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ERISA FIDUCIARY RULE IMPACT ON UNREGISTERED INVESTMENT FUNDS

SUMMARY

ERISA imposes stringent conduct standards (and potential liability) on any person who acts as a "fiduciary," a term that includes a person who renders "investment advice" to an ERISA plan or an IRA. The DOL has issued a regulation, effective June 9, 2017, that significantly expands what constitutes "investment advice" for this purpose. This expanded scope of investment advice makes it unclear whether customary fund sponsor activities and communications in the context of marketing interests in a fund that previously were not considered to be fiduciary in nature will confer fiduciary status unless an exception applies. As a result, until there is better clarity, many fund sponsors will likely want to be able to rely on the so-called independent fiduciary exception (the IF Exception) discussed below.

As a practical matter, fund sponsors marketing to large plans, and IRAs and smaller plans with a professional adviser, will not be impacted by the new Fiduciary Rule by satisfying the IF Exception discussed below. However, fund sponsors that market to IRAs and smaller plans without a professional adviser will need to consider whether they will continue to market to such investors.

The Fiduciary Rule

The Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (the Code), provide that a "fiduciary" includes any person or entity that renders "investment advice" for a fee or other compensation (a Fiduciary). The fee need not be specifically "for" the advice; it need only flow from following the advice. Fiduciaries are bound by both the duty of prudence and the duty of loyalty, which require the Fiduciary to act for the exclusive benefit and in the interest of the plan or IRA and to avoid engaging in non-exempt prohibited transactions, including self-dealing.

On April 6, 2016, the Department of Labor (the DOL) released a final regulation significantly expanding the term "investment advice" and issuing several new prohibited transaction class exemptions (PTCEs) and related amendments to a number of existing PTCEs (collectively, the "Fiduciary Rule" or the "Rule") with an "applicability date" of April 10, 2017. The Fiduciary Rule significantly expands the scope of communications with retirement investors that constitute "investment advice" and confer fiduciary status. Following a 60-day delay, the new definition of "investment advice" (and certain other provisions of the Rule) is applicable on June 9, 2017.

What is and is not a "Recommendation"?

The Rule provides that "investment advice" includes recommendations with regard to both the purchase and sale of investments and the management of investments. A “recommendation” is defined as a communication that, based on its content, context and presentation, would reasonably be viewed as a “suggestion.” This expanded scope of investment advice will cause many fund sponsor activities and communications in the context of marketing interests in a fund that previously were not considered to be fiduciary in nature to now confer (or at least potentially confer) fiduciary status unless an exception applies. As a result, many fund sponsors will likely want to be able to rely on the IF Exception discussed below.

The DOL identified a few types of communications that would generally not rise to the level of a “recommendation”:

- General communications (includes broadly disseminated materials, such as newsletters, articles and research reports; certain marketing materials, such as market data; prospectuses and price quotes; and performance reports),
- Investment education information and materials given to plan participants or IRA owners (includes plan information; general financial, investment and retirement information; certain standard asset allocation models; and certain interactive investment materials), and
- “Hire me” communications where a firm or an individual is marketing its own services (or those of an affiliate). “Hire me” is only applicable to the marketing of services, not products, such as funds.

Independent Fiduciary Exception

The IF Exception provides that communications that would otherwise constitute “investment advice” under the expanded definition will not confer fiduciary status where the recommendation is provided to an independent fiduciary and the following conditions are satisfied:

- The independent fiduciary must be a registered investment adviser, a U.S. bank, a U.S. insurance company, a registered broker-dealer or otherwise have at least $50 million in total assets under its management or control.
- The fund sponsor must know or reasonably believe that the independent fiduciary is (1) a fiduciary and (2) capable of evaluating investment risks independently, both in general and with respect to specific transactions and investment strategies.
- The fund sponsor must know or reasonably believe that the independent fiduciary is a fiduciary under ERISA or the Code, or both, with respect to the investment in the fund and is responsible for exercising independent judgment in evaluating such investment.
- The fund sponsor must fairly inform the independent fiduciary (1) that the fund sponsor is not undertaking to provide impartial investment advice or to act in a fiduciary capacity and (2) of the existence and nature of the fund sponsor’s financial interest and any potential conflicts of interest.
- Neither the fund sponsor, nor any of its affiliates, receives a fee or other compensation directly from the plan or IRA, plan fiduciary (including the independent fiduciary), plan participant or beneficiary or IRA owner for the provision of investment advice (as opposed to other services) in connection with the investment in the fund.
- Fund sponsors may rely on representations in the subscription documents or obtained via a negative consent procedure to satisfy the knowledge or reasonable belief requirements in the first three items above.

The rationale behind this exception is that as long as the fiduciary to whom the recommendation is directed is independent and sophisticated, it can agree that the fund sponsor is not providing fiduciary investment advice. This exception works well when marketing a fund to large plans with over $50 million in assets. It also works when marketing the fund to smaller plans or IRAs that have an independent professional adviser responsible for making the decision or evaluating the investment opportunity on behalf of the plan or IRA.

IF Exception Unavailable

The IF Exception, however, provides no relief for proposals or transactions with smaller plans or IRAs that are not represented by an independent professional adviser. Fund sponsors will need to carefully consider if and how they will continue to market to, and accept investments from, such investors.

Some alternatives that fund sponsors may consider include:

- Prohibit investments by IRAs and smaller plans that are not represented by an adviser who qualifies for the IF Exception,
- Ensure that they are not making a recommendation in marketing the fund that could constitute investment advice and thereby give rise to fiduciary status, although this may be quite difficult in the context of marketing a fund given the broad definition of investment advice, or
- Comply with the requirements of the Best Interest Contract Exemption (the BIC Exemption) promulgated by the DOL in conjunction with the issuance of the Fiduciary Rule and designed to deal with situations where the IF Exception is not available. However, the BIC Exemption has a number of onerous requirements (many of which will not be applicable until January 1, 2018) and is unlikely to be an attractive alternative to many fund sponsors.

Next Steps

Commencing June 9, 2017, fund sponsors may want to implement changes to their practices to comply with the Rule. Where the communications and activities will (or may) now constitute "recommendations," many fund sponsors will want to take steps to ensure that the IF Exception is available with respect to all ERISA plan and IRA investors. Some of the steps that we recommend such fund sponsors take include:

- Update offering documents, such as private placement memoranda and offering memoranda, to include disclosure consistent with utilization of the IF Exception.
- For all post-June 8, 2017, closings, update subscription documents to include representations designed to assure the availability of the IF Exception.
- Update responses to RFPs to address such representations via a negative consent process.
- Consult with ERISA counsel before accepting any new IRA or small plan investors or accepting any additional commitments from existing IRA or small plan investors, unless the IRA or small plan is being represented by an independent professional fiduciary.

During a transition period from June 9, 2017, to January 1, 2018, the DOL has stated that its focus will be on encouraging diligence and good faith compliance by fiduciaries rather than on enforcement. However, the private right of action available to ERISA investors remains an additional source of potential liability for any fund sponsor who is determined to be acting in a fiduciary capacity in marketing its fund. Finally, we note that the DOL's review of the Fiduciary Rule is ongoing. We anticipate that further developments may continue throughout 2017 and perhaps beyond.

For questions, please contact Scott Webster, Jack Cleary, Jim Mattus or any member of Goodwin's ERISA & Executive Compensation Practice or your regular Goodwin contact.

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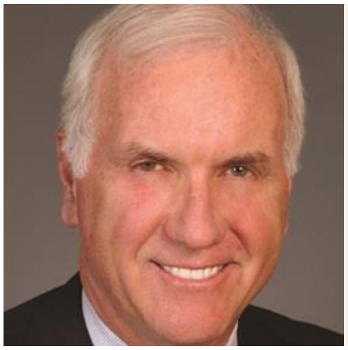

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