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Fiduciary Duty

Steps Hedge Fund Managers May Take Today to Avoid Being Deemed a Fiduciary Under the DOL's New Fiduciary Rule

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By Robert Sichel, *K&L Gates LLP*

In February 2017, many investment advisers were relieved when President Trump ordered the Department of Labor (DOL) in a presidential memorandum to evaluate the likely impact of the "Definition of the Term 'Fiduciary': Conflict of Interest Rule – Retirement Investment Adviser" (Fiduciary Rule), which was originally scheduled to become applicable on April 10, 2017. Many industry participants hoped that this reevaluation would lead to a lengthy or permanent delay of the Fiduciary Rule, which, in its current form, expands the range of persons considered "fiduciaries" under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (Code).

While a delay was eventually granted by the DOL, it was limited to 60 days. Consequently, the initial set of requirements under the Fiduciary Rule became applicable on June 9, 2017. Hedge fund managers therefore may need to take steps to ensure they are not deemed fiduciaries under the rule in connection with their marketing activities.

This article provides an overview of the Fiduciary Rule, identifies the types of activities that may trigger fiduciary status thereunder, addresses common misconceptions under the rule and provides a roadmap for how a manager can avoid becoming a fiduciary under the Fiduciary Rule in connection with its marketing activity.

For a discussion of the evaluation of the Fiduciary Rule ordered by President Trump, see "Despite the DOL Fiduciary Rule's Uncertain Future Under the Trump Administration, Managers Should Continue Preparing for Its April 2017 Implementation (Part Two of Two)" (Feb. 23, 2017).

Background of the Fiduciary Rule

Expanding the Definition of Fiduciary Under ERISA and the Code

An investment manager can become a fiduciary under ERISA or the Code by:

1. becoming a "discretionary fiduciary" by exercising discretionary authority or discretionary control with respect to the management of an employee benefit plan covered by ERISA (Plan) or an individual retirement account (IRA); or

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2. becoming an "investment advice fiduciary" by rendering investment advice to a Plan or IRA for a fee or other compensation or by having responsibility to do so.

The DOL recently finalized the Fiduciary Rule, which redefines an investment advice fiduciary. The Fiduciary Rule has the effect of greatly expanding the scenarios under which service providers to Plans and IRAs, such as investment managers, are acting as investment advice fiduciaries.

What Constitutes Fiduciary Investment Advice?

Under the Fiduciary Rule, fiduciary investment advice includes certain "recommendations" or statements that would reasonably be viewed as suggestions to take or refrain from taking a particular course of action. According to the DOL, content, context and presentation inform the determination of whether a communication constitutes a fiduciary recommendation. Also, the more individually tailored the communication, the more likely it is to be a fiduciary recommendation.

In drafting the Fiduciary Rule, the DOL expressed specific concern for protecting individual Plan participants and IRA owners from "conflicted advice"; however, the Fiduciary Rule has wide-ranging consequences outside of the retail investor context. Under the new, broad definition of fiduciary, "investment advice" activities commonly associated with sales and marketing – which previously were not considered to be fiduciary in nature – may now be considered fiduciary investment advice.

When marketing a fund to an ERISA investor or its fiduciary adviser, such as a consultant, a marketing person may make a statement similar to the following: "Your plan should invest in our fund because our returns are uncorrelated to your other managers." This statement could constitute fiduciary investment advice because the statement is a call to action tailored to the investor.

Traditionally, investment managers avoided ERISA fiduciary status in similar circumstances through a number of safeguards. First, advisers made sure there was no "mutual understanding" between the manager and the investor that the manager was providing investment advice when selling. Investment managers accomplished this by (1) including disclaimers on marketing materials; and (2) obtaining investor representations and acknowledgements in subscription agreements and investment management agreements that there was no mutual understanding that the marketing material would serve as a primary basis for investment decisions. A second approach was to take the position that any advice that may have been provided was not done so on a "regular basis." Neither approach will be effective to avoid fiduciary status under the new Fiduciary Rule.

Consequences of Fiduciary Status

If fiduciary status attaches to an investment manager as a result of the adviser promoting its products and services to ERISA and IRA investors, the investment manager is prohibited from using the authority, control or responsibility which makes it a fiduciary to cause the investor to pay an additional fee to the investment manager or an affiliate of the investment manager (or other person in which the investment manager has an interest which may affect the exercise of the investment manager's best judgment as a fiduciary). Therefore, the investment manager could not accept the investment into one of its funds and begin earning a management fee. As a

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result, changes to the way investment managers market their products and services may be necessary.

How to Avoid Fiduciary Status Under the Fiduciary Rule

Despite the expansion of the definition of fiduciary under the Fiduciary Rule, there are still ways for advisers to market to ERISA investors and IRAs without being deemed to be an ERISA investment advice fiduciary.

First, general communications that a reasonable person would not view as investment recommendations, such as providing performance reports or prospectuses, are not fiduciary in nature (the so-called "general communication exception").

Second, furnishing certain types of investment-related information and materials that are educational in nature is not deemed to constitute fiduciary investment advice (the so-called "investment-education exception").

Third, a marketing professional can have a "hire me" discussion with a prospective investor, touting the quality of the investment manager without becoming a fiduciary (the so-called "hire me concept"). The DOL, however, has cautioned that combining a hire me discussion with a recommendation of a particular product or investment program constitutes fiduciary investment advice.

Finally, communications between an investment manager and a sophisticated, independent fiduciary acting on behalf of a retirement investor, where there is no expectation of reliance, does not constitute fiduciary investment advice (the so-called "independent fiduciary exception").

Misconceptions and Clarifications

Three Common Misconceptions

A common belief by many private fund managers is that "my marketing professionals do not provide investment advice."

There are cases where the marketing activity by the manager's business development team does not involve investment advice or recommendations as described by the DOL and will not therefore result in the manager being deemed a fiduciary under the Fiduciary Rule. For example, an investor may find a fund or investment manager through a database search or may seek out a fund and ask due diligence questions that lead to factual responses about the fund or the manager.

There is a risk, however, that marketing communications beyond the scope of these two circumstances will include statements that could reasonably be viewed as suggestions to take a particular course of action. For example, the communications may be tailored to the specific investor (*i.e.*, the investor's specific circumstances may be considered in formulating the communication). Therefore, marketing professionals may be providing fiduciary investment advice under the new Fiduciary Rule, unless one of the exceptions outlined above applies.

Two additional erroneous beliefs include: "I am already a fiduciary under ERISA, so the Fiduciary Rule does not impact me"; and "I do not have to deal with the Fiduciary Rule because

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my fund is not an ERISA plan assets fund (*e.g.*, ERISA and IRA participation is below the 25 percent threshold)."

In determining whether the new Fiduciary Rule has implications for an investment manager, it is irrelevant whether the manager is managing a plan assets or non-plan assets fund. The new Fiduciary Rule has implications if the manager is marketing its products and services to in-scope investors such as Plans and IRAs.

How Hedge Fund Managers Can Avoid Fiduciary Status Under the New Rule

Step One – Evaluate All Marketing Activities

Managers are advised to identify all of their marketing activities and then determine whether each activity could constitute fiduciary investment advice under the new Fiduciary Rule.

Marketing activities take many forms, such as responding to requests for proposals, meeting with investors and sending investors written materials. Each type of activity should be reviewed to see if the general communication exception, the investment-education exception, the hire me concept or a combination of these approaches is available to provide relief.

If none of the exceptions provides relief, the marketing may constitute fiduciary investment advice, and for IRAs and smaller Plan investors, an investment manager may need to rely on the "Best Interest Contract Exemption" (discussed in Step Three below) to avoid a prohibited transaction under ERISA and the Code when the investment manager begins earning a management fee. For institutional Plan investors, an investment manager may need to rely on the independent fiduciary exception (discussed in Step Two below) to avoid being deemed a fiduciary under ERISA.

Step Two – Apply Independent Fiduciary Exception

Managers should determine whether communications with consultants and investors are covered by the independent fiduciary exception to the Fiduciary Rule.

The new Fiduciary Rule includes a very helpful exception that allows investment managers to communicate with certain parties (independent, sophisticated fiduciaries) without the communications causing the investment manager to become an ERISA fiduciary. The exception may provide relief for communications with consultants and other gatekeepers and, in some cases, communications directly with a potential investor.

An investment manager has the burden of proving that the requirements of the independent fiduciary exception are met. To satisfy the exception, the independent fiduciary receiving the communication must be a bank, insurance company, registered investment adviser, registered broker-dealer or a party with at least $50 million in assets under its management or control. If a party is responsible for multiple pools of assets, such as some Taft-Hartley trustees, the pools can be combined for purposes of the $50 million test. For example, if a trustee is responsible for a $30 million welfare plan and a $40 million retirement plan, the $50 million test is met.

In order to rely upon the independent fiduciary exception, the investment manager must inform the independent fiduciary (1) that the investment manager is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity with respect to the

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transaction; and (2) of the existence and nature of the investment manager's financial interests in the transaction. In addition, an investment manager looking to rely on the exception must know or "reasonably believe" that the independent fiduciary (1) is a fiduciary under ERISA or the Code with the responsibility to exercise independent judgment in evaluating the transaction; and (2) has the capability to evaluate investment risks.

Reliance on written representations from the independent fiduciary will satisfy the reasonable belief requirement. In May 2017, the DOL issued guidance in the form of FAQs. In response to question 13, the DOL confirmed that negative consent to a written representation can be a written representation for purposes of the reasonable belief requirement. Some investment managers, therefore, have elected to send negative consent representation and disclosure letters to their distribution partners, such as consultants. The letters state that if the recipient does not respond to the investment manager within a specified number of days, the recipient will be deemed to agree with the letter's contents.

Some investment managers are also adding representations and disclosures to their fund documents, such as their subscription agreements and private placement memoranda, to help foster adherence to the independent fiduciary exception to the new Fiduciary Rule. Others are having their investors complete a supplement to the subscription agreement.

An investment manager should also consider contacting existing investors regarding the independent fiduciary exception prior to marketing subsequent funds or seeking additional capital contributions from an existing investor. An investment manager may currently be a fiduciary to the existing investor over the money that is currently invested in the fund but should seek to avoid becoming an investment advice fiduciary in connection with the investor's decision to invest additional money either in the same fund or a subsequent fund. Should these communications go beyond the hire me concept or not fit within the general communication or investment-education exceptions, the investment manager may need to rely on the independent fiduciary exception to avoid becoming an investment advice fiduciary.

Step Three – Decide Whether to Continue Marketing

Managers will need to determine whether to continue marketing to IRA and smaller Plan investors.

An IRA account holder cannot meet the independent fiduciary exception regardless of the level of assets in the IRA account. Some smaller Plan investors may not meet the $50 million minimum to be a sophisticated, independent fiduciary (although, as discussed, separate pools of assets may be aggregated for purposes of meeting the $50 million test).

The independent fiduciary exception will not provide relief for larger Plans if the fiduciaries do not possess adequate financial sophistication.

If such investors are not represented by an independent fiduciary that meets the requisite criteria for the independent fiduciary exception, an investment manager must decide whether to market to those investors and rely on a prohibited transaction exemption called the "Best Interest Contract Exemption." The Best Interest Contract Exemption has numerous requirements that are currently scheduled to become applicable on January 1, 2018.

Between now and January 1, 2018, parties looking to rely on the Best Interest Contract Exemption must comply with "impartial conduct standards," which require the investment manager to:

1. act in the best interest of the investor;

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2. not make materially misleading statements to the investor; and
3. not charge the investor more than reasonable compensation.

Investment managers looking to comply with the impartial conduct standards may want to have written procedures to promote adherence with these requirements.

Rather than deal with the impartial conduct standards and the more complex rules that are currently scheduled to become applicable on January 1, 2018, some managers may choose not to market to IRAs and smaller Plans, unless the investors are represented by an independent fiduciary that meets the requisite criteria for the independent fiduciary exception. The Fiduciary Rule, therefore, may have the effect of causing IRAs and smaller Plans to hire advisers so that the investors can continue to access private funds.

Conclusion

The longer-term status of the new Fiduciary Rule is not settled as the Trump administration directed the DOL to (1) examine whether the Fiduciary Rule may adversely affect the ability of Americans to gain access to retirement information and financial advice; and (2) prepare an updated economic and legal analysis concerning the likely impact of the rule as part of that examination. Challenges to the new Fiduciary Rule also continue to wend their way through the courts.

Some of the rule's requirements, however, are now applicable. Hedge fund and other private fund managers, therefore, regardless of whether they currently manage plan assets funds, may need to alter the way they market their products and services to in-scope investors, such as Plans and IRAs as well as intermediaries and gatekeepers such as consultants.

Robert Sichel is a partner in the New York office of K&L Gates, where he is a member of the investment management practice group and oversees the ERISA fiduciary practice. He has extensive experience helping financial institutions and corporate retirement plans navigate the complexities of ERISA, as well as issues under the Dodd-Frank Act that pertain to "special entities." Sichel's practice focuses on advising investment managers and other financial institutions on the fiduciary responsibility and prohibited transaction rules of ERISA; assisting investment managers with drafting and implementing ERISA-related policies and procedures; providing training and compliance advice with respect to DOL prohibited transaction exemptions; and drafting and negotiating investment management agreements, fund documents, side letters and trading-related agreements (such as ISDAs, clearing agreements, futures agreements, securities lending agreements and prime brokerage agreements) on behalf of financial institutions, investment managers and institutional investors.

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