Schulte Roth & Zabel

Alert

New DOL ERISA Fiduciary Regulation Takes Effect (at Least for Now)

June 2, 2017

The DOL regulation expanding the definition of who is a fiduciary in the context of marketing investment products to Individual Retirement Accounts ("IRAs") and ERISA-covered pension plans ("ERISA Plans") takes effect on June 9. On May 22, the Secretary of Labor authored an op-ed piece in which he expressed concern that this new fiduciary regulation did not align with President Trump's deregulatory goals. However, he concluded that the DOL could not act on its own to postpone the effective date of the regulation. Thus, the Secretary of Labor stated that the DOL continues to study the rule, but any changes will have to be effected in the ordinary course under the Administrative Procedure Act, which requires proposal, notice and a comment period before any changes can be made.

Action Items for Private Fund Managers

1. Identify all fee-paying IRA and ERISA Plan investors.
2. Send a notice to the fee-paying IRA and ERISA Plan investors (in the form available here) that sets forth the required manager disclosures and the manager's understanding of the availability of a carve-out from fiduciary status.
3. For new subscriptions and additional investments, consider using an attachment to the subscription documents containing the manager disclosures and representations from IRA and ERISA Plan investors. Because the DOL could change the applicable requirements, it may be advisable to use an attachment at this point instead of revising the subscription documents themselves.

The DOL regulation has no impact on whether the assets of a private fund such as a hedge fund or a private equity fund are treated as "plan assets" of the investors that are ERISA-covered plans and Individual Retirement Accounts. Rather it delineates when the manager of the private fund may become a fiduciary of its investors and potential investors in marketing the fund, and provides carve-outs that eliminate fiduciary status. The carve-outs should permit the continued marketing of private funds to sophisticated plan fiduciaries almost unimpeded. Many investors will fit within one of the carve-outs briefly summarized below, and thus the fund manager will not be a fiduciary to those investors when recommending the purchase of, or continued holding of, interests in a fund.

In the absence of one of the carve-outs, recommending investment in a fund will cause the manager to be a fiduciary in connection with the decision of an IRA or ERISA Plan to invest in the fund. The term "recommendation" is very broad and encompasses any communication that a reasonable person could view as recommending that he or she buy, hold or sell interests in a fund. While the offering memorandum of a fund may not be viewed as a recommendation, a periodic letter may be viewed as recommending that the investor continue to hold his or her investment in the fund. In addition, discussions about the fund with Investor Relations or other fund personnel may also be viewed as a recommendation.

Institutional Investors

The broadest carve-out applies when marketing to institutional ERISA Plan investors. A private fund manager will not be a fiduciary when it markets its fund to a plan committee that the fund manager reasonably believes holds or has under management and control total assets in excess of $50 million if certain conditions are met. The size of the particular ERISA Plan investor is irrelevant as long as the plan committee that controls the investment of the ERISA Plan's assets meets the $50 million test. The conditions to the fiduciary carve-out require that the private fund manager know or reasonably believe that: (a) the plan committee is capable of evaluating investment risks independently, both in general and with regard to the private fund's investment program and strategies; and (b) that the plan committee is a fiduciary with respect to the transaction and is exercising independent judgment in evaluating the transaction.

In addition to the status of the plan committee, the carve-out requires the private fund manager to take several proactive steps. As set forth in the Notice available here, the private fund manager must: (a) fairly inform the plan committee that it is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with the investment in the private fund; and (b) fairly inform the plan committee of the existence and nature of the person's financial interests in the transaction (this information may already be set forth, at least in a general way, in the fund's offering memorandum). Further, the private fund manager cannot receive a fee, directly or indirectly, for the provision of investment advice. This condition is not violated by the fact that the private fund pays its manager an asset under management fee and/or incentive compensation.

Independent Fiduciaries

Regardless of the size of an ERISA Plan investor's assets and in all cases with respect to an Individual Retirement Account or a self-directed 401(k) plan participant, similar carve-outs apply to the extent that the private fund manager knows or reasonably believes that an ERISA Plan investor or Individual Retirement Account has an independent fiduciary advising it with respect to an investment in a fund. The independent fiduciary can be a bank, a registered investment adviser, or a broker-dealer. This independent fiduciary must meet the tests otherwise applicable to a plan committee that holds or manages assets in excess of $50 million. Thus, while the independent fiduciary need not have discretionary authority over the ERISA Plan's or Individual Retirement Account's investment, he or she must be advising the plan decision maker (or Individual Retirement Account holder) as an ERISA fiduciary and make the recommendation to buy or hold interests in a private fund. The disclosures that the private fund manager must make to the plan committee are the same as those it must make to the independent fiduciary (as set forth in the Notice available here).

The DOL has stated that, a plan representative or Individual Retirement Account holder may attend a meeting in which the private fund manager makes a presentation. However, for the independent fiduciary carve-out to be available, the private fund manager must know or reasonably believe that the independent fiduciary is making the buy or hold recommendation and otherwise meets the test applicable to the plan committee of large pension investors. In light of this interpretation, private fund managers should consider adopting procedures that require the presence of the independent fiduciary if a representative of an ERISA plan or Individual Retirement Account holder contacts Investor Relations directly, whether prior to the investment or any time after the investment. Similarly, if interests in a private fund are sold through investment bank or broker-dealer platforms or are sold using third-party placement agents, a representative of the platform sponsor or third-party placement agent should participate in any call or other discussions with the direct investor in the fund.

In order to comply with the carve-out for recommendations to large pension plans and represented ERISA Plans and Individual Retirement Accounts, the private fund manager must make specific disclosure with respect to itself and may rely on written representations from the plan committee or a negative consent with respect to those items the private fund manager must know or reasonably believe. Although the typical offering memorandum may already contain most if not all of the disclosures required to take advantage of one or more of the fiduciary carve-outs, an additional notice to this effect may be included in an update to investors. While the DOL has approved of negative consent, we believe that it makes sense, on a going-forward basis, to supplement the subscription documents to request large and small ERISA Plan investors as well as investors who have invested through their self-directed 401(k) Plan or an Individual Retirement Account, to identify the carve-out applicable to ongoing communications.

Other Investors

Recommendations to an unrepresented Individual Retirement Account, a participant in a self-directed 401(k) plan or small ERISA Plans (i.e., where the plan committee controls less than $50 million) will not fall within one of the fiduciary carve-outs and may cause the fund manager to be a fiduciary to a new investor in this category with their decision to invest in the fund. Accordingly, private fund managers may wish to suspend new investments by this category of potential investor. A grandfather rule may apply to existing investors in certain circumstances.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel.

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