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THE DOL'S NEW INVESTMENT ADVICE REGULATION

May 2, 2016

The U.S. Department of Labor (the "DOL") recently published its controversial final regulation (the "Regulation") amending rules that had been in place since 1975 concerning when a person is deemed to be a "fiduciary" of a pension plan ("Plan") or individual retirement account ("IRA") by reason of providing investment advice to the Plan or IRA. The stated purpose of the Regulation is to mitigate the adverse impact on retirement savers of conflicts of interest inherent in the market for financial products purchased with retirement savings. The Regulation fundamentally changes how the fiduciary responsibility provisions of U.S. pension law apply to financial institutions that deal with retirement assets. The Regulation is scheduled to become effective generally on April 10, 2017. This memorandum briefly summarizes the Regulation, analyzes the resulting regulatory framework and discusses important issues concerning its application in certain contexts.

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Statutory and Regulatory Framework

1. ERISA Fiduciary Duties. A principal focus of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), as the statutory name clearly suggests, is to enhance the likelihood of payment (that is, the security) of retirement income (that is, pension) promises made to employees. Towards that end, part 4 of Subpart B of Title I of ERISA includes a handful of core provisions, mostly borrowed from trust law, concerning the obligations of Plan "fiduciaries," including the obligation of fiduciaries to act prudently and *solely* in the interest

of Plan participants and beneficiaries and to not deal with Plan assets in their own interest, represent both sides in a transaction involving a Plan or take payments from third parties in connection with a transaction involving Plan assets (usually referred to as an "anti-kickback" rule). A person's status as a fiduciary of a Plan is, obviously, the threshold question as to that person's responsibilities under these provisions.

2. Definition of "Investment Advice". There are three alternative standards under ERISA by which a person can become a "fiduciary." A person is a fiduciary of a Plan if he exercises discretion over the management or disposition of Plan assets, provides investment advice to the Plan for compensation or has discretionary authority or responsibility in connection with the administration of the Plan. The Regulation is only concerned with the investment advice prong of the definition. The statutory language reads as follows:

> A person is a fiduciary with respect to a plan to the extent . . . (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so.

In 1975, a year after ERISA was enacted, the DOL fleshed out that statutory language in its regulations as follows:

> A person shall be deemed to be rendering "investment advice" . . . only if . . . (B) [he] renders any advice [as to *the value of securities or other property*, or makes recommendation as to *the advisability of investing in, purchasing, or selling securities or other property*] on a *regular basis* to the plan pursuant to a *mutual agreement*, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a *primary basis* for investment decisions with respect to plan assets, and that such person will render *individualized investment advice* to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.

The italicized phrases in the language above are added to highlight the five principal components of the old definition.

The Regulation modifies the rule for determining when a person is deemed to be rendering "investment advice" as follows:

> A person shall be deemed to be rendering investment advice . . . if — (1) Such person provides . . . the following types of advice for a fee or other compensation, direct or indirect: (i) A recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, or a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA; (ii) A recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., brokerage versus advisory); or [(iii)] Recommendations with respect to rollovers,

transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer, or distribution should be made; and

> (2) With respect to the investment advice described in [the preceding clause (1)], the recommendation is made either directly or indirectly (e.g., through or together with any affiliate) by a person who: (i) Represents or acknowledges that it is acting as a fiduciary within the meaning of the Act or the Code; (ii) Renders the advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the advice recipient; or (iii) Directs the advice to a specific advice recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.

Parsing the Regulation compared to the old five-part test, it can be seen that the new language (1) substantially broadens the type of advice that could give rise to fiduciary status to include, for example, advice about manager selection, the decision to rollover from a Plan to an IRA and the decision to convert from a commission-based account to an account that charges a fixed fee based on assets under management, (2) eliminates the "regular basis" and "primary basis" aspects of the old test, and (3) eliminates the need for a "mutual" agreement to form the basis for a fiduciary relationship of trust. In sum, the Regulation substantially widens the scope of the phrase "investment advice."

The Regulation goes on to define the term "recommendation," which is key to the application of the new definition of "investment advice," as follows:

> For purposes of this section, "recommendation" means a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action. The determination of whether a "recommendation" has been made is an objective rather than subjective inquiry. In addition, the more individually tailored the communication is to a specific advice recipient or recipients about, for example, a security, investment property, or investment strategy, the more likely the communication will be viewed as a recommendation. Providing a selective list of securities to a particular advice recipient as appropriate for that investor would be a recommendation as to the advisability of acquiring securities even if no recommendation is made with respect to any one security. Furthermore, a series of actions, directly or indirectly (<u>e.g.</u>, through or together with any affiliate), that may not constitute a recommendation when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program.

Although the DOL specifically declined to adopt the Financial Industry Regulatory Authority ("<u>FINRA</u>") standard for "recommendation," it took "an approach to defining 'recommendation' that is consistent with and based upon FINRA's approach" and also tracked guidance of the Securities and Exchange Commission (the "<u>SEC</u>") under the Investment Advisers Act of 1940 (the "<u>Advisers Act</u>"). Indeed, the preamble makes clear that "communications that require the adviser to comply with suitability requirements under applicable securities or insurance laws will be viewed as a recommendation" under the

Regulation. While reference to practice under these other standards may be helpful, the DOL also clearly stated that while it "aimed to avoid conflict with other federal laws and minimize duplicative provisions between ERISA, the Code and federal securities laws …ERISA and the Code establish consumer protections for some investment advice that does not fall within the ambit of federal securities laws, and vice versa."

Also, while the regulatory language specifies that the test is "objective," it is clearly not a "bright-line" test. Instead, the word "objective" is intended to convey that whether a communication should be viewed, in context, as a suggestion that the recipient act (or refrain from acting) should be based on a "reasonableness" standard. Clearly, the application of the standard in a particular setting requires a subjective judgment that could be questioned in hindsight. As a result, substantial uncertainty and risk attach to any communication that might be viewed as a "suggestion" relating to the investment of Plan assets.

Similarly, the DOL argues in the release accompanying the Regulation that the definitions set forth above retain a meaningful distinction between typical marketing communications that seek only to tout the excellence of a particular service provider, and those that sell a product (the so-called "hire me" exception). The argument is, in effect, that marketing a firm is different than marketing a particular investment product. While there may be substance to that distinction in certain circumstances, relying on that type of distinction in some contexts – for example, in the context of an investment manager with a narrowly focused range of product types – will entail substantial risks.

In sum, whatever one's view of the objective of the Regulation, replacement of a longstanding and fairly well-understood standard with a new vague and "contextual" standard will have the effect of creating significant uncertainty and risk concerning the identification of fiduciaries, a key concept underlying the fundamental policy of ERISA, as well as great complexity for financial service providers attempting to adjust their business conduct to conform to the new regulatory approach.

3. <u>IRAs, Plans and the Prohibited Transaction Rules</u>. IRAs are not subject to ERISA, because they are not plans established by employers for their employees. As a result, fiduciaries of IRAs are not obligated to act prudently and *solely* in the interest of the IRA, unlike fiduciaries to Plans. However, persons who interact with IRAs and Plans are subject to a penalty tax provision of the Internal Revenue Code of 1986 (the "<u>Code</u>") that mirrors certain of the fiduciary conflict of interest rules of ERISA, as well as other "prohibited transaction" rules also found in ERISA. The prohibited transaction rules prohibit persons with relationships to Plans or IRAs, including service providers (whether or not the services give rise to fiduciary status) (defined as "disqualified persons" in the Code and "parties in interest" in ERISA), from transacting with Plans or IRAs unless a specific exemption is available. While the tax rules do not directly provide fiduciary standards of conduct, they do prohibit actions that violate the self-dealing and anti-kickback fiduciary provisions of ERISA. The tax is imposed on "any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such)." Pursuant to an interagency agreement, the DOL has, since 1978 been delegated the authority to issue regulations, rulings, opinions and exemptions under these provisions of the Code.

4. <u>Framework Summary</u>. In sum, ERISA and, to a somewhat limited extent with respect to IRAs, the Code impose standards of fiduciary conduct on certain persons who deal with Plans and IRAs. The Regulation's expansion of the definition of "investment advice" substantially

broadens the scope of persons who will be deemed to be fiduciaries. The principal challenges arising from the Regulation are therefore as follows:

a. Identifying New Advice Fiduciaries Under the Regulation. Financial services providers who under the old rules were not fiduciaries, but who will potentially become advice fiduciaries by reason of the Regulation, must carefully consider whether they can continue to avoid fiduciary status through a combination of careful interpretation and application of the Regulation and adjustments to the manner in which they carry on their business. Though the Regulation includes some provisions, in addition to those mentioned above, that are intended to clarify the application of the Regulation in specific business contexts, the uncertainty inherent in the new definition of "investment advice" means that an approach to applying the rules that relies on fine-tuned distinctions may result in risk some firms will be unwilling to bear.

b. Application of the Fiduciary Rules to New Fiduciaries. If a financial services provider will become an advice fiduciary by reason of the Regulation, consideration must be given to how it needs to change the conduct of its business in light of its new fiduciary status. In connection with the adoption of the Regulation, the DOL has also adopted two new prohibited transaction exemptions to provide some relief from the consequences of persons becoming advice fiduciaries. One of the new exemptions is a "Best Interest Contract" exemption (the "BIC Exemption") that permits an advice fiduciary to give advice in situations in which it has an interest (for example, providing advice that a Plan or IRA execute a securities transaction that might lead to its receipt of a commission), in certain contexts and subject to substantial conditions. The second is a new "Principal Transactions" exemption that permits advice fiduciaries to enter into principal transactions in certain property with Plans and IRAs, subject again to substantial conditions (the "Principal Transactions Exemption").

Contextual Background

Potential new advice fiduciaries essentially have one year to react to the Regulation (unless effectiveness is delayed through the political process or litigation). The following notes are intended to provide contextual background to consider in the process of evaluating current practices and determining whether, to what extent and how to make adjustments.

1. Shift in the Retirement Savings Landscape. The DOL justifies the fundamental changes arising from the Regulation by noting that the "market for retirement advice has changed dramatically since the Department promulgated the 1975 regulation." In particular, the DOL notes the trend away from traditional defined benefit pension arrangements, which tend to be professionally managed, towards participant-directed retirement savings vehicles, such as 401(k) plans and IRAs, in which advice to individual savers is common. This suggests that the changes imposed by the Regulation on institutional products and lines of business *should* be minor. In fact, one could view any changes in the institutional market arising from the Regulation as collateral consequences of the analytical approach used to address the shift in the retirement landscape that is the stated rational for the Regulation. While there is some basis for interpretive positions that would limit the impact on the institutional market, caution is advisable because of the broad reach of the regulatory language and the potential draconian penalties and other liabilities arising from breaches of the conflict of interest rules.

2. IRAs Are Not Subject to ERISA. As described briefly above, the protections of ERISA apply, generally, to participants in and beneficiaries of employer-sponsored plans, and do not extend to IRA owners. While the Code contains penalty tax provisions that parallel to a significant extent the conflict of interest rules of ERISA, those provisions do not impose the same legal obligations on IRA fiduciaries as exist for Plan fiduciaries, nor do they provide similar recourse and remedies for breaches of such obligations as are available to Plans under ERISA. A substantial purpose of the Regulation is to extend the prudent expert standard and other protections ERISA affords to Plan participants and beneficiaries to IRA holders, and to give IRA holders an individual enforcement right. The Regulation achieves this objective by incentivizing financial services providers to IRAs to comply with the new BIC Exemption. The BIC Exemption conditions its relief on the advice fiduciary contractually agreeing to meet the core fiduciary standards of ERISA in connection with its dealings with an IRA. While the DOL seems to have the authority to make these changes, it is not so clear that there is any basis in the statutory framework or legislative intent of ERISA or the Code to impose trust law principles generally on financial service providers to IRAs.

3. Principles-Based Approach of the BIC Exemption. In addition to using the BIC Exemption to impose ERISA fiduciary standards on financial services providers to IRAs, the DOL uses the BIC Exemption to enhance the fiduciary protections available to retail retirement savers by adding a number of "bells and whistles" to these standards. For example, in order to qualify for the BIC Exemption an advice fiduciary is required to adopt policies and procedures that are "reasonably designed to mitigate any harmful impact of conflicts of interest," "in fact" comply with those policies and procedures, avoid materially misleading statements, avoid "quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that are intended or would reasonably be expected to be inconsistent with" the best interest of Plans and IRAs, except for the payment of differential compensation that is "reasonably and prudently designed to avoid a misalignment" of interests, and provide extensive disclosure. Further, the BIC Exemption will not be available if the Plan participant or beneficiary, or IRA owner, purports to waive his right to participate in a class action in court in any dispute with the advice fiduciary.

Moreover, the DOL characterizes the approach of the BIC Exemption as "principles-based," which is a departure from the prior uniformly-applied approach in DOL exemptions of bright-line, prescriptive rules and conditions. Although FINRA and the SEC also rely on principles-based approaches to regulation in similar areas, the enforcement process and consequences under ERISA for rule violations are materially different than those under the FINRA and SEC rules. While the BIC Exemption is not generally relevant for financial service providers in institutional lines of business, circumventing the need to rely on the BIC Exemption in retail lines of business will be challenging. Accordingly, the principles-based approach of the BIC Exemption together with its enhanced contractual protections should be expected to give rise to additional litigation risk for financial services firms.

4. Potential Spillover Effects For Non-Retirement Assets. The need for financial services firms to implement processes, policies, training programs and IT modifications to reflect permissible practices in light of the Regulation will impose a substantial burden. The DOL estimates that the cost to comply with the Regulation and the accompanying exemptions will be between $10 billion and $31.5 billion over 10 years, with a primary estimate of $16 billion, on a present value basis. In many lines of business it will be difficult for financial services firms to differentiate between services provided to Plans and IRA accounts that are subject to the

Regulation, and services provided to other accounts held by the same or other clients. For example, will it be practical (in the actual retail market) for a broker to comfortably provide a recommendation that a client invest in a particular security for his non-retirement savings account, which would be sold by the firm out of inventory, while not having the recommendation apply, or other communications be viewed as recommendations under the Regulation, to the same client's investments in an IRA account? If not, the Regulation may drive changes in communications with non-retirement accounts that impose additional spillover costs.

5. A Swing of the Pendulum and then Some? The extraordinarily broad prohibitions of ERISA essentially require that all financial transactions, including the provision of routine financial services, be conducted pursuant to an exemption. The statutory provisions of ERISA provide about 20 legislative exemptions from its prohibitions, and give the DOL authority to grant administrative exemptions. The DOL has granted hundreds of such exemptions, on an individual and class basis, over the years. Most of these exemptions have numerous conditions carefully crafted to protect the Plan or IRA. To illustrate the all-encompassing nature of the ERISA prohibitions, the statute as originally enacted effectively prohibited Plans from buying U.S. treasury bonds, and an administrative exemption was granted in 1975, with retroactive application, that permitted such transactions. The breadth of the prohibitions is due, in large part, to the fact that ERISA (and the corresponding provisions of the Code) prohibit transactions between Plans or IRAs and any person who is a service provider to the Plan or IRA (as noted above, "disqualified persons" under the Code and "parties in interest" under ERISA). In 2006, Congress amended ERISA and the Code (through the Pension Protection Act of 2006) to provide a broad statutory exemption for transactions between Plans or IRAs and parties in interest or disqualified persons who were not acting as fiduciaries in the transaction, provided only that the Plan or IRA receive "adequate consideration" in the transaction. While this exemption has not replaced reliance on other exemptions to the extent that seemed possible in 2006 (even though it requires compliance with seemingly fewer and less onerous conditions), it nevertheless structurally narrowed in very substantial respects the reach of ERISA's prohibitions. One can view the Regulation's sizeable expansion of the universe of financial service providers deemed to be fiduciaries as a swing back of the pendulum to the more protective pre-2006 world, and indeed beyond.

6. Comparison to the U.K. Although it is not a prominent feature of the materials accompanying the publication of the Regulation, the DOL interestingly notes in an FAQ that its regulatory initiative represents a "middle ground" between the status quo in the U.S. and an approach taken by U.K. regulators in 2012. According to the DOL, the UK approach "realigned adviser and platform incentives with those of consumers by prohibiting advisers from receiving commissions in return for selling or recommending investment products." The Regulation, by contrast, permits such conflicts of interest – i.e., commission-based arrangements – subject to compliance with the BIC Exemption requirements.

Application of the Regulation in Certain Contexts

1. Avoiding "Advice Fiduciary" Status. The Regulation's definitions of "investment advice" and "recommendation" sweep broadly – far too broadly in the view of many. Critics continue to note, in particular, the reasonable aspects of the old regulatory language that for many years provided an appropriately balanced dividing-line between what should be viewed as sales activity and what should be viewed as the advice of a trusted fiduciary. While largely rejecting those criticisms, the DOL did effectively distinguish between the application of the new

broad standard in retail and institutional contexts, by providing an exclusion concerning communications with a Plan or IRA (including an entity whose assets are deemed to include Plan or IRA assets) that is represented by an independent, sophisticated fiduciary. For Plans and IRAs that are so represented in dealing with a counterparty (including, in our view, a service provider), the counterparty will not be deemed to be a fiduciary, assuming certain conditions are met, by reason of making recommendations that, in the context, are properly viewed as more like sales pitches than trusted fiduciary advice. The application of that effective distinction in specific lines of business is fleshed out briefly below.

In addition, the DOL attempted to provide comfort that certain types of general communications (whether between sophisticated parties or otherwise) will not be considered to give rise to fiduciary status, as follows:

> The furnishing or making available of [the following] information and materials . . . is not a "recommendation": . . . Furnishing or making available to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner general communications that a reasonable person would not view as an investment recommendation, including 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, or prospectuses.

Nevertheless, the broad sweep of the new definition of investment advice, exacerbated by the absence of bright-line parameters and the potentially limited utility of the offered regulatory comfort, gives rise to reasonable concern over the potential for an overly inclusive application of the rules, notwithstanding the DOL's attempt to defend the scope of the Regulation.

a. Institutional. Specifically, the Regulation provides that a person generally will not be deemed to be providing investment advice that makes the person a fiduciary solely by reason of providing advice to an independent fiduciary that holds or has under management or control total assets (including non-retirement assets) of at least $50 million, or that is a bank, insurance company, registered investment adviser or registered broker-dealer, provided that (1) the recipient of the advice is sophisticated and reasonably believed by the advice provider to be acting as an independent fiduciary of the Plan or IRA, (2) the advice provider informs the fiduciary that it is not providing impartial or fiduciary advice and discloses the existence and nature of any financial interests in the transaction and (3) the advice provider does not (A) receive a fee or other compensation directly from the Plan or IRA "for the provision of investment advice (as opposed to other services)" in connection with the transaction or (B) represent or acknowledge that he is acting as a fiduciary (the "Seller's Exclusion").

The Seller's Exclusion can be viewed as analogous, in certain respects, to the commonly-used "QPAM exemption" (DOL Prohibited Transaction Class Exemption 84-14, concerning transactions determined by an independent "Qualified Professional Asset Manager"), insofar as it avoids the application of certain of the prohibited transaction rules in a transaction involving a Plan or IRA if the Plan or IRA is represented by an independent, sophisticated agent. The QPAM exemption and the Seller's Exclusion are both premised on the theory that Plans and IRAs can be protected from the impact of conflicts if the Plan or IRA is adequately represented in the transaction. Similar to the evolution of practices in connection with the use of the QPAM exemption, we expect that practices will develop concerning representations and other assurances that will be provided by the parties to each other in connection with a transaction in which the protection of the Seller's Exclusion is sought. In many cases parties may need to rely on both QPAM (or another applicable exemption) and the Seller's Exclusion since they each apply to different potential prohibited transactions.

The Regulation provides a similar exclusion that is specifically tailored to advice provided to Plans (which notably excludes, for this purpose, plan asset vehicles) by swap dealers, major swap participants and swap clearing firms, in light of the extensive regulation of the activities of those financial intermediaries by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

If communications in the nature of advice in connection with a transaction can be managed in a manner that avoids advice fiduciary status under the Regulation, through reliance on the Seller's Exclusion or other rules described above, the analysis concerning the direct impact of the Regulation stops, because the person making the communication will not be deemed to be a fiduciary and the Regulation should not impact the existing application of the rules of ERISA or the Code to that person.

b. Retail. Under the Regulation as applied in the retail context, by contrast, it will be very challenging to avoid advice fiduciary status. As a result, potential advice fiduciaries will be forced into either complying with the BIC Exemption or restructuring their operations and compensation models to avoid prohibited fiduciary conflicts arising, for example, from commission-based accounts, revenue sharing, or the distribution of proprietary products, as discussed below. There are two special rules, similar structurally to the exclusions discussed above, but each of these presents its own substantial compliance challenges.

(i) Platform Providers. The Regulation clarifies that "marketing or making available to a plan fiduciary of a plan, *without regard to the individualized needs of the plan, its participants, or beneficiaries* a platform or similar mechanism from which a plan fiduciary may select or monitor investment alternatives" generally will not be deemed to constitute a recommendation. The DOL's release accompanying the Regulation further clarifies that marketing materials that reflect segmentation of the market (between, for example, large plans and small plans) will not be deemed to be individually tailored. However, the limitation on individually tailored communications is, in the real world, likely to prove a compliance challenge. Therefore, we believe that platform providers who attempt to rely on the platform provider provision to avoid advice fiduciary status generally will assume significant risk. It is notable in this regard that fee issues in platform arrangements have already been a substantial area of litigation. Furthermore, the platform provider provision is not applicable to IRAs, on the theory that in the Plan context there is a Plan fiduciary (e.g., the Plan sponsor) standing between the platform provider and individual retirement savers, whereas in the IRA context the platform provider would interact directly with the IRA owner, exacerbating in the DOL's view the potential adverse consequences of a conflicted trust relationship.

(ii) Investment Education. The Regulation makes provision for non-tailored investment education. The DOL issued extensive guidelines for investment education in 1996. The Regulation provides more limited accommodation for investment education than the 1996 guidance, particularly in the retail context. The impact of the Regulation in this area will therefore probably have the result that many investment education products and services, such as widely used computer-assisted and individually provided asset allocation modeling and similar tools, will be revised to eliminate specific product references that could exceed the boundaries of the rule and therefore give rise to fiduciary characterization risk.

In sum, in contexts involving Plans or IRAs that are represented by independent, sophisticated agents, it is likely that the risk of advice fiduciary status for persons who engage in investment-related communications can be limited. However, in most retail contexts, where such agents are not present, the risk that such persons will become advice fiduciaries under the Regulation are substantial.

2. Retail Advisory Brokerage Accounts. Persons who become advice fiduciaries by reason of the Regulation must consider how to deal with the newly prohibited conflicts of interest that arise from such characterization. The DOL's view is that a fiduciary violates the exclusive benefit and self-dealing conflict of interest rules if he gives investment advice concerning a transaction in which he has an interest. Accordingly, for example, a fiduciary who recommends the purchase (or sale) of a security is impermissibly conflicted in giving that advice if the fiduciary (or a person in which the fiduciary has an interest, such as an affiliate) would earn a commission from the transaction or receive management or other fees as a result of the transaction. Similarly, an impermissible conflict exists if the fiduciary (or any such related person) would be the counterparty in purchasing or selling the security (even if there is a liquid market for the security). Also, a fiduciary who, for example, participates in an underwriting of a security in a manner that makes him a fiduciary by reason of recommending the purchase of the security to a Plan or IRA would, similarly, be considered by the DOL to have an impermissible conflict of interest if a purchase by the Plan or IRA could result in the fiduciary (or any such related person) being paid an additional underwriting fee as a result of the sale.

The BIC Exemption provides advice fiduciaries and related persons with an exemption so that they can receive compensation as a result of their provision of investment advice that would otherwise give rise to conflicts of interest, subject to substantial conditions. The conditions include the requirement that the advice be prudent and demonstrably in the best interest of the advice recipient, and that the advice provider adopt, and in fact comply with, policies and procedures that are designed to mitigate the risks that its conflict of interest will interfere with its advice. As discussed briefly above, the Regulation is designed both to push financial services providers in retail lines of business into using the BIC Exemption and to impose real costs and risks on such providers – in the form of additional protections for retail accounts – for its use.

Those twin goals are present even in retail arrangements involving level fees, in which the discussion so far might suggest that there is no need for an exemption because the fee leveling eliminates conflicts. The Regulation and accompanying materials caution against that conclusion in all circumstances. In fact, the BIC Exemption includes specific, modestly-streamlined, conditions that apply when fee-leveling is present. That part of the BIC Exemption is relevant, for example, when the "investment advice" that triggers fiduciary status involves a recommendation to roll over assets from a 401(k) plan into a (fee-leveled) IRA account, or to move from a commission-based account into a fixed-fee account. Even in the absence of that type of advice, for which the conflict relates to the receipt by the advice fiduciary of any kind of compensation at all as a result of the advice, the DOL seems to caution against a blanket conclusion that level fees eliminates conflicts of interest in all circumstances in a way that eliminates the need for the BIC Exemption:

Several commenters asked whether a fiduciary investment adviser would need to utilize the Best Interest Contract Exemption or other prohibited transaction exemptions if the only compensation the adviser receives is a fixed percentage of the value of assets under management. Whether a particular relationship or compensation structure would result in an adviser having an interest that may affect the exercise of its best judgment as a fiduciary when providing a recommendation, in violation of the self-dealing provisions of prohibited transaction rules under section 406(b) of ERISA, depends on the surrounding facts and circumstances. The Department believes that, by itself, the ongoing receipt of compensation calculated as a fixed percentage of the value of a customer's assets under management, where such values are determined by readily available independent sources or independent valuations, *typically* would not raise prohibited transaction concerns for the adviser. Under these circumstances, the amount of compensation received depends solely on the value of the investments in a client account, and ordinarily the interests of the adviser in making prudent investment recommendations, which could have an effect on compensation received, are consistent with the investor's interests in growing and protecting account investments. (emphasis added)

As a result, in our view, it is likely that acceptance of the risks attendant on the use of the BIC Exemption will make sense as a business matter for many financial services providers in retail contexts, in large part because there will be few better alternatives available in light of the business considerations. Other providers will attempt to minimize the risk that they will be deemed to be providing investment advice and to mitigate the risks arising from conflicts in order to be able to avoid the costs that come with reliance on the BIC Exemption. The latter approach, though a viable one in certain businesses, will likely entail the assumption of significant risk.

3. <u>Retail Distribution of Fund Products</u>. Retail distribution of fund products – including mutual funds, alternative investment funds and other types of managed portfolios – involve perhaps the most complex set of permutations and analytical approaches arising from the Regulation. It is beyond the scope of this memorandum to cover the entire landscape. Instead, we aim to outline the general framework under which these issues must be considered. It is far too early for a clear indication of how market practices will evolve, and the facts and circumstances of particular businesses will, we believe, have a substantial impact on that evolution. Preliminarily, by "retail distribution" we mean sales to Plans and IRAs that are not covered by the Seller's Exclusion.

a. Will the manager of the fund or its affiliates become a fiduciary in connection with marketing and distribution activities, even when using an intermediate broker-dealer? The answer depends on application of the "investment advice" definition, including the definition of "recommendation" described above, and will differ depending on the nature of the communications between the manager and the potential retail investor. In many but not all contexts, including for example the marketing of alternative investment funds, it is common for communications that may constitute investment advice under the Regulation to occur between the manager and the potential retail investor in the distribution process, notwithstanding the intermediation of a distributor. As a result, there are two permutations to consider for this part of the analysis:

(i) First, if the manager refrains from engaging in communications that make it an advice fiduciary, then the manager should not be impacted by the Regulation. We note in this regard, on the one hand, that it is possible under the Regulation that advice fiduciary status could arise from indirect communication, including the dissemination of marketing materials. The risk that such indirect communications might give rise to advice fiduciary status can be mitigated, but not eliminated, by ensuring that marketing materials are not based on the particular investment needs of the investor or directed by the manager to a specific potential investor or investors. On the other hand, the definitions of "investment advice" and "recommendation," together with some helpful language in the DOL release accompanying the Regulation, make it reasonably clear that typical communications between the manager and the distributor should not cause the manager to become an advice fiduciary merely because the distributor may be, or may become, a fiduciary to retail retirement investors. As noted above, it will be challenging to avoid the risk of advice fiduciary status if direct communications occur between the manager and the potential retail investor.

(ii) Second, if (based on the foregoing) the manager becomes an advice fiduciary in connection with marketing activities through a distributor, then the manager must find an exemption to address the conflict that is deemed to exist because the manager will benefit from a purchase of its product based on its deemed fiduciary advice. That exemption will likely have to be the BIC Exemption, with all of its many substantial challenges.

b. Will the distributor become a fiduciary in connection with the distribution? The answer primarily depends on the nature of the distribution process. As noted above, it will be difficult for a financial services provider that engages in communications with retail clients to avoid becoming an advice fiduciary. The DOL's release accompanying the Regulation strains in its discussion to emphasize that not every communication with a retail investor constitutes investment advice. As noted by the DOL, if a retail client calls a broker and says "please purchase for my account 100 shares of mutual fund X," no investment advice will have been provided. However, this approach is a narrow one (particularly in light of how the retail distribution market works in practice), requires strong compliance discipline and, even then, entails risk. Alternatively, the distributor can assume advice fiduciary status, in which case the distributor must either structure its business (including its compensation practices at potentially both the financial institution and individual adviser levels) to avoid the types of conflicts with which the rule is concerned (e.g., through fee leveling or a fixed-rate advisory fee structure), or use an exemption such as the BIC Exemption or one of a handful of older exemptions covering specific product types that have been modified in connection with the Regulation to add the basic BIC Exemption conditions (e.g., Prohibited Transaction Class Exemption 77-4 regarding the sale of open-end mutual funds to fiduciary clients).

c. The DOL includes important cautionary language in the release accompanying the adoption of the BIC Exemption concerning the use of the BIC Exemption specifically in the context of certain types of fund investments, as follows:

> The Department expects that Advisers and Financial Institutions providing advice will exercise special care when assets are hard to value, illiquid, complex, or particularly risky. Financial Institutions responsible for overseeing recommendations of these investments must give special attention to the policies and procedures surrounding such investments and their oversight of Advisers' recommendations, if they are to properly discharge

> their fiduciary responsibilities. Financial Institutions should identify such investments and ensure that their policies and procedures are reasonably and prudently designed to ensure Advisers' compliance with the Impartial Conduct Standards when recommending them. In particular, Financial Institutions must ensure that Advisers are provided with information and training to fully understand all investment products being sold, and must similarly ensure that customers are fully advised of the risks. Additionally, when recommending such products, the Financial Institution and Adviser should take special care to prudently document the bases for their recommendation and for their conclusions that their recommendations satisfy the Impartial Conduct Standards.

Furthermore, the DOL notes the following in the context of its decision in the BIC Exemption as adopted to eliminate the approved asset list covered by the BIC Exemption that was included in the BIC Exemption as proposed:

> However, the fact that the exemption was broadened does not mean the Department is no longer concerned about some of the attributes of the investments that were not initially included in the proposed definition of Asset, such as unusual complexity, illiquidity, risk, lack of transparency, high fees or commissions, or tax benefits that are generally unnecessary in these tax preferred accounts. This broadening of the exemption for products with these attributes must be accompanied by particular care and vigilance on the part of Financial Institutions responsible for overseeing Advisers recommendations of such products. Moreover, the Department intends to pay special attention to recommendations involving such products after the Applicability Date to ensure adherence to the Impartial Conduct Standards and verify that the exemption is sufficiently protective.

In the event of a dispute between a potential advice fiduciary and a retail investor concerning the purchase of fund products of the type contemplated by the foregoing, that language could prove very unhelpful to the potential advice fiduciary.

d. Similarly, the DOL includes important cautionary language in the release accompanying the adoption of the BIC Exemption concerning monitoring obligations in connection with certain fund products:

> Further, when determining the extent of the monitoring to be provided, as disclosed in the contract pursuant to Section II(e) of the exemption, such Financial Institutions should carefully consider whether certain investments can be prudently recommended to the individual Retirement Investor, in the first place, without a mechanism in place for the ongoing monitoring of the investment. This is particularly a concern with respect to investments that possess unusual complexity and risk, and that are likely to require further guidance to protect the investor's interests. Without an accompanying agreement to monitor certain recommended investments, or at least a recommendation that the Retirement Investor arrange for ongoing monitoring, the Adviser may be unable to satisfy the exemption's Best Interest obligation with respect to such investments. Similarly, the added cost of monitoring such

investments should be considered by the Adviser and Financial Institution in determining whether the recommended investments are in the Retirement Investors' Best Interest.

Given the heightened focus of the DOL on alternative investment products, what appears in the release accompanying the BIC Exemption as an almost "Best Interest plus" standard, and the conditions of the BIC Exemption, including notably that fiduciary advisers must "document the bases" for their recommendations in light of their fiduciary obligations to minimize the impact of conflicts of interest, the Regulation has the potential to have a substantial impact on the way in which alternative investment products are distributed to retail investors. In our view certain fund managers and distributors are likely to reasonably conclude that making certain fund products available to Plans and IRAs in circumstances in which the Seller's Exclusion is not available involves excessive business risks. We note that the discussion in this item 3 does not vary based on whether or not the fund being distributed is deemed to include "plan assets" (i.e., generally, regardless of whether Plan and IRA investment in the fund exceeds 25%, the fund is registered under the Investment Company Act of 1940, or the fund qualifies as a "VCOC" or "REOC").

We also note that the nature of certain of the risks outlined above is, as a practical matter, very different from risks generally arising in similar circumstances under the Advisers Act, even as amended by Section 913 of the Dodd-Frank Act. Generally, under the Advisers Act the manager of a fund will be deemed to have obligations to the fund, which is treated as the manager's client, and the recourse of the investors in the fund against the fund manager will be narrower and dictated largely by the fund documentation, as compared to the recourse arising under ERISA as a result of the Regulation. Indeed, Section 913(g) of the Dodd-Frank Act, enacted in July, 2010, a few months prior to the DOL's initial investment advice proposal, amended Section 211 of the Advisers Act to give the SEC authority to promulgate rules setting forth a best interest "standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers," subject to the condition that "the Commission shall not ascribe a meaning to the term 'customer' that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser." Section 913(g) of the Dodd-Frank Act also amended Section 211 of the Advisers Act to provide that such rules shall provide that "any material conflicts of interest shall be disclosed and may be consented to by the customer," and that "the receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation" of the fiduciary standard. These statutory provisions, which were added by Congress in the specific context of its direction to the SEC regarding the fiduciary standards applicable to broker-dealers and investment advisers and essentially contemporaneously with the DOL's rulemaking, when considered in light of the application of the Regulation as outlined above, seem to undercut the contention in the DOL's release accompanying the Regulation that the Regulation "neither undermines, nor contradicts, the provisions or purposes of the securities laws, but instead works in harmony with them."

4. Principal Transactions with Retail Accounts. As noted above, the regulatory material accompanying the publication of the Regulation includes the Principal Transactions Exemption, a second new administrative exemption, in addition to the BIC Exemption, that provides an avenue for retail Plans and IRAs to enter into principal trades (including riskless principal transactions) for cash with advice fiduciaries, subject to conditions that are similar to the basic BIC Exemption conditions. The Principal Transactions Exemption is available for sales by Plans

and IRAs of any type of property, and for purchases by Plans or IRAs of certain high-quality corporate, asset-backed and governmental debt securities. The Principal Transactions Exemption may be a practical alternative for handling transactions with retail accounts for which a broker is an advice fiduciary in limited categories of high-quality assets that are frequently sold from inventory. While it would have been consistent with the purpose of the Principal Transactions Exemption to cover transactions in at least very liquid foreign currencies, such transactions are not covered by the Principal Transactions Exemption. As a result, for retail accounts in which the broker is an advice fiduciary, transactions in foreign currency incident to purchases and sales on the market will probably have to be effected with an unaffiliated foreign currency dealer. In addition, the Principal Transactions Exemption is not, in any event, available in the context of underwritten transactions in which the advice fiduciary or its affiliates is a participant in the syndicate, although Plans and IRAs may be able to purchase in underwritten transactions under a 1975-vintage exemption (Prohibited Transaction Class Exemption 75-1, Part III), subject however to a newly added "best interest" and other conditions.

Conclusion

The Regulation and related materials require significant change to current practice and present substantial challenges for many financial services providers who deal with retirement assets, which must be addressed and resolved within a relatively short transition period. Because of the quantum nature of the changes imposed by the Regulation, as well as the many uncertainties referred to above, the Regulation gives rise to a greater than normal risk of unintended consequences and potential disputes. The reaction of other regulators, particularly FINRA and the SEC, to these developments may have an important impact on the marketplace.

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