary Rule will fall on brokers and registered investment advisers ("**RIAs**") who give individualized non-discretionary advice in the "retail" marketplace, discretionary investment managers in the "institutional" space will also be affected, primarily in connection with sales of investment products and services. In this respect, the Fiduciary Rule may be relevant to:

- An RIA seeking to enter into an investment management agreement directly with an ERISA Plan to manage a separate account portfolio;
- The manager of a private fund that is open to investment by ERISA plans – regardless of whether the fund will hold ERISA "plan assets"; and
- The manager of a private fund that is open to investment by IRAs – including friends and family and employee IRAs (unless all fees will be waived).

<u>Overview</u>

Under the Fiduciary Rule, "investment advice" includes recommendations with regard to both the purchase and sale of investments and the management of investments, including recommendations with regard to the "selection of other persons to provide investment management services." For these purposes, a "recommendation" is defined as "a communication that, based on its context, content, 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 Fiduciary Rule also provides, with certain exceptions, that merely directing an investment recommendation to a specific benefit plan investor is sufficient to impose fiduciary status on the person making the recommendation if such person, or an affiliate, receives compensation from any source "in connection with or as a result of" such recommendation. The Fiduciary Rule's reference to recommending "*other* persons to provide investment management services" suggests that typical marketing discussions between an investment manager and potential investors would fall outside the definition of investment advice. Indeed, the DOL explained in the preamble to the Fiduciary Rule that it did not intend for an investment manager to "become a fiduciary merely by engaging in the normal activity of marketing oneself or an affiliate as a potential fiduciary . . . ." The DOL cautioned, however, that "when a recommendation to 'hire me' effectively includes a recommendation on how to invest or manage plan or IRA assets . . . that recommendation would need to be evaluated separately under the provisions in the final rule." This significant limitation of the "hire me" exception may raise challenging issues for many investment managers looking to rely on this exception in connection with the marketing of their services, including:

- Investment managers associated with a specific investment strategy;
- Investment managers who provide their services exclusively through collective investment vehicles; and
- Investment managers who provide their services exclusively to IRAs sponsored or trusteed by a particular financial institution.

Although investment managers customarily acknowledge fiduciary status in connection with the provision of discretionary investment management services to benefit plan investor clients *after they are hired*, the potential extension of fiduciary status to statements made in connection with the *marketing* of such services to potential benefit plan investor clients should prompt investment managers to carefully scrutinize their existing marketing practices. Investment managers whose marketing practices involve recommendations that may be characterized as investment advice and who do not satisfy an exception under the Fiduciary Rule by the April 10, 2017, applicability date risk violating prohibited transaction rules that bar a fiduciary from advising a benefit plan investor to engage in transactions that result in the payment of additional fees to the fiduciary or related parties. The following section describes these exceptions in detail and suggests ways that investment managers can prepare for the rule.

Independent Fiduciary Exception

The Fiduciary Rule provides an exception for investment recommendations made to an independent fiduciary of a benefit plan investor in connection with an arm's-length transaction "related to the investment of securities or other investment property," provided the independent fiduciary meets certain financial sophistication requirements. A fiduciary will generally be considered "independent" of an investment manager if the fiduciary has no financial interest or other relationship to the investment manager that may conflict with the interests of the benefit plan investor for which it acts or may otherwise affect its best judgment as a fiduciary.

The conditions of this exception, which an investment manager can fulfill by including appropriate representations in an investment management agreement, subscription agreement or side letter executed by the benefit plan investor, are:

- The investment manager knows or reasonably believes that:
    - the independent fiduciary is a U.S. bank or insurance company, a U.S. registered investment adviser or broker-dealer or a fiduciary that holds, or has under its management or control, total assets (including both plan and non-plan assets) of at least $50 million;

- the independent fiduciary is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies; and
- the independent fiduciary is a fiduciary under ERISA or the Code or both, with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction;

- The investment manager fairly informs 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 and fairly informs the independent fiduciary of the existence and nature of the person's financial interests; and

- The investment manager does not receive a fee or other compensation directly from the benefit plan investor or independent fiduciary for the provision of investment advice (as opposed to a fee for other services) in connection with the transaction.

The DOL declined to extend this exception to cover advice provided to fiduciaries to small plans, individual plan participants or IRA owners that are not represented by an independent fiduciary – including high net worth individuals that are considered sophisticated investors under U.S. securities laws. In doing so, the DOL rejected the notion that wealth is necessarily correlated with financial sophistication. Therefore, the owner of a self-directed IRA with $50 million or more in assets would not qualify as an "independent fiduciary" under this exception. Investment managers that market their services to these types of retail retirement investors and wish to avoid being deemed "fiduciaries" under the Fiduciary Rule and possibly having to comply with the Best Interest Contract Exemption should consider adopting policies and procedures designed to ensure that the communications made to such investors in connection with their marketing activities fit within the "hire me" exception discussed above or one of the categories described below.

General Communications

The Fiduciary Rule provides that investment advice does *not* include furnishing to a benefit plan investor "general communications that a reasonable person would not view as an investment recommendation," including general marketing materials and prospectuses. In the preamble to the Fiduciary Rule, the DOL explained that the "reasonable person" requirement was included because the label assigned to a document or communication is not determinative, and "there may be circumstances in which a person uses a label . . . from the list [of general communications] but the communication nonetheless clearly meets the requirements of a recommendation . . . ." Accordingly, investment managers will need to pay close attention to the content, context and presentation of these communications. For example, whether the act of furnishing a prospectus or other offering materials to a benefit plan investor constitutes an investment recommendation could depend on factors such as whether the materials were furnished in response to:

- a request for information relating to an investment program or vehicle specified by the benefit plan investor;

- a request for information on investments that the investment manager considers *appropriate* for the benefit plan investor; or

- a request for information on investments meeting certain objective criteria specified by the benefit plan investor.

These are just a few examples of general communications that are likely to raise interpretive questions under the Fiduciary Rule. Therefore, investment managers should consider adopting protocols designed to ensure that prospectuses and other offering materials furnished to benefit plan investors, and communications surrounding those materials, do not include statements that could be viewed by a reasonable person as an investment "recommendation."

Investment Education

The Fiduciary Rule also clarifies that investment advice does not include the furnishing of "investment education" information and materials. This provision tracks closely (and supersedes) Investment Bulletin 96-1, which also provided relief from "fiduciary" status in the investment education context. In most cases relevant to investment managers selling their products and services, the information that can be provided under this exception is fairly general. For example, an investment manager may provide information and materials that describe product features, investor rights and obligations, fee and expense information, applicable trading restrictions, investment objectives and philosophies, return information, and related prospectuses of investment alternatives available under a plan or an IRA. Importantly, such information may not reference the "appropriateness" of any individual investment alternative. Although this exception should be considered when analyzing an investment manager's status as a fiduciary in connection with its marketing activities, it may have limited application to sales of *specific* investment products or services. It also is possible that this exception could, *in combination with* other available exceptions – such as the "hire me" exception discussed above, provide relief to some investment managers. However, the extent to which such combinations are viable is an evolving matter.

Conclusion

The Fiduciary Rule likely will be the single most impactful development in the retirement services space since ERISA was enacted in 1974. The specific consequences of this regulation in the investment management arena are unfolding. Investment managers will need to consider how their existing practices fit within the new regulatory framework, and whether they need to alter those practices to comply with the Fiduciary Rule. For example, subscription agreements, investment management agreements and offering and marketing materials will need to be reviewed and revised. In addition, sales personnel and placement agents who market to benefit plan investors, particularly those who are not represented by independent fiduciaries, will need to ensure that their communications to such investors satisfy one or more of the other exceptions outlined above. Investment managers will also need to carefully assess their potential exposure and their ability to navigate through the conditions of the various exceptions.