

The logo for K&L GATES, featuring the text in white on an orange rectangular background.

K&L GATES

A blurred background image of a city skyline at night, with lights from buildings and streets creating a bokeh effect.

2016 INVESTMENT MANAGEMENT CONFERENCE

ERISA For Investment Advisers

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OVERVIEW

- The Basics
- New Fiduciary Rule
- Fund Perspectives
- Disclosure Obligations



ERISA: THE BASICS

WHAT IS “ERISA”?

- Employee Retirement Income Security Act
- Federal law regulating benefit plans
- State laws preempted
- Other Federal laws (Advisers Act) apply

WHAT PLANS ARE COVERED BY ERISA?

- Corporate retirement plans
- Corporate “welfare” plans
- Union retirement/welfare plans
- “Taft-Hartley” plans

WHAT PLANS ARE NOT COVERED BY ERISA?

- Self-employed (“Keogh”) plans
- Individual retirement accounts

But, . . .

Internal Revenue Code Section 4975

WHAT PLANS ARE NOT COVERED BY ERISA?

(CONTINUED)

- Government plans
- Church plans
- Foreign plans

“FIDUCIARY” STATUS

The key ERISA concept

- Fiduciary status is “functional”
- Basic fiduciary functions include (but are not limited to):
 - Investment discretion
 - Investment advice (new DOL Fiduciary Rule impacts this)

FIDUCIARY DUTIES – GENERAL

- “Solely in the interest”; “exclusive purpose”
- Prudence; diversification
- Comply with plan documents
- Duty of disclosure – an evolving concept
- Avoid prohibited transactions
- Employer securities rules

CONSEQUENCES OF BREACH OF FIDUCIARY DUTY

- Restore “losses”
- Disgorge “profits”
- “Equitable relief”
- Excise tax under Code Section 4975
- “Correction” of prohibited transaction

FIDUCIARY DUTIES – PROHIBITED TRANSACTIONS

Two categories of prohibited transactions:

- **“Fiduciary” prohibited transactions** – transactions involving self-dealing or conflicts of interest by plan fiduciaries
- **“Party in interest” transactions** – transactions between a plan and a “party in interest” of the plan

“FIDUCIARY” PROHIBITED TRANSACTIONS

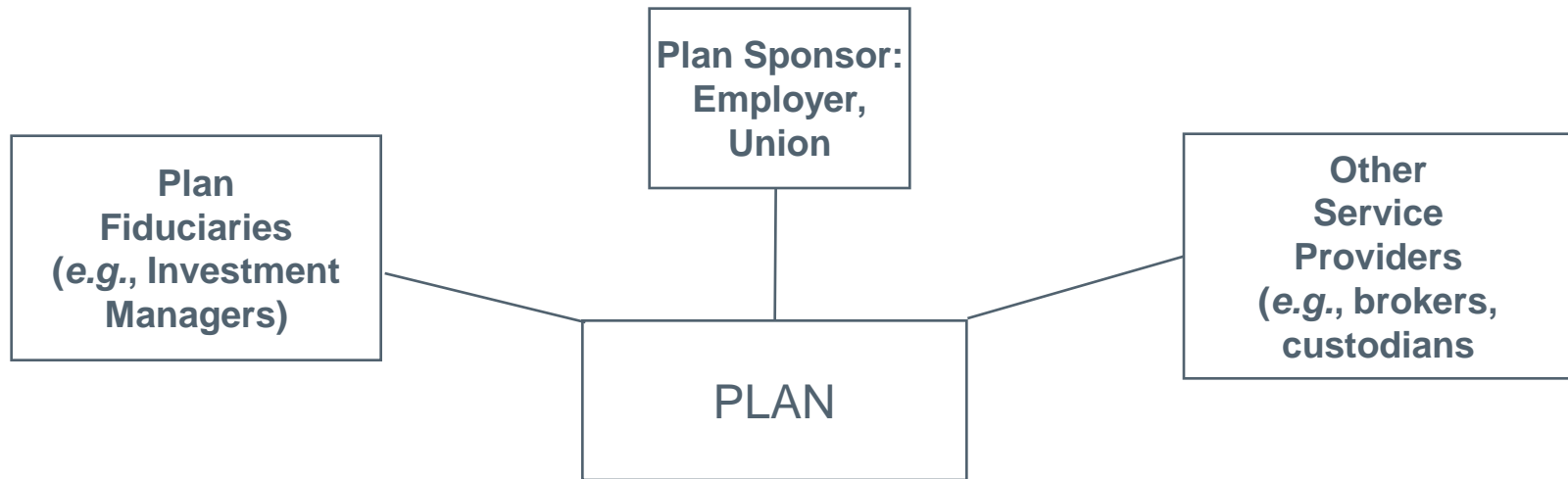
- Statutory prohibition against fiduciary self dealing and conflicts of interest
- General principles in DOL regulation
- Examples:
 - Compensation arrangements
 - Cross trades
 - “Kickbacks”

“PARTY IN INTEREST” PROHIBITED TRANSACTIONS

- Plan fiduciary may not cause plan to engage in any of following transactions if fiduciary knows or should know the transaction is with a “party in interest”:
 - Sale, exchange, lease
 - Loan, extension of credit
 - “Use” of plan assets for benefit of party in interest
 - Services

“PARTY IN INTEREST” PROHIBITED TRANSACTIONS

- Who is a “party in interest”?



And, certain affiliates and parties related to the persons described above



New Fiduciary Rule



OVERVIEW OF RULE

- Greatly expands the number of market participants that are ERISA fiduciaries by reason of providing investment advice
- Doesn't change "discretionary" fiduciary definition
- Advice is fiduciary investment advice if both (A) and (B) are met (No requirements of (i) regular basis, (ii) primary basis or (iii) mutuality):

(A)	(B)
<p><u>Types of advice</u> – Need one of the following recommendations:</p>	<p><u>Type of advice provider</u> – Need one of the following:</p>
<ul style="list-style-type: none"> • “Recommendations” regarding acquiring, holding, disposing of, or exchanging, securities or other investment property, including recommendations about how property should be invested after a rollover • “Recommendations” regarding the management of investment property, the selection of other persons to provide investment advice or management services, the selection of investment account arrangements, and recommendations regarding rollovers, transfers or distributions 	<ul style="list-style-type: none"> • Represents or acknowledges that it is acting as a fiduciary under ERISA or the Internal Revenue Code • Renders advice pursuant to an agreement, arrangement or understanding that the advice is based on the particular investment needs of the advice recipient • Directs the advice to a specific advice recipient regarding the advisability of a particular investment or management decision regarding plan assets



“RECOMMENDATION”

- Broadly includes statements that would reasonably be viewed as suggestions to take or refrain from taking a particular course of action
- Content, context and presentation inform the determination
- The more individually tailored the communication, the more likely it is a suggestion
- Consider promotional activities



CAN I AVOID FIDUCIARY STATUS?

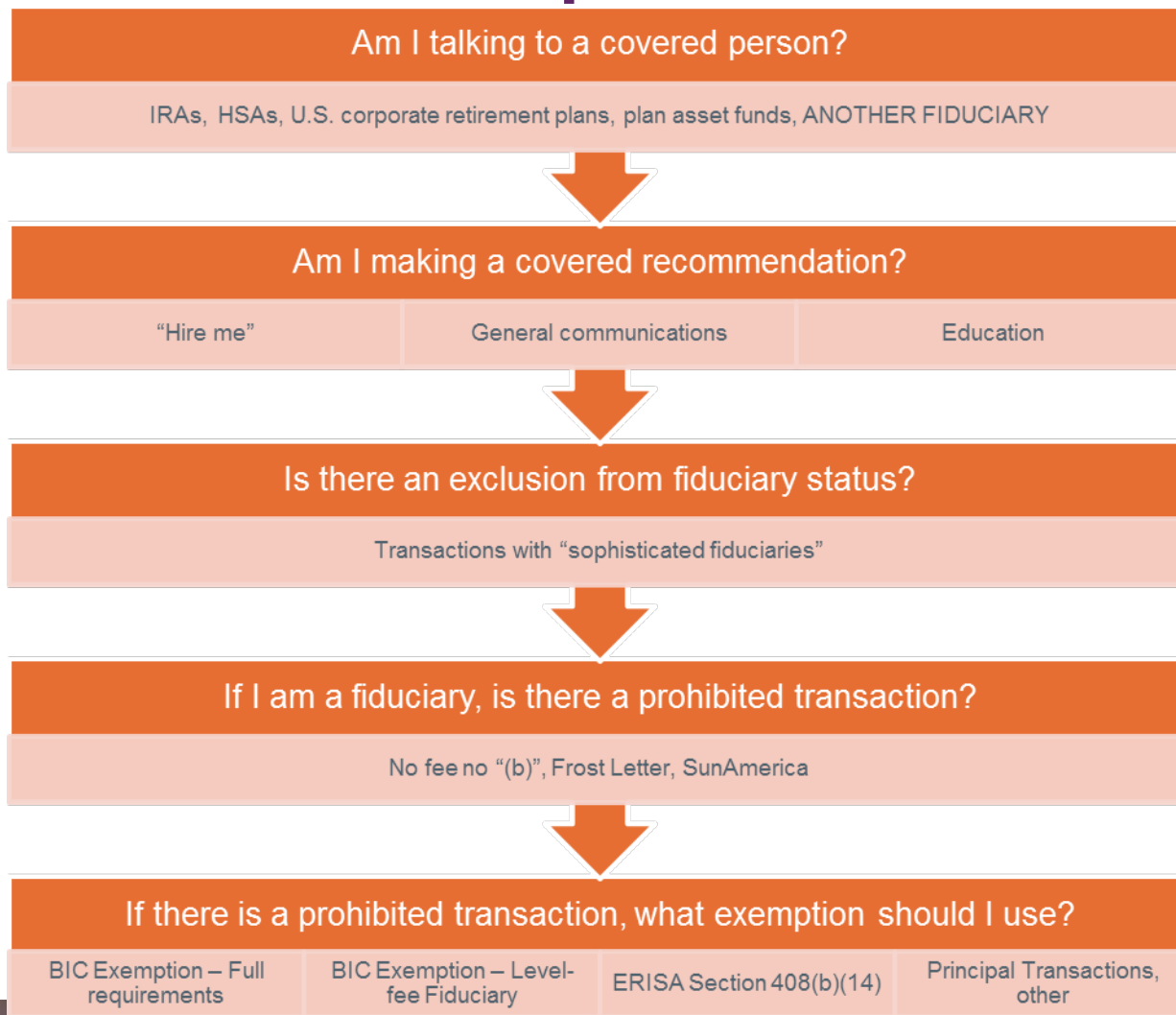
- “Hire Me”
- Investment education
- General communications
- Transactions with independent fiduciaries with financial expertise (“Sophisticated Fiduciary”)
 - Retail vs. Institutional Investors



BEST INTEREST CONTRACT EXEMPTION

- Allows otherwise impermissible compensation
 - 12b-1 fees
 - Commissions
 - Sales loads
 - Revenue-sharing payments
 - BUT fees to sales people are limited
- Not available for non-“riskless” principal transactions
- Compliance Burdens: Many requirements, including
 - Compliance with “Impartial Conduct Standards”
 - Policies and procedures
 - Disclosures
- Streamlined requirements for “level fee fiduciaries”

Analysis Overview – Consider both “promotional” and “operational” activities





ERISA AND INVESTMENT FUNDS

FUND PERSPECTIVE

- Mutual Funds
- Bank Collective Trusts
- Insurance Company Separate Accounts
- Private Investment (Hedge) Funds

DOES ERISA APPLY? (ARE FUND ASSETS “PLAN ASSETS”?)

If fund assets are “plan assets” –

- Fund manager is an ERISA “fiduciary”
- Plans have “undivided interests” in all fund assets
- Fund transactions subject to ERISA restrictions, including prohibited transactions
- Exculpation, indemnity of fund manager limited

“PLAN ASSETS”?

- Registered investment company – mutual fund or closed-end fund?
NO
- Bank collective trust fund
YES
- Insurance company pooled separate account
YES

WHAT ABOUT PRIVATE (HEDGE) FUNDS?

The “25% Test” –

Assets of a private investment fund are treated as “plan assets” if benefit plan investors hold 25% or more of any class of equity interests in the fund – *not counting* any interests held by the fund manager or its affiliates for their own account.

THE NUMERATOR: “BENEFIT PLAN INVESTORS”

- Defined in ERISA § 3(42):
 - Plans subject to ERISA
 - Plans subject to Code Section 4975
 - “Plan asset” funds

25% TEST – THE FORMULA

Numerator:

ERISA plans
plus Code 4975 plans
plus “Plan-asset” funds (ERISA “portion”) = 25%

Denominator:

Investments by all investors
less investments by fund manager and
“affiliates” (or more) per class?



DISCLOSURE OBLIGATIONS

OVERVIEW

- Schedule C of Form 5500
 - Plan administrator discloses “Service Provider Information” to DOL
 - However, service providers expected/required to provide information to plan administrator on request.
- Service Provider Exemption/ERISA 408(b)(2)
 - Disclosures from Covered Service Providers to plan fiduciary under ERISA 408(b)(2) regulation
- Participant Disclosures
 - Disclosures from plan administrator to plan participants under ERISA 404(a)
 - However, plan administrators will request info from providers of “designated investment alternatives.”

WHAT MUST BE DISCLOSED?

Schedule C (Form 5500)	Service Provider Exemption/408(b)(2)	Participant Disclosures
<ul style="list-style-type: none"> ▪ “Compensation” (money or “anything of value”), if \geq \$5000. ▪ Direct compensation ▪ Indirect compensation 	<ul style="list-style-type: none"> ▪ Services provided ▪ Status statement ▪ “Compensation” (anything of monetary value) – direct, indirect, termination, “offset” compensation 	<ul style="list-style-type: none"> ▪ Plan-related information ▪ Information related to “Designated Investment Alternatives”



CONCLUSION



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