2016 INVESTMENT MANAGEMENT CONFERENCE

ERISA Developments

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TOPICS

- Changing Retirement Landscape
  - New DOL fiduciary regulation
  - Litigation
- Risks for Investment Managers
Changing Retirement Landscape
RETIREMENT LANDSCAPE IS UNDERGOING DRAMATIC CHANGES

<table>
<thead>
<tr>
<th>Traditional defined benefit pension plans</th>
<th>401(k) plans</th>
<th>IRAs</th>
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<tbody>
<tr>
<td>~$2.8T in assets</td>
<td>~$6.8T in assets</td>
<td>~$7.4T in assets</td>
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<td>Beginning to wane as plans are closed, frozen, and terminated</td>
<td>Experiencing growth</td>
<td>Experiencing growth but may stagnate under the new DOL fiduciary regulation</td>
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Causes include:
- New DOL fiduciary regulation
- Litigation

Source: Investment Company Institute [www.ici.org/research/stats/retirement/ret_16_q2](www.ici.org/research/stats/retirement/ret_16_q2)
NEW DOL FIDUCIARY REGULATION

- In April 2016, the DOL issued a new regulation that redefines “investment advice fiduciary”
- Greatly expands the types of market participants deemed to be ERISA fiduciaries
- Alters key “prohibited transaction” exemptions
- Includes a new Best Interest Contract Exemption
- Many of the requirements are applicable beginning in April 2017
BROAD REACH

- Under the new fiduciary regulation, a fiduciary “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 “recommendation”
- Fiduciary recommendations must meet a “best interest” standard and raise conflict of interest considerations
- Pivotal Concern: Many activities currently considered to be “promoting” or “marketing” of investment products or services can now be captured as ERISA fiduciary “recommendations”
INSTITUTIONAL CLIENT APPROACH: SOPHISTICATED FIDUCIARY

- **Rule:** It is not fiduciary investment advice for a party to communicate with a sophisticated, independent fiduciary acting on behalf of a retirement client where there is no expectation of reliance

- **Requirements include:**
  - The party providing the advice knows or reasonably believes the fiduciary is a: (i) bank, (ii) insurance company, (iii) RIA, (iv) broker-dealer, or (v) party that holds or has under management or control at least $50M in assets
  - The party providing the advice informs the fiduciary that it is not providing impartial investment advice or giving advice in a fiduciary capacity
  - The party providing the advice knows or reasonably believes the fiduciary is a fiduciary under ERISA and/or the Internal Revenue Code with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction
  - The party providing the advice knows or reasonably believes the fiduciary is capable of evaluating investment risks independently, both in general and with regard to the particular investment
SOPHISTICATED FIDUCIARY: ACTION STEPS

- Develop and implement a process to promote adherence
- Training
- Add investor representations and investment manager disclosures to fund documents and IMAs
- Consider due diligence on the client’s fiduciary
RETAIL CLIENT APPROACH: BEST INTEREST CONTRACT EXEMPTION

- **Rule**: Permits promotional activities and allows investment advice fiduciaries to receive certain types of compensation that would otherwise be impermissible.

- **Requirements Include**:
  - Compliance with “impartial conduct standards”
  - Policies and procedures
  - Disclosures
  - “Level fee fiduciaries”
    - Streamlined requirements
    - A level fee is a fee or other compensation that is provided on the basis of a fixed percentage of assets or a set fee that does not vary with the particular investment recommended, rather than a commission or other transaction-based fee.
BIC EXEMPTION: ACTION STEPS

- Develop and implement a process to promote adherence
- Determine whether the streamlined requirements for level fee fiduciaries are available
- Draft model contracts and disclosures
- Identify material conflicts of interest
- Determine whether changes to business models are necessary
- Draft policies and procedures
LITIGATION

- Unlike securities laws, which are primarily based on the concept of full disclosure, ERISA regulates what “fiduciaries” may and may not do and does so in a manner designed to ensure that actions are in the best interests of retirement clients.

- ERISA class actions against fiduciaries have focused principally on (i) the soundness of investments, (ii) the reasonableness of compensation received by service providers and (iii) investments in employer stock.

- Proliferation of class actions in recent months.
ERISA CLASS ACTIONS

- ERISA class actions have alleged the following:
  - Failure to adequately monitor costs
  - Use of more expensive share classes when less expensive share classes were available
  - Use of proprietary funds that charged excessive fees
  - Use of actively managed funds that charged higher fees than index funds
  - Failure to use collective trusts and separately managed accounts
FOCUS ON PLANS MAINTAINED BY INVESTMENT MANAGERS

- A number of recent complaints target retirement plans maintained by investment managers for their employees alleging it is imprudent to offer proprietary funds
Risks for Investment Managers
# PRINCIPAL RISKS

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<tr>
<th>Risk</th>
<th>Mitigation</th>
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<tr>
<td>Becoming a fiduciary when selling/promoting services to clients</td>
<td>1. General communications exception</td>
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<td>(prior to contract engagement or product/service selection)</td>
<td>2. Investment education exception</td>
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<td>3. “Hire me” concept</td>
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<td>4. Sophisticated fiduciary or BIC Exemption</td>
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<td>Failure to adjust to new environment of heightened focus on fees/expenses</td>
<td>1. Review internal analytics to ensure appropriate emphasis on fees/ expenses of underlying fund products and manager strategies</td>
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<td>Litigation Risk</td>
<td>1. Enhance internal process</td>
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<td>2. Learn from current litigation</td>
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