June 6, 2017

Compliance With the ERISA Fiduciary Advice Rule for Private Investment Fund Managers and Sponsors and Managed Account Advisers: Beginning June 9, 2017

Executive Summary

The DOL's "fiduciary advice rule" (the "Rule") will take effect on June 9, 2017. The DOL has published FAQs on the implementation of the Rule applicable to the period between June 9th and December 31st (the "Transition Period") and updated its previously issued enforcement policy that will take effect during the Transition Period. This most recent guidance provides that during the Transition Period, the DOL will not pursue claims against fiduciaries who are working diligently and in good faith to comply with the Rule and the related exemptions, safe harbor, or other potentially available relief. In addition, the IRS has indicated that it will not apply the Internal Revenue Code Section 4975 prohibited transaction provisions to transactions or agreements covered by this DOL enforcement policy.

As described in Katten's earlier advisories, the Rule affects a broad range of financial services providers who deal with "Protected Investors" (as defined below). This advisory provides a brief overview of the specific effects of the Rule on investment managers and sponsors of private funds that accept investments from Protected Investors and on investment advisers that provide managed account services to Protected Investors (collectively, "Advisers" and each, an "Adviser").

The Rule will apply to an Adviser when (A) it makes investment recommendations ("Recommendations") to a Protected Investor (i) during the Adviser's marketing or offering activities with regard to a Protected Investor's decision to allocate assets to a fund or managed account or (ii) in connection with the Protected Investor's decision to retain an investment in a fund or managed account or to make a withdrawal from either, *and* (B) in respect of either of the foregoing, the Adviser directly or indirectly receives any fee or other compensation for that recommendation. If the Adviser becomes subject to the Rule because (A) and (B) apply, it will *be deemed to have engaged in a prohibited transaction under ERISA or the Internal Revenue Code unless it qualifies for one of the DOL's published exemptions or other relief*. This advisory provides targeted guidelines for Advisers to navigate this new regulatory landscape *whether or not an Adviser currently is a fiduciary with respect to Protected Investors under existing law*. If an Adviser is a fiduciary under existing law (because the Adviser is managing a "plan assets" fund or has a managed account with a "plan"), the Rule will not affect the Adviser's current fiduciary obligations (which will continue to apply), but will impose additional consequences for that Adviser if it becomes subject to the Rule. By the same token, an Adviser that becomes a fiduciary

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under the Rule will not become a fiduciary with respect to the management of "plan assets" under existing law simply because it becomes subject to the Rule.

Application of the Rule

For purposes of the Rule, the following definitions apply:

- "Protected Investor" refers to a retirement plan or its participants and/or beneficiaries and any IRA.
- "Recommendation" is defined as a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the Protected Investor engage in or refrain from taking a particular course of action.
- "Retail Investors" refer to Protected Investors who are not represented by an "independent fiduciary with financial expertise" (discussed below).

The Rule will take effect on June 9, 2017 and will apply to Advisers making Recommendations to Protected Investors as described above and that receive compensation (whether direct or indirect). Inasmuch as Advisers typically receive compensation for sponsoring or advising a fund or managed account (which will constitute compensation under the Rule whether or not the Adviser is compensated for the Recommendation itself), in order for an Adviser to determine whether the Rule will apply to it, an Adviser's primary consideration is whether it will be making Recommendations to Protected Investors.

The Rule does not provide clear-cut guidance as to what communications by an Adviser to a Protected Investor will be considered Recommendations. As a general matter, communications that provide information or advice based on the particular investment needs of the Protected Investor or specific advice regarding the advisability of a particular investment decision with respect to a Protected Investor's investment will constitute Recommendations (whether the foregoing relate to the Protected Investor's initial decision to allocate assets to the Adviser or its decision to retain or withdraw that allocation). This is true regardless of whether or not the communications are in response to an inquiry from the Protected Investor. Some representative examples include but are not limited to the following:

- A fund manager would be making a Recommendation if it advises a Protected Investor to invest in a particular fund, or series or class of a fund, out of several that it manages or recommends an investment amount to the Protected Investor.
- A managed account Adviser would be making a Recommendation to a Protected Investor if it advises as to why a managed account the Protected Investor opened with it would be responsive to the Protected Investor's particular investment needs or makes a suggestion about a Protected Investor's proposed portfolio composition.
- A fund manager or managed account Adviser would be making a Recommendation to a Protected Investor if it encourages the Protected Investor to retain its fund investment or managed account allocation, as applicable, or discourages a withdrawal of either.

On the other hand, the Rule provides that the following would not constitute Recommendations: disseminating generalized marketing or offering materials, prospectuses, or performance reports, or making available other general information that is not specifically tailored to Protected Investors.

Many other direct communications with Protected Investors may not be as easily categorized and may, depending on the circumstances and context, be considered to be Recommendations, as follows:

- unscripted discussions or written communications between a fund manager's investor relations staff and a Protected Investor;
- periodic letters sent by fund managers to Protected Investors which could be viewed as an effort to encourage investments or additional investments or to discourage withdrawals; and
- periodic one-on-one meetings between an Adviser and a managed account client to review the performance of the client's account during which the Adviser responds to the client's questions regarding the account.

Consequently, an Adviser can avoid application of the Rule entirely by limiting its communications with Protected Investors to those that are clearly not Recommendations or, in the alternative, avoiding all contact with Protected Investors or their representatives. An Adviser that does so will not be subject to the Rule and will not be subject to any additional regulatory obligations under the Rule after June 9th. An Adviser that adopts this approach should consider incorporating disclosures or representations in its managed account agreement or fund subscription documents, as applicable, to document that it does not make Recommendations; this should be accomplished either currently or at some point before the Transition Period expires.

Compliance With the Rule During the Transition Period

If an Adviser either intends to make Recommendations or does not wish to be precluded from making Recommendations and will be receiving direct or indirect compensation from a Protected Investor, the Adviser may become subject to the Rule during the Transition Period. Accordingly, it may be reasonable for that Adviser during the Transition Period to make sure that it complies with either (i) the Impartial Conduct Standards (ICS) under the Best Interest Contract Exemption ("BIC Exemption") with respect to Retail Investors or (ii) the Independent Fiduciary Safe Harbor as discussed below. This is true whether or not the Adviser has determined if and how it will comply with the Rule after the Transition Period ends on January 1, 2018.

While the following discusses the ICS under the BIC Exemption and the Independent Fiduciary Safe Harbor, depending on an Adviser's particular circumstances, there may be other relief available in the form of advisory opinions or other exemptions issued by the DOL. An Adviser should confer with counsel to determine whether these other forms of relief may be available.

Under the ICS, an Adviser will be required to:

- give advice that is in the "*best interest*" of the Retail Investor, which requires acting in accordance with the "prudent person" standard of ERISA and based on the investment objectives, risk tolerance, financial circumstances and needs of the Retail Investor, without regard to any financial interests of the Adviser;
- receive *no more than "reasonable compensation"* as defined under ERISA and the Internal Revenue Code; and
- make *no materially misleading statements* about recommended transactions, fees, compensation, conflicts of interest or other relevant matters.

In FAQs issued in May, the DOL stated that, in respect of adherence to the ICS, it expects Advisers to adopt such policies and procedures as they reasonably conclude are necessary to ensure that they comply with the ICS and that they retain flexibility to choose precisely how to safeguard that compliance, whether by mitigating conflicts of interest associated with compensation, increased monitoring and surveillance of investment recommendations, or other approaches or combinations of approaches. An Adviser seeking to rely on the BIC Exemption to deal with Retail Investors should consult with its counsel to develop policies and procedures that are designed to ensure compliance with the BIC Exemption's requirements and that accurately reflect the Adviser's business practices.

Advisers that do not deal with Retail Investors will be permitted to make Recommendations to specified "independent fiduciaries" that act on behalf of Protected Investors (the "Independent Fiduciary Safe Harbor"). (Advisers with a mix of Retail Investors and other Protected Investors could rely on the BIC Exemption for the former and the Independent Fiduciary Safe Harbor for the latter.) Reliance on the Independent Fiduciary Safe Harbor generally will involve amending an Adviser's managed account agreement or fund subscription documents, as applicable, to incorporate the following provisions:

- Representations from the Protected Investor or its independent fiduciary that the independent fiduciary is (i) independent of the Adviser making the Recommendation to it; (ii) capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies; (iii) a fiduciary as defined under ERISA or the Internal Revenue Code and is responsible for exercising its independent judgement in evaluating the transaction; and (iv) one of the following:
  - a bank subject to U.S. federal or state regulation;
  - an insurance company qualified under a state's law to manage plan assets;
  - a registered investment adviser under the Investment Advisers Act of 1940;
  - a broker-dealer registered under the Securities Exchange Act of 1934; or

  - any other independent fiduciary with total assets under management of at least $50 million (such as the investment committee of a plan).
- A representation from the Adviser making the Recommendation that it is not providing impartial advice and is not giving advice as a fiduciary.
- Disclosure of the nature and extent of the financial interest of the Adviser in the transaction and confirmation that the Adviser is not receiving any fee or other compensation directly from the Protected Investor (on whose behalf the independent fiduciary is acting) for providing the advice.

In this regard, with respect to existing investors, the DOL has stated that it will permit the satisfaction of these requirements through negative consent by a written notice containing the applicable representations and disclosures. An Adviser that determines to rely upon the negative consent of an existing investor should have a reasonable basis for believing that the investor is represented by an independent fiduciary separate and apart from the absence of a response from that investor.

As a matter of prudence and policy, we recommend that Advisers intending to comply with the Independent Fiduciary Safe Harbor avoid all contact with Protected Investors other than through their independent fiduciaries. As an alternative, these Advisers should ensure that (i) any meetings with a Protected Investor are attended by its independent fiduciary or (ii) any other communications between the Adviser and a Protected Investor are approved in advance by its independent fiduciary.

We believe it is reasonable to conclude that during the Transition Period an Adviser's compliance with the ICS under the BIC Exemption with respect to Retail Investors or the Independent Fiduciary Safe Harbor will not bind an Adviser to that approach during the post-Transition Period beginning on January 1, 2018. Accordingly, during the Transition Period an Adviser should understand the Rule as it would apply on January 1, 2018 and determine how it will implement the necessary policies and procedures to comply with the Rule once the Transition Period expires.

Compliance With the Rule Following the Transition Period, Beginning January 1, 2018

The Transition Period is currently scheduled to expire on January 1, 2018. Under the current provisions of the Rule, an Adviser that wishes to make Recommendations with respect to the assets of Protected Investors on or after January 1, 2018 (whether or not it has made Recommendations during the Transition Period) will need to comply with either (i) the Independent Fiduciary Safe Harbor or (ii) with respect to Retail Investors, the ICS and additional conditions to adhere to the BIC Exemption.

Under the current provisions of the Rule, no additional requirements apply under the Independent Fiduciary Safe Harbor post-Transition Period. However, under the current provisions of the Rule, beginning January 1, 2018, an Adviser intending to rely on the BIC Exemption, in addition to adhering to the ICS, must comply with significant additional conditions, including the following: a written statement of the Adviser's fiduciary status; specified disclosures about, among other things, conflicts of interests, various compensatory arrangements, and costs and expenses in substantial detail; a written commitment to adhere to, and also monitoring adherence to, the ICS; compliance with certain recordkeeping requirements; and establishment of a publicly available website setting forth among, other things, certain disclosures, certain of the Adviser's policies and procedures, and substantial specified information that must be updated periodically. However, the DOL has indicated that it will be requesting comments and studying the Rule and possibly make changes to it during the Transition Period.

Enforcement and Litigation Following the Effective Date of the Rule

In its May FAQs, the DOL indicated that it was aware that other compliance models to satisfy the ICS are being developed and that such development may extend beyond the Transition Period. The DOL invited comments on the time necessary to develop such compliance solutions and whether an extension of the Transition Period would be appropriate to permit such development and implementation. The DOL also stated that it "is broadly available to discuss compliance approaches and related issues with interested parties, and would invite interested parties to contact the Department if they have questions about planned compliance systems, policies and procedures, or other compliance-related issues." Interested persons may wish to submit comments or questions.

The DOL has stressed its compliance-oriented approach to the Rule, noting that it will emphasize assisting, among others, Advisers that *work diligently and in good faith to understand and come into compliance* with the Rule, rather than citing violations and imposing penalties. Consistent with the foregoing, the DOL has determined that temporary enforcement relief is appropriate and in the interest of plans, plan fiduciaries, plan participants and beneficiaries, IRAs, and IRA owners. The DOL's approach to enforcement may potentially mitigate the risk of private litigants bringing suits under ERISA against Advisers during the Transition Period.

The DOL's May FAQs are available here.

Field Assistance Bulletin No. 2017-02 (Transition Enforcement Policy) is available here.

Katten's earlier advisories on the Rule are available here.