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ALERT MEMORANDUM

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New Proposed Fiduciary Rules Could Significantly Impact the Marketing of Private Investment Funds to ERISA Plans and IRA Investors

On April 14, 2015, the Department of Labor ("DOL") proposed rules (the "Proposed Rules") expanding the circumstances under which a person will be considered to be providing "investment advice" to an employee benefit plan or individual retirement account ("IRA") and thereby considered to be a fiduciary within the meaning of the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code of 1986 ("Code"). Under the Proposed Rules, ordinary marketing activities could be considered investment advice.

The Proposed Rules, if adopted as proposed, would (i) limit the marketing of private investment funds to ERISA plans that either have 100 or more participants or have a manager with at least $100 million in ERISA plan assets under management, and (ii) make it very difficult for IRA investors to invest at all in many private investment funds.

Why the New Rules? ERISA (and corresponding provisions of the Code in respect of IRAs) provides that "a person is a fiduciary with respect to a plan to the extent… 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." Fiduciaries of plans and IRAs are subject to stringent conflict of interest rules. The DOL issued regulations in 1975 which set forth a five-part test for determining whether a person could be considered to be providing "investment advice" for this purpose. In proposing the Proposed Rules, the DOL said that it does not believe that the 1975 framework adequately protects the significant population of Americans with interests in participant-directed 401(k) plans or IRAs, and therefore, the Proposed Rules seek to expand significantly the scope of activities that will result in fiduciary status.

What are the New Rules? Under the Proposed Rules, unless a carve-out applies, a person renders "investment advice" for a fee or other compensation, whether direct or indirect, if the person provides certain categories of advice, and either (i) "represents or acknowledges that it is acting as a fiduciary within the meaning of [ERISA or the Code], or (ii) renders the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to, the recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA."

The categories of advice most relevant to the marketing of private investment funds are:

- *Investment recommendations*. "A recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property . . . ." The Proposed Rules clarify that virtually any pitch or sales presentation could be considered an "investment recommendation" under this definition.

- *Recommendations of persons to provide investment advice for a fee or to manage plan assets*. "A recommendation of a person who is also going to receive a fee or other compensation for providing any of the types of advice described [above]."

A person will be deemed to receive a "fee or other compensation" if the person (or an affiliate) receives any fee or compensation from any source incident to the transaction in which the investment advice is rendered or will be rendered. For example, a trailer fee paid over time and related to the amount invested in a private investment fund by a plan or IRA investor would likely be considered a "fee or other compensation" in connection with investment advice to the plan or IRA investor.

Any Applicable Carve-Outs from the New Rules? The DOL included a number of specific carve-outs in the Proposed Rules whereby a person (i.e., the fund sponsor or its representative) providing investment advice to a plan fiduciary, plan participant or IRA owner will not be treated as a fiduciary. The carve-out most relevant to the marketing of private investment funds is the "Seller's Carve-Out," which provides that advice given to certain ERISA plans may be excluded from the definition of "investment advice" if the fund sponsor or its representative has not represented or acknowledged that he or she is acting as a fiduciary under ERISA and one of the following two tests is met:

➢ *$100 Million Asset Test.* Prior to providing any recommendation, the fund sponsor or its representative:

  - knows or reasonably believes that the plan fiduciary (who must be independent of the fund sponsor or its representative) has responsibility for management of at least $100 million of ERISA plan assets;

    - *Note*: if the fiduciary is representing a single plan, the fund sponsor or its representative can rely on the asset value disclosed in the plan's most recent publicly available IRS Form 5500; if the fiduciary is representing several ERISA plans, the fund sponsor or its representative can rely on representations from the fiduciary as to the value of plan assets under management.

  - fairly informs the plan's fiduciary that it is not providing impartial investment advice or advice in a fiduciary capacity; and

  - does not receive any fee or other compensation directly from the plan or plan fiduciary for the provision of investment advice in connection with the transaction.

OR

➢ *100 Participants Test.* Prior to providing any recommendation, the fund sponsor or its representative:

- obtains a written representation from the plan fiduciary (who must be independent of the fund sponsor or its representative) that:
    - the plan has 100 or more participants,
    - the plan fiduciary, not the plan participants, exercises authority or control over the management of the plan's assets, and
    - the plan fiduciary will not rely on the fund sponsor or its representative to act in the best interests of the plan, to provide impartial investment advice, or to give advice in a fiduciary capacity;
- informs the fiduciary of the existence and nature of its financial interests in the transaction;
- does not receive a fee or other compensation directly from the plan or plan fiduciary for the provision of investment advice in connection with the transaction; and
- knows or reasonably believes that the fiduciary has sufficient expertise to evaluate the transaction and determine whether it is prudent and in the best interest of the participants (including by relying on written representations from the plan or plan fiduciary to that effect).

The DOL's proposing release explained that the Seller's Carve-Out was explicitly meant to be unavailable to retail investors – plan participants, small ERISA plans and IRAs. The purpose of the carve-out was to avoid imposing fiduciary obligations on sales pitches that are part of an arm's length transaction where the potential buyer should not assume that the other party is an impartial adviser, and therefore does not expect a relationship of undivided loyalty and trust. The DOL states, "[m]ost retail investors and many small plan sponsors are not financial experts, are unaware of the magnitude and impact of conflicts of interest, and are unable effectively to assess the quality of the advice they receive." Therefore, under the Proposed Rules, a private investment fund essentially cannot market to IRAs, small ERISA plans or 401(k) plan participants without becoming a fiduciary subject to ERISA and potentially rendering the purchase of a fund interest a prohibited transaction under ERISA and the Code. Prohibited transactions generally give rise to burdensome tax consequences (including excise taxes) and put rights for plan or IRA purchasers.

The DOL did include in the Proposed Rules a new prohibited transaction exemption – the Best Interest Contract Exemption – intended to allow certain fiduciaries, broker-dealers and other agents to receive compensation (that might otherwise be prohibited) for the provision of investment advice to 401(k) plan participants and beneficiaries with investment authority, IRA owners, and non-participant-directed ERISA plans with fewer than 100 participants. The proposed exemption, however, covers only compensation for services provided in connection with the purchase, sale or holding of specified liquid assets (e.g., bank deposits, CDs, shares in registered investment companies, etc.) which do not include interests in private investment funds. Accordingly, as proposed, a private investment fund sponsor cannot rely on the Best

Interest Contract Exemption. Even if the asset list were expanded, meeting the conditions of the exemption as written would be impractical in the private investment fund context.

What to Do about the New Rules? The DOL has requested comments on the Proposed Rules no later than July 6, 2015, including specific comments related to the Seller's Carve-Out and whether the proposed plan size limitations are appropriate thresholds or whether other conditions would be appropriate.

While the protections in the Proposed Rules may be appropriate for some IRA owners and smaller ERISA plans in some contexts, there are large numbers of high net worth individuals who are financially sophisticated, who appreciate the opportunity to access private investment funds as part of their portfolios and who therefore will be unnecessarily restricted from using their IRAs (or smaller ERISA plans) to invest in private investment funds. The DOL could appropriately limit the scope of the Proposed Rules by revising them in final regulations to reflect the Securities and Exchange Commission's ("SEC's") standard for investor sophistication in the investment fund context – i.e., to permit the use of the Seller's Carve-Out in transactions with any ERISA plan or IRA that qualifies as a "Qualified Purchaser" as defined in the Investment Company Act of 1940. By allowing small ERISA Plans and IRA investors who are Qualified Purchasers to invest in private investment funds under the Seller's Carve-Out, the DOL could avoid significant market interruption while still achieving its goal of protecting unsophisticated retail investors.

The Proposed Rules significantly expand the scope of ERISA's fiduciary rules. Mitigating the practical impact of that expansion by providing the Seller's Carve-Out for large plan investors will require implementation of additional compliance procedures, but these are not insurmountable obstacles. However, as proposed the Proposed Rules would effectively deny sophisticated but smaller ERISA plans and IRA investors the opportunity to access private investment funds as part of their portfolios. The SEC has recognized that this result is not justified, and the DOL should follow suit.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "[Executive Compensation and ERISA]" under the "Practices" section of our website at http://www.clearygottlieb.com.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road, Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Cleary Gottlieb Steen & Hamilton LLP
45th Floor, Fortune Financial Center
5 Dong San Huan Zhong Lu
Chaoyang District
Beijing 100020, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Abu Dhabi Global Market Square
Al Maryah Island, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099