

The U.S. Department of Labor's New Conflict of Interest Regulation – Implications for Non-U.S. Investment Managers

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TOPICS

- Background
- Conflict of Interest Regulation
- Considerations When Selling/Promoting Products and Services
- Considerations When Managing U.S. Retirement Assets



Background



ERISA

- U.S. federal retirement statute
- Complex system of laws and regulations
- Imposes duties, responsibilities and liabilities on fiduciaries and other service providers to employee benefit plans

ERISA *(continued)*

- ERISA is different
 - Includes per se prohibited transactions – in effect, it is unlawful for an ERISA fiduciary to act when it has a conflict of interest, unless a prohibited transaction exemption is available
 - Restrictions cannot be altered contractually
 - Disclosure is not a remedy

TODAY, FUND MANAGERS–

May be subject to ERISA

- A fund manager is subject to ERISA, if the fund passes a certain threshold of ownership by “benefit plan investors”
- Exceptions for mutual funds and private equity funds that meet the requirements to be real estate operating companies and venture capital operating companies

“PLAN ASSET REGULATION”

- Sets the threshold of “benefit plan investors” that causes the assets of a private fund to be ERISA assets
- Generally, if “benefit plan investors” own 25% or more of any class of a fund’s equity interests:
 - The entity will be a plan asset vehicle
 - The manager will be an ERISA fiduciary with respect to each ERISA investor

BENEFIT PLAN INVESTORS

Type of Investor	Benefit Plan Investor?
U.S. private sector retirement plan	Yes
Taft-Hartley (union) plans	Yes
U.S. employer-funded medical plans	Yes
Commingled fund or collective investment trust (other than a registered investment company)	Maybe
Retirement and medical plans for U.S. federal, state or local government employees	No
IRAs and Keogh plans	Yes
Non-U.S. retirement and medical plans	No
Insurance company general accounts	Maybe

NEW REGULATIONS

- Do not change these rules
- Have implications for managers that sell products and services to U.S. retirement clients, even when a fund itself is not subject to ERISA



Conflict of Interest Regulation



UNDER ERISA

One can become a fiduciary by:

- ***Discretionary Fiduciaries.*** Exercising discretionary authority or discretionary control with respect to the management of a plan or its assets or having discretionary authority over the administration of a plan or
- ***Investment Advice Fiduciaries.*** Rendering investment advice to a plan for a fee or other compensation or having any responsibility to do so; regulations define the scope

INVESTMENT ADVICE – OLD REGULATION

Advice is fiduciary investment advice if five elements are met:

- 1 Render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property
- 2 On a regular basis
- 3 Pursuant to a mutual agreement, arrangement or understanding
- 4 That the advice will serve as a primary basis for investment decisions
- 5 The advice is individualized to the needs of the plan

INVESTMENT ADVICE – NEW REGULATION

Advice is fiduciary investment advice if both (A) and (B) are met

(A)	(B)
Need one of the following recommendations:	Need one of the following:
<ul style="list-style-type: none">• Recommendation regarding acquiring, holding, disposing of, or exchanging securities or other investment property, including recommendations about how property should be invested after a rollover• Recommendation regarding the management of investment property, the selection of <u>other persons</u> 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">• Advice provider represents or acknowledges that it is acting as a fiduciary under ERISA or the Internal Revenue Code• Advice is rendered pursuant to an agreement arrangement or understanding that the advice is based on the particular investment needs of the advice recipient• Advice is directed to a specific 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

EXCLUSIONS

- Platform providers
- Selection and monitoring assistance
- Investment education
- General communications
- Transactions with independent fiduciaries with financial expertise (“Sophisticated Fiduciary”)
- Swap counterparties
- Plan sponsor employees

PROHIBITED TRANSACTION EXEMPTIONS

- Statutory or administrative authority that permits certain activities
- The new regulations include new exemptions and amend several existing exemptions
- Best Interest Contract Exemption (“BIC Exemption”) is the centerpiece of the new and revised exemptions

BIC EXEMPTION

- Permits promotional/sales activities
- Many requirements, including:
 - Compliance with “Impartial Conduct Standards”
 - Policies and procedures
 - Disclosures

BIC EXEMPTION – LEVEL FEE FIDUCIARY

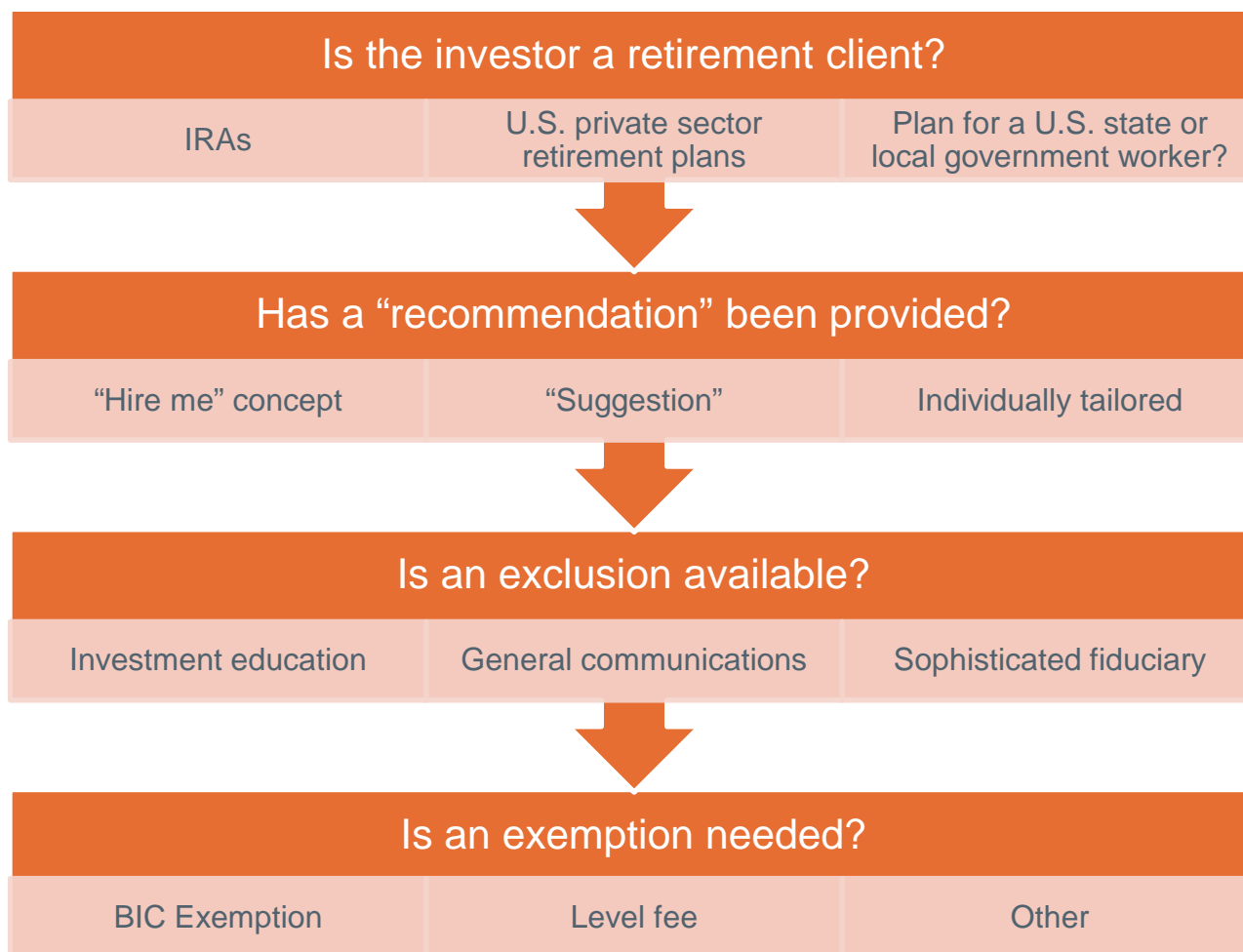
- A “level fee fiduciary” receives only a fixed fee or fee based on a fixed percentage of AUM
- Streamlined requirements
 - Written statement of adviser and financial institution’s fiduciary status
 - Comply with the impartial conduct standards
 - Document “best interest” basis for the recommendation (in many cases)



Considerations when Selling/Promoting Products and Services



ANALYSIS OVERVIEW



SCENARIO 1: CROSS-SELLING FUNDS

- Situation: Manager of private funds is looking to raise money for a new fund from existing institutional investors
- Analysis:
 - Recommendation?
 - Exclusions?
 - Exemption?

“HIRE ME”

- Can one have a “hire me” discussion with a prospective client touting the quality of the firm without becoming a fiduciary?
 - Combining a “hire me” discussion with a recommendation of a particular product or investment program is fiduciary investment advice
- According to the DOL:
 - The regulation “draws a line between an adviser’s marketing of the value of its own advisory or investment management services, on the one hand, and making recommendations to retirement investors on how to invest or manage their savings on the other”

EXCLUSION: INVESTMENT EDUCATION

- **Rule:** It is not fiduciary investment advice to furnish certain types of investment-related information and materials to a plan, plan fiduciary, plan participant or IRA
- **Limitation:** With limited exceptions, the information and materials cannot include recommendations with respect to:
 - Specific investment products
 - Specific plan or IRA alternatives
 - Investment or management of particular securities or other investment property

EXCLUSION: GENERAL COMMUNICATIONS

- **Rule:** It is not fiduciary investment advice to furnish or make available general communications that a reasonable person would not view as an investment recommendation
- **Examples:**

- General circulation newsletters
- Commentary in publicly broadcast talk shows
- Remarks and presentations in widely attended speeches and conferences
- Research or news reports prepared for general distribution

- General marketing materials
- General market data, including data on market performance, market indices or trading volumes
- Price quotes
- Performance reports
- Prospectuses

SCENARIO 2: INTERMEDIARIES

- Situation: Private fund manager works with consultants to sell funds to investors
- Analysis:
 - Recommendation?
 - Exclusions?
 - Exemption?

INTERMEDIARIES

- Pension plans often hire consultants to provide advice regarding private funds
- Different business offerings
 - Some have traditionally taken the position that they are not ERISA fiduciaries
 - Under the new regulations, it is difficult to envision a scenario where a consultant is not an ERISA fiduciary

EXCLUSION: SOPHISTICATED FIDUCIARY

- **Rule:** It is not fiduciary investment advice to communicate with sophisticated independent fiduciaries where there is no expectation of reliance
- **Requirements include:**
 - Advice provider is independent of the advice recipient (i.e., the independent fiduciary)
 - Advice provider knows or reasonably believes the advice recipient is one of the following: (i) bank, (ii) insurance company, (iii) RIA, (iv) broker-dealer or (v) a party that holds or has under management or control at least \$50M in assets
 - Advice provider fairly informs the advice recipient that the advice provider is not providing impartial investment advice or giving advice in a fiduciary capacity
 - Advice provider does not receive compensation directly from the plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner for the provision of investment advice (as opposed to other services) in connection with the transaction

SCENARIO 3: NEW FUND; NEW MANAGER

- Situation: (a) Manager to begin offering a new fund or (b) new manager to begin operations
- Analysis:
 - Investor/gatekeeper due diligence – More extensive? More frequent? Formalized?
 - Herd mentality
 - Fees – Heightened focus?

FEES

- Fiduciaries are required to adhere to the impartial conduct standards, including the requirement to provide advice that is in the client's best interest and to charge no more than reasonable compensation
- Advisers subject to these standards may favor less expensive options thereby increasing the downward pressure on fees
- Pressure to offer lower cost investment options could limit the range of investment options available, such as alternative asset classes

SCENARIO 4: PROPRIETARY PRODUCTS

- Situation:
 - Adviser recommends a retirement client invest in a proprietary fund
 - Adviser has an advisory agreement with client
 - Adviser does not have an advisory agreement with client
- Analysis:
 - Recommendation?
 - Exclusion?
 - Exemption?
 - Level fee?



Considerations when Managing U.S. Retirement Assets



PROHIBITED TRANSACTION EXEMPTIONS

- The regulations amended several prohibited transaction exemptions (PTEs)
- Managers should take an inventory of all PTEs relied upon and determine whether any have been amended
- If a relevant PTE has been amended, the manager may need to change its processes to ensure compliance or to adhere to a different PTE

SERVICE PROVIDERS

- Service providers may:
 - Make changes to service offerings
 - Require the manager to make new representations

FINAL THOUGHTS

- Determine approach for distribution
 - Work with distribution partners
 - Perform business training
 - Amend model investor representations
- Review contracts
 - Investors
 - Service providers
- Review PTEs relied upon



Questions



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