DOL Fiduciary Rule

Midland IRA Podcast

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Welcome and thank you for tuning into alternative investment talks with Midland IRA where we talk everything alternative investments.

I'm Matt Almaguer with Midland IRA and today we have a great topic in store as we will be discussing the new DOL Fiduciary Rule. My guest for today's show is Steve Graham of Constellation Advisers.

DOL Podcast Presentation

1) **Steve, thanks for joining me today. Why don't we start with you telling us a little about yourself and your specialty?**
    a. First, I want to thank you, Matt, and Midland IRA for inviting me to participate on this podcast. My name is Steve Graham. I am the Managing Director of Compliance in Constellation Advisers Dallas Office.
        i. Constellation Advisers is a premier investment management consulting firm with a customized boutique firm approach. Constellation was voted best advisory firm by HFM Week Services Awards.
        ii. We provide regulatory and compliance advisory services as well as accounting and operational support to hedge funds, private equity funds, venture capital funds, family offices, mutual funds, and fund of funds.
        iii. Constellation is headquartered in New York with offices in Dallas and San Francisco.
        iv. Before joining Constellation, I was a Senior Enforcement Attorney with the SEC for about 12 years where I investigated and prosecuted a variety of market participants for violating various securities laws, including the Investment Advisers Act, Investment Company Act, Securities Act, Exchange Act, and other rules and regulations.
        v. I was also Senior Regional Counsel in FINRA's enforcement department for nearly 5 years where I investigated and prosecuted broker-dealers for violating securities laws and FINRA rules.
        vi. And I started my career in private practice with a law firm here in the DFW area where I was a commercial litigator for over 5 years.
    b. And I have a disclaimer.
        i. This presentation is for informational purposes only.
        ii. It is not intended to constitute legal advice and should not be used as legal advice.

2) **Can you explain the new fiduciary rule, and what it means from a macro point of view?**
   a. I'd be glad to. First, I think some background will help provide context that will make the new DOL fiduciary rule more understandable. ERISA, which is shorthand for the Employee Retirement Income Security Act of 1974, is legislation passed by Congress that is designed to protect retirement plan beneficiaries and participants from a number of problems including misuse of plan assets by parties related to the plan.
      i. ERISA seeks to achieve this protection by imposing numerous obligations on fiduciaries as well as by prohibiting many transactions that give rise to conflicts of interest, which are commonly known as "prohibited transactions".
      ii. With respect to the alternative investment community, many of ERISA's protections do not apply if the level of retirement assets invested in a fund stays below 25%. In this circumstance, the fund is not considered a retirement plan and the ERISA protections do not apply to the hedge fund, private equity fund, mutual fund, or other pooled investment. They apply to the ERISA plan investing in the private fund, but they don't attach to the private fund.
   b. The DOL, which is shorthand for the Department of Labor, is the federal agency with primary responsibility for administering and enforcing ERISA.
      i. As you can see, ERISA's protections did not extend to private fund managers when the amounts invested in the private fund was kept below the 25% threshold level. In ERISA terms, this means that the alternative investment managers were not deemed to be managing "plan assets".
      ii. Based on the DOL's changes, now instead of private funds and their advisers only having to deal with the ERISA fiduciary standard when managing plan assets (meaning 25% or more of the fund was comprised of retirement assets), they now have to deal with the DOL fiduciary standard when making a recommendation to a plan, its participants and/or beneficiaries, or to an IRA owner and as a result receive a fee or other compensation (direct or indirect, such as commissions, revenue sharing, finder's fees and marketing or distribution fees) that flow from that advice.
      iii. From a macro point of view, the DOL fiduciary rule's aim is to prohibit persons selling financial advice, products and services from seeking greater profits for themselves by placing retirement assets in vehicles that are not in the retirement account holder's best interest; generally referred to as ERISA's self-dealing prohibition.
      iv. If we keep this goal in mind, the discussion about the new changes are easier to follow because pension plans are going away (i.e. (i) private

company pensions are becoming more rare, (ii) the federal government and SROs like FINRA have been and are reducing pensions, and (iii) social security benefits have increasingly become the subject of discussions of collapse), so it appears that individuals are going to have to rely on their own retirement savings in their golden years. Because 401k and IRA rules prohibit you from withdrawing those funds until you reach retirement age, this is where the average American's money is most likely to pool and be available for living expenses later in life.

v. It appears that the DOL implemented the fiduciary rule in order to broaden ERISA's protections to a space where its reach was limited. To accomplish this goal, the DOL focused on investment advice to retirement plans and IRAs; not just persons who invested in pooled funds that were deemed plan assets. The DOL's focus was on extending the protections of ERISA to retirement assets that were arguably not receiving the full benefit of ERISA fiduciary protections.

vi. To broaden its reach, the new DOL rule replaces the previous 5-part fiduciary test with a singular "recommendation" test. Previous key factors to determine whether advice was fiduciary including "given on a regular basis", "primary basis for investment decision", and "pursuant to a mutual agreement" are now gone.

vii. But, you may ask, "What's the big deal"? Fund managers and advisers already owe a fiduciary duty to their investors. That's true. But there's two things to note: first, broker-dealers do not owe a fiduciary duty to clients. They are required to make suitable recommendations and seek best execution of their recommended transactions, but they have no fiduciary obligations. With the DOL fiduciary rule, broker-dealers making recommendations to a plan, its participants, beneficiaries or IRA owners now have a fiduciary duty with respect to those recommendations. Second, advisers and managers can disclose conflicts of interest to clients and investors who can then waive those conflicts. Once appropriately disclosed and waived, managers and advisers can carry on without violating their fiduciary duties to the clients and investors. With the DOL fiduciary rule, the conflict cannot be waived. Instead, the manager or adviser must find an exemption in order to avoid violating their fiduciary duty. We'll address each of these items over the course of our discussion.

3) Who is going to be affected the most in the alternative investment arena by this and why?

a. I think hedge fund managers will be the most affected. Under the new rule, recommending an investment in a hedge fund may be deemed investment advice and when given to an ERISA plan while functioning as the ERISA fiduciary

and collecting a fee from the fund in which the ERISA plan invests may be a prohibited transaction for self-dealing because the manager is recommending the investment and then collecting a fee on the invested assets. Advisers to hedge funds will need to be very careful about representations to existing clients and also be mindful that new contributions from existing clients will not be grand-fathered into the new DOL rule. So, the risk for hedge funds and their advisers for inadvertently creating an issue under the new DOL fiduciary rule for simply carrying on relationships with existing clients is greater than for private equity funds. Typically, private-equity funds are closed-funds. So, if the fund was closed before the new DOL rule went into effect, the investment recommendation and decision have already occurred and the DOL rule should not create issues for those existing clients. This includes capital calls after June 9 as long as the capital was committed by the client before June 9, because the investment decision was made at the time the capital was committed.

4) **What does the process look like for fund managers bringing on IRA investors without an independent fiduciary?**
    a. Interestingly, ERISA does not apply to IRAs. But the Internal Revenue Code does have self-dealing prohibited transaction provisions. The Internal Revenue Code prohibitions mirror those imposed by ERISA. Accordingly, if a fiduciary engages in a self-dealing prohibited transaction, then that fiduciary will likely be subject to fiduciary liability under ERISA with respect to ERISA-governed plans and be liable for excise taxes under the Internal Revenue Code with respect to both ERISA plans and IRAs.
        i. Therefore, whether you're bringing on an ERISA plan investor or an IRA investor, the adviser should look first to identify the ERISA fiduciary and if not immediately identifiable, then for one of the exemptions that are available for prohibited transactions that would avoid liability for breaching the fiduciary duty and the excise taxes that would otherwise flow from those transactions.
    b. The exemption most applicable to IRA investors with an independent fiduciary is the "independent fiduciary exclusion". This exemption precludes application of the new fiduciary rule to fund managers and advisers who are dealing with separately advised fiduciaries.
        i. Essentially, the exclusion permits a fund manager or adviser to make recommendations to the independent fiduciary of the plan or IRA when that independent fiduciary is capable of evaluating the advice and is informed that the recommendation is not intended to be impartial. The fund manager or adviser also cannot receive a fee or other compensation directly from the plan or IRA for providing the investment advice in connection with the recommended securities transaction.
    c. The independent fiduciary exemption is not available to IRA owners, small plan fiduciaries or plan participants and beneficiaries that are not separately advised

by fiduciaries. Therefore, fund managers bringing on IRA investors without an independent fiduciary would have to look for another exemption or work with the client to place the IRA account with an adviser willing advise the account as the fiduciary.

5) **Do they need a BICE form, and what is a BICE form?**
    a. This is one of those exemptions I was just alluding to. At the outset, it's important to note that transactions with an ERISA plan or IRA are essentially presumed to be prohibited unless an exemption applies.
    b. One of those exemptions is BICE, which is an acronym for "Best Interest Contract Exemption".
        i. It is a new prohibited transaction exemption that is intended to align the fiduciary adviser's interests with those of the ERISA plan or IRA customer.
        ii. BICE is a contract that will permit the adviser to participate in a transaction if the adviser agrees to: (1) provide advice and act in the client's best interest; (2) warrant that it has adopted anti-conflict of interest policies and procedures; and (3) disclose conflicts of interest that may affect the adviser's best judgment (such as hidden fees) while providing investment advice. Once the adviser meets these requirements, then the BICE exemption will permit the adviser to receive 12b-1 fees, commissions, sales loads, and revenue-sharing payments in limited circumstances.
            1. But if the adviser fails to comply with any of these requirements, then it can be held liable for breach of contract in addition to breach of fiduciary duty actions.
            2. BICE, however, is not available for riskless principal transactions, which are trades where a broker-dealer receives an order to buy (or sell) a security and then the broker-dealer in its capacity as a principal purchases (or sells) the same security from another broker-dealer at the same price in order to satisfy that customer's order. In a riskless principal transaction, the broker-dealer generally charges the customer a markup, markdown or commission on the transaction.
    c. There is also discussion that the BICE may be amended or removed from these new rules, so stay tuned on this one.

6) **Can managers amend their offering documents to say they aren't soliciting or advising the IRA?**
    a. They can, but whether a fund manager or adviser is soliciting or advising a plan or IRA is a facts-and-circumstances analysis. To determine whether a communication is fiduciary investment advice, you have to look at: (1) the nature of the communication; and (2) who is providing the communication.
        i. First, the nature of the communication:

            1. Includes “recommendations” regarding acquiring, holding, disposing of, or exchanging securities or other investment property, including recommendations about how property should be invested after a rollover, transfer or distribution from a plan or IRA; or
            2. “recommendations” regarding the management of investment property, the selection of other persons to provide investment advice or management services, the selection of investment account arrangements, and recommendations regarding rollovers, transfers or distributions.
      ii. Now let’s look at who is providing the communication:
            1. This covers persons who render advice pursuant to an agreement, arrangement or understanding that the advice is based on the particular investment needs of the advice recipient; or
            2. Persons who direct the advice to a specific advice recipient regarding the advisability of a particular investment or management decisions regarding plan assets or an IRA.
      iii. If the communication satisfies both of these elements, it will be subject to the DOL fiduciary rule regardless of what disclaimers you put in the offering docs.
      iv. In practical terms, the more individually tailored the communication, then the more likely it will be considered fiduciary investment advice. If you are sending offering documents and subscription agreements to persons with retirement funds and recommending that they invest those retirement funds into your private fund (including rolling over IRAs into your private fund), then you are likely making a recommendation that will fall under the DOL rule.
   b. But that doesn’t mean you can’t amend your offering docs to incorporate the language necessary to satisfy one of the exemptions we previously discussed. For example, if the fund manager or adviser intends to comport with the independent fiduciary exemption or BICE exemption, then they can incorporate representations into the offering and subdocs to elicit the investor’s agreement to those requirements and necessary representations.
   c. On a somewhat related note, we also recommend including a disclaimer on communications with clients along the lines that the information is not being provided in a fiduciary capacity and is not intended to be and should not be considered as impartial investment advice. These types of disclosures may not be outcome determinative in clear cases of making recommendations to retirement plans and IRA holders, but they can help in an adviser’s attempts to avoid accidentally falling under the fiduciary rule in border-line cases.

7) Do you think this will discourage advisors from allocating to alternative investments?

a. I doubt it. There may be some apprehension while the rule is being implemented. But in the long run, I don't think it will significantly impact allocations to hedge funds and private equity firms.
    i. In its FAQs published in May 2017, the DOL indicated that fees that are level "substantially insulate advisers from conflicts of interest" assuming that the fees are reasonable. The DOL's tone gives the sense that its prominent concern is advisers that recommend investments that pay the highest commission when alternative investments with lower costs are available. Because managers and advisers of hedge funds and private equity funds typically charge a level fee that is a percentage of AUM, the fee structure will cause less concern for the DOL based on its comments.
    ii. Therefore, once the alternative investment managers and advisers get their disclosures and agreements revised in compliance with the new rule, placing clients into those investment vehicles should not create any significant risk of violating the DOL rule.
    iii. Another objective of the DOL's rulemaking was to bring accounts that may not have a sophisticated fiduciary under the protection of the prohibited transaction rules and give them the benefit of a sophisticated fiduciary. The portion of the industry's assets represented by these types of accounts is very small.

8) Do you think there will be any retraction of this rule before January 1st when they are going to start enforcing it?

a. Hard to say. But just within the last couple of weeks, the DOL filed a notice with the Office of Management and Budget proposing amendments to BICE and other new and amended prohibited transaction exemptions related to the new fiduciary rule. These proposed amendments would extend the transition period for 18 months to July 1, 2019. As of today, which is August 22, the full text of DOL's proposal has not been published in the Federal Register, but the length of the extension for the transition period suggests that the DOL is considering what may be fairly extensive changes to the rule.
b. To close out the loop, the Treasury Department and Internal Revenue Service indicated that the excise tax provisions and reporting obligations will also not be enforced during the DOL transition period, which is currently scheduled to end on 1/1/2018. I haven't seen anything from them indicating that they will extend their period of non-enforcement to July 1, 2019, but I suspect they will.
    i. In addition, it is an open question whether there is exposure beyond the DOL in the form of private actions by ERISA plans or their participants for failures to comply with the fiduciary standard.

9) If there isn't a retraction, do you think it will be a full repeal or just an adjustment?

a. That's anyone's guess. But I think all of those options are on the table.
b. Also, I think it's very interesting to note that SEC Commissioner Piwowar submitted a comment letter to the DOL wherein he expressed sharp criticism regarding the DOL's fiduciary rule. His criticisms focused on: (1) the DOL's dismissive views on the efficacy of disclosure as a means to address conflicts of interest; (2) the failure to distinguish selling activities from advice activities; and (3) his belief that the rule will disrupt the broker-client relationship beyond retirement accounts.
c. Commissioner Piwowar argued that disclosure is an effective means to mitigate conflicts of interest and that the SEC has spent decades enforcing disclosure-based regulations. In addition, Piwowar argued that the DOL's fiduciary rule runs contrary to Sections 206(1) and 206(2) of the Advisers Act and Section 913 of the Dodd-Frank Act.
d. It is unusual for a Commissioner of another agency to publicly provide critical remarks of this nature in writing. We will have to wait and see if these comments have any meaningful impact on the DOL in the long run.

10) What do you think managers need to be doing now to prepare for this if they haven't done anything yet?

a. The DOL has indicated that it will not pursue claims against fiduciaries who are working diligently and in good faith to comply with the Rule and the related exemptions and safe harbors. Therefore, as of now, it is advisable to start good faith efforts to comply with the Rule. First, audit your existing investor base, see who among your clients or fund investors may be an ERISA plan or IRA account and is there a named fiduciary between you (as the manager) and the plan beneficiary. Second, update your sub-docs. Third, update your disclaimers in your marketing materials. Fourth, determine what policies and procedures are necessary to adopt in order to comply with the Impartial Conduct Standards promulgated by the DOL. And last, start working on creating a program for compliance, education and monitoring to ensure that the managers and advisers are complying with their obligations. Even if the DOL ultimately revises the rule, providing more disclosures and improving compliance processes are always well-received by regulatory authorities.

Thank you for inviting me to participate on this podcast. Again, my name is Steve Graham with Constellation Advisers.