Bloomberg BNA

Securities Regulation & Law Report™

Reproduced with permission from Securities Regulation & Law Report, 48 SRLR 1191, 6/13/16. Copyright © 2016 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

INVESTMENT ADVISERS

BNA Insights: DOL Fiduciary Rule Implications for Private Investment Fund Managers

BY DANIEL V. WARD, GREGORY L. DEMERS, AND WILLIAM T. DAVISON

On April 6, 2016, the United States Department of Labor (''DOL'') issued a new rule that will subject a wider group of investment advisers to fiduciary standards under the Employee Retirement Income Security Act of 1974 (''ERISA'') in connection with providing so-called investment ''recommendations,'' which will become effective April 10, 2017. The rule is designed to curb conflicts of interest that could lead advisers to recommend high-fee investments that potentially harm retirees, and is targeted at retail-level investment advisers not previously subject to fiduciary obligations—in particular, broker-dealers.

Some critics have praised the final rule as a reasonable compromise that establishes new safeguards for investors, while also imposing limitations on the scope of the rule to address concerns from the investment advisory community. However, the breadth of the rule and its expansive definition of ''investment advice'' raise questions about its potential impact on firms managing pools of assets that include retirement savings—including private equity sponsors and hedge fund managers.

Dan Ward is a litigation partner in Ropes & Gray's Boston office whose practice is focused on securities litigation and enforcement matters and other complex commercial disputes. Greg Demers and Bil Davison are associates in Ropes & Gray's Boston office practicing in the business and securities litigation department.

A key feature of the DOL rule is its definition of an investment ''recommendation''—that is, what constitutes advice to an investor of retirement assets sufficient to trigger fiduciary status under the rule. It is an open question whether, and how, the rule could be applied to fund managers who oversee large pools of assets that may include investments by benefits plans or IRA owners.

In addition, the new rule raises questions as to whether certain communications to investors, including advertising or fundraising communications directed towards ERISA-governed plans, will cause sponsors of these private investment vehicles to be treated as ''fiduciaries'' governed by the strict requirements of ERISA.

If the rule is deemed to apply to private fund managers, there are important limitations in place that may mitigate its impact. For example, the rule creates carve-outs for certain kinds of recommendations (e.g., sales pitches for advice providers) and certain types of plans (e.g., those plans with over $50 million in assets under management). And many private equity firms and hedge fund managers are already subject to fiduciary

standards under the Investment Advisers Act (the ''Advisers Act''). At the same time, the DOL's fiduciary standard could create additional challenges for fund managers, despite meaningful limitations on its scope.

The DOL's Fiduciary Rule

At the heart of the new DOL rule is an expanded definition of ''fiduciary'' status. Under pre-existing law, ERISA and the Internal Revenue Code (''IRC'') together define a ''fiduciary,'' in relevant part, as any person who ''renders investment advice for a fee or other compensation, direct or indirect'' with respect to benefits plan or IRA investments. 29 U.S.C. § 1002(21)(A). However, the DOL has authority to make rules outlining precisely when persons are acting as fiduciaries for ERISA and IRC purposes. The DOL's prior rule, issued in 1975, set forth a five-part test that narrowly limited fiduciary status and exempted many broker-dealers and investment advisers from the definition of ''fiduciary.'' Under this test, the person must: (1) make recommendations on investing in, purchasing or selling securities or other property, or give advice as to the investments' value, (2) on a regular basis, (3) pursuant to a mutual understanding that the advice (4) would serve as a primary basis for investment decisions and (5) would be individualized to the particular needs of the plan.

The new rule limits this exemption, and thus broadens the scope of persons who may be considered ''fiduciaries.'' The new rule was motivated by a perceived evolution in how Americans save for retirement. In its Regulatory Impact Analysis accompanying the fiduciary rule, the DOL recently proclaimed that since the 1975 version of the rule was issued, ''the retirement savings market has changed profoundly,'' with ''increasingly complex and varied'' financial products available to investors. Regulating Advice Markets: Regulatory Impact Analysis for Final Rule and Exemptions, Department of Labor, at 3 (Apr. 2016), http://www.dol.gov/ebsa/pdf/conflict-of-interest-ria.pdf. The 2016 rule was designed to protect ''[r]etail investors [who] are now confronted with myriad choices of how and where to invest, many of which did not exist or were uncommon in 1975.'' *Id.* The DOL estimates that the rule will generate between $66 billion and $76 billion in gains to IRA investors over twenty years, while resulting in $10 billion to $31.5 billion in compliance costs over ten years for businesses. *Id.* at 10.

Originally proposed in 2010 and then again in modified form in 2015, the new rule generated thousands of comments from market participants, many of which focused on clarifying the scope of the rule and what kind of advice will bring advisers within the auspices of the rule. The final rule, released by the DOL on April 6, 2016, applies to communications that constitute ''fiduciary investment advice.'' This includes any ''recommendation'' to a retirement plan, plan participant, beneficiary, or IRA owner concerning the buying, holding, managing or selling of securities or other investment property in connection with retirement. 29 C.F.R. 2510.3-21(a). The rule defines ''recommendation'' as ''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.'' *Id.* As some legal analysts have noted, how the DOL interprets and applies this terms will have a significant impact on the reach of the new rule.

The rule also contains a number of exemptions that could mitigate its impact on certain investment advisers. ''Rather than create a highly prescriptive set of transaction-specific exemptions,'' the DOL created ''exemptions that flexibly accommodate a wide range of current types of compensation practices, while minimizing the harmful impact of conflicts of interest on the quality of advice.'' One significant exemption known as the ''Best Interest Contract'' (BIC) exemption allows advisers to continue giving advice that affects the adviser's compensation—generally prohibited by ERISA—as long as the advice meets certain criteria aimed at ensuring the advice will be in the investor's best interests. This exemption ''is designed to promote the provision of investment advice that is in the best interest of retail investors such as plan participants and beneficiaries, IRA owners, and certain plan fiduciaries, including small plan sponsors.'' 29 C.F.R. 2550 [Application No. D–11712].

The rule appears to be intended to increase safeguards for retail investors, with an eye towards imposing fiduciary obligations on brokers and other advisers not previously subject to ERISA. However, it is an open question whether, and to what extent, the rule applies to private equity sponsors, hedge fund managers, and other investment advisers that oversee commingled pools of assets, which may include retirement savings. As discussed in more detail below, mutual fund managers, their registered investment advisers, and their primary underwriters are exempt from the provisions of ERISA so long as the mutual fund merely serves as a funding vehicle for the employee benefit plan.

Application to Private Funds

Private fund managers do not provide ''fiduciary investment advice'' in the traditional sense—that is, they do not advise plan administrators about how to invest their retirement funds. Rather, they typically manage buckets of pooled assets for groups of investors (which may or may not include retirement assets), with investment returns distributed pro rata among investors. The new rule limits the definition of ''recommendation'' to communications to a ''specific advice recipient or recipients regarding the advisability of a particular investment or management decision . . . .'' 29 C.F.R. 2510.3-21 (a)(2)(ii). Because of the structure of private funds, their advisers—including hedge fund managers and private equity sponsors—should be outside the bounds of the new rule when making investment decisions on behalf of the funds.

The new DOL rule does not explicitly apply to such private funds, but does not expressly exempt them, either. While clearly not the intended target of the regulation (which is aimed at broker-dealers advising retail investors), private funds and their managers could be pulled within the auspices of the rule depending on the nature of their investments, their interactions with plan participants or IRA owners, and the interpretation of the rule's scope.

Private funds may be able to avoid becoming subject to ERISA if they meet one of at least two exceptions: (1) the Venture Capital Operating Company exemption (the ''VCOC''), or the ''significant participation'' exception, also known as the ''25 Percent Rule.'' Under the VCOC exception, an investment vehicle that holds at least 50 percent of assets invested in operating compa-

 COPYRIGHT © 2016 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0037-0665

nies involved in the production or sale of a product or service other than the investment of capital and exercises management rights in those companies does not hold ''plan assets'' for ERISA purposes. 29 C.F.R. 2510.3-101. The ''significant participation'' exception states that if retirement plan assets represent less than 25% of any class of equity of a fund, the fund will not be deemed to hold plan assets under ERISA. *Id.*

Both of these ERISA exceptions are highly complicated in their application and may require a compliance regime all their own. It should be noted, however, that neither of these exceptions explicitly come into play until the investment vehicle is actually established.

A private fund cannot fall under the VCOC exception until it has actually invested in an operating company. Therefore, prior to its first investment, a private fund may not by protected by this exception to ERISA. This raises questions about whether communications between a private fund manager and potential investors—or with subscribed investors, before the date of the fund's first investment—could fall within the ambit of the new DOL rule.

Similarly, the ''significant participation'' exception is usually only triggered after fundraising is complete. While the exception provides that no more than 25 percent of each class of equity interest of any fund may be held by retirement plan investors, this calculation cannot necessarily be made until a fund has closed and the investors are known.

If the fund meets one of these exceptions, then it would not be deemed to hold plan assets, and the new rule should not be implicated. If however, a fund is determined to hold plan assets—*i.e.*, it does not meet one of the foregoing exceptions—then the question is how, if it all, the new rule would impact a fund's compliance regime.

As fund managers typically manage invested assets, and make investment decisions through their explicitly delegated discretion over plan assets, it is unclear whether the decision of a fund manager to invest pooled assets through a specific transaction would constitute a ''recommendation'' under the new rule if the fund is determined to hold retirement plan assets. However, given that there exists a specific exemption in ERISA for mutual funds, as discussed below, it is an open question as to how broadly ''recommendation'' will be interpreted.

To the extent that managers of pooled investment vehicles are deemed to provide ''recommendation[s]'' to investors, it is not clear whether managers of commingled funds will become subject to the rule, if any. ERISA already exempts from its regulatory scheme registered mutual funds so long as the mutual fund merely serves as a funding vehicle for a retirement plan. ERISA § § 3(21)(B), 401(b)(1). This exemption protects the mutual fund, its investment adviser, and its principal underwriter from being defined as a ''fiduciary,'' ''party in interest,'' or ''disqualified person'' under ERISA. *Id.* Thus, mutual funds should not be impacted by the DOL's fiduciary rule. However, it is yet to be determined whether the managers of various forms of private investment funds—including hedge funds and private equity funds—may become subject to the new rule when investing retirement assets.

To be clear, exceptions do exist for private funds that meet certain criteria (discussed below), and it would seem that such exceptions would continue to apply notwithstanding the new rule, as long as those criteria are met. However, it is possible that the question will be the subject of future litigation or regulatory inquiry—and different courts or regulators, faced with different factual circumstances, may reach different conclusions. Additionally, as discussed below, the new fiduciary rule raises questions as to how communications made by private funds with potential investors prior to the closing of the fund-raising period will be treated.

Effect on Marketing of Private Funds

As most marketing for closed-end private funds occurs prior to closing, it is unclear whether the new rule would apply to marketing materials and other solicitations by private funds before the foregoing exceptions are triggered. In response to comments received during the notice-and-comment period, the DOL expanded the so-called ''seller's exception,'' which was created to exempt recommendations and materials provided to ''independent fiduciaries with financial expertise.'' 29 C.F.R. 2510.3-21(c)(1)

This exception, while broader than what was contemplated in the original version of the proposed rule, still raises questions regarding the potential impact on private funds. As written, the ''seller's exception'' arguably puts the onus on fund managers to ensure that marketing materials are provided only to individuals who qualify under the exception. Making such a determination and setting ground rules for future solicitations could create new compliance hurdles for private fund managers.

To fall under this exception, the potential investor must be an independent fiduciary with financial expertise, which would include (a) a bank, (b), an insurance company, (c) an entity registered as an investment adviser under the Investment Advisers Act of 1940 or registered as an investment adviser with the state in which it has its principal office, (d) a broker-dealer registered with the SEC, or (e) an independent fiduciary that holds, or has under management or control, at least $50 million. *Id.* In addition, the person providing the ''recommendation'' must reasonably believe that the independent fiduciary is capable of evaluating investment risks independently and must also inform the fiduciary that it is not providing impartial advice and may have an interest in the transaction. *Id.*

Although this exception may cover some portion of investors in private funds, fund managers will have to navigate these waters in the months prior to the rule's effective date. As a result, like with so many regulatory changes, a new compliance burden may have been inadvertently created. The DOL already allows private funds to manage investments for retirement plans without becoming ensnared in the requirements of ERISA so long as they meet the VCOC or significant participation exemption. However, it is unclear whether the new DOL rule creates another hurdle that private funds must clear prior to the close of a fund.

Although it would appear to be in tension with the express purpose of the rule, the plaintiffs' bar could argue that the DOL has created a new requirement for private funds during the marketing and fund-raising phase. In that case, in addition to ensuring the accuracy of marketing materials for purposes of the Investment Advisers Act, fund managers would also be required to either (1) take preemptory steps to ensure that each potential

investor who received individualized marketing materials fits into one of the defined ''independent fiduciary'' categories, or (2) simply accept that they must act as a fiduciary in providing marketing materials to potential investors. If this is a consequence of the new fiduciary rule, it appears to be an unintended consequence, as it is not mentioned anywhere in the comments by the DOL and seems far afield from the stated purpose of the rule.

Should this rule be deemed to apply to the marketing of private funds, it may create a host of additional challenges. Many private fund managers are already regulated by the Securities and Exchange Commission as registered investment advisors. This new rule could now place them in the regulatory crosshairs of the Department of Labor, subjecting them to a new set of regulators and a new compliance regime.

Furthermore, ERISA provides different statutory rights and penalties than those available under the Investment Advisers Act. For example, should the new rule apply to advertising materials utilized by private fund managers, potential investors may have a private right of action. Such right would not exist under the Investment Advisers Act, which does not provide a private right of action for current or potential investors (although Section 10(b) of the Securities and Exchange Act provides a private right of action for material misrepresentations in connection with the purchase or sale of securities, and a right of action may arise out of an investment agreement). This rule may allow for such suits prior to any agreement being entered. ERISA also imposes on fiduciaries substantive requirements of ''prudent'' management and diversification of assets. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a). Finally, by drawing such private fund managers into a new regulatory scheme, the new rule could subject them to multiple interpretations of the requirement of a fiduciary depending on the agency applying the interpretation.

In short, the new rule may have unintended consequences requiring private fund managers to follow a number of potentially complicated and expensive procedural steps to ensure that materials provided to potential investors do not somehow cause the private fund manager to owe a fiduciary duty to such potential investors and become entangled in a complex web of ERISA regulations.

Conclusion

While the new DOL rule was intended to protect consumer investors, it may have the unintended consequence of creating new regulatory hurdles for private funds. Because its definition of ''recommendation'' is so broad, it calls into question whether many communications made by private fund managers with potential investors are swept into the rule. Although private funds generally are able to avoid ERISA requirements through specific exemptions, these exceptions may not apply to pre-close marketing materials, and therefore, it is possible that such materials could fall under the definition of ''recommendation,'' creating a new regulatory requirement for private funds.

 COPYRIGHT © 2016 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0037-0665