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Investment Advisor
**Compliance Update**
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# The DOL Fiduciary Rule Update

Like it or not, the Department of Labor's ("DOL's") new fiduciary rule (the "Rule") is coming. Although temporarily delayed, the Rule's ultimate fate appears to be cemented. Much ink has been spilled in dissecting and analyzing the Rule for every possible contingency, and that will not be rehashed here. Rather, it is critical for advisers to be aware of the sometimes convoluted timeline and compliance requirements, in preparation for the inevitable. This will serve as a high-level guide to the Rule's requirements, and when each will become applicable to different firms.

## General Timeline

The Rule can be cleanly broken out into two distinct phases of implementation: the Transition Period and the Effective Date. Each period will have differing requirements and, depending on the firm's fee and compensation structures, will have different implications for each firm.

## Transition Period

The Transition Period was the subject of the Rule's delay. Originally marked to begin on April 10, 2017, the Transition Period's start date has been pushed back to June 9, 2017. This delay will provide relevant regulators time to reassess the Rule and its implications, but more importantly, it will also provide advisers with additional time to implement required compliance procedures.

During the Transition Period, the compliance requirements under the Rule are fairly straightforward. The adviser is required to:

a. Adhere to the Impartial Conduct Standards;
b. Provide a written Fiduciary Acknowledgment; and,
c. Designate a person responsible for addressing material conflicts of interest and monitoring advisers' adherence to the Impartial Conduct Standards

*Impartial Conduct Standards*

According to the DOL, the Impartial Conduct Standards are "consumer protection standards that ensure that advisers adhere to fiduciary norms and basic standards of fair dealing." The Impartial Conduct Standards are further detailed by the DOL. The standards require advisers to:

- Give advice that is in the best interest of the retirement investor,
    - This includes the prudence standard, which holds that advice must meet a professional standard of care
    - It also includes the loyalty standard, meaning advice must be based on the interests of the customer, rather than the competing financial interests of the adviser
- Charge no more than reasonable compensation, and
- Make no misleading statements about investment transactions, compensation, and conflicts of interest

*Fiduciary Acknowledgement*

The Fiduciary Acknowledgment is a flexible requirement. Per the terms of the DOL, the adviser must "affirmatively state in writing that it…act[s] as a fiduciar[y] under ERISA, the Code, or both with respect to any investment advice provided by the…adviser…with respect to any investment recommendations regarding the Plan or participant or beneficiary account."

There is no clear limitation on the form that this notice can take. As such, many advisers are simply incorporating the acknowledgment into their already existing documents, such as the Form ADV and their Investment Advisory Agreements. This works fine for new clients, as the requirement is easily met through delivery of the ADV and the agreement at the time of engagement.

Existing clients, however, necessitate a bit more legwork. Since the ADV and agreements are presumably already in the clients' hands, amendments to such documents would not be sufficient to deliver the required acknowledgment. Instead, the best practice to ensure that every client receives the required acknowledgment would be to send a separate acknowledgment letter to existing clients, informing them of the adviser's newfound role as an ERISA fiduciary. We have prepared a model letter to be sent to existing clients, so be sure to contact your attorney for further details.

*Designated Person*

The final requirement is likely already met, as all firms are already required to name a Chief Compliance Officer. For most firms, this aspect of the Rule will be the easiest to satisfy, as advisers should already have an individual in place to detect and address conflicts of interest and, through their statuses as Investment Advisers Act fiduciaries, advisers are likely already adhering to the Impartial Conduct Standards. To the extent an adviser is not already observing the tenants of the Impartial Conduct Standards, compliance policies and procedures must be implemented to address the concerns raised by the standards, and the Chief Compliance Officer must be tasked with ensuring their implementation and effectiveness.

## Effective Date

As of January 1, 2018, all bets are off. This is the date on which the Rule and its much ballyhooed Best Interest Contract Exemption (the "BICE") will go into full effect. However, the requirements for compliance with the BICE may differ from firm to firm. The BICE will apply differently, depending on whether or not the firm is considered a Level Fee Fiduciary.

*Level Fee Fiduciaries*

A Level Fee is defined by the DOL as "a fee or compensation that is provided on the basis of a fixed percentage of the value of the assets or a set fee that does not vary with the particular investment recommended, rather than a commission or other transaction-based fee." In addition, Levels Fees do not include third party payments, such as 12b-1 fees and revenue sharing payments.

If an adviser is considered a Level Fee Fiduciary, the BICE requirements are streamlined. This is because many of the conflicts for which the Rule was designed are not present, since the adviser is theoretically incapable of increasing its compensation by recommending certain products or product types over others. For Level Fee Fiduciaries, the majority of the BICE requirements are satisfied through adherence to the Transition Period rules.

The only additional obligation is a Best Interest Analysis, which must be performed whenever the adviser recommends a rollover from an ERISA Plan or IRA into an IRA that the adviser will manage for a fee. The obligations differ slightly depending on whether the assets are being rolled from an ERISA Plan or an IRA.

For a rollover from an ERISA Plan, the analysis must include:

- Consideration of the Retirement Investor's alternatives to a rollover, including leaving the money in his or her current employer's Plan, if permitted
- Consideration of the fees and expenses associated with both the Plan and the IRA
- Whether the employer pays for some or all of the plan's administrative expenses
- The different levels of services and investments available under each option

For a rollover from an IRA, or in the case of a switch from a commission-based account to a level fee arrangement, the adviser must simply document the reasons that the arrangement is considered to be in the best interest of the Retirement Investor, including the services that will be provided for the fee.

*Non-Level Fee Fiduciaries*

For Non-Level Fee Fiduciaries, the compliance requirements are quite a bit more complex. As of the Rule's Effective Date, any adviser that is not a Level Fee Fiduciary is required to execute a Best Interest Contract with each impacted client. For new clients, this can be done either through incorporation of the required terms (detailed below) into the firm's already existing advisory agreements or by creating a separate standalone Best Interest Contract. For existing clients, this requirement can be met through a negative consent letter, which incorporates all required items, and states that the failure to terminate the amended contract within 30 days constitutes assent to the terms included therein.

Similar to the requirements during the Transition Period, a Best Interest Contract must include both a Fiduciary Acknowledgment and an affirmative statement that the adviser will adhere to the Impartial Conduct Standards. In addition, the contract ***cannot*** include the following:

- Exculpatory provisions which disclaim or otherwise limit the liability of the adviser for a violation of the contract's terms
- A liquidated damages provision
- A waiver or qualification as to the client's right to bring or participate in an individual or class action suit, except as provided in a pre-dispute arbitration clause
  - However, such arbitration clause cannot force the client to pursue the remedy in a venue that is distant or otherwise unreasonably impairs the client's ability to assert a claim

The contract must include specific affirmative warranties that the adviser has:

- Adopted and will comply with policies and procedures designed to adhere to the Impartial Conduct Standards
- In formulating its policies and procedures, specifically identified and documented its material conflicts of interest, adopted measures reasonably and prudential designed to prevent such material conflicts of interest from interfering with the firm's compliance with the Impartial Conduct Standards, and designate a person or persons, identified by name, title, or function, responsible for addressing material conflicts of interest and ensuring compliance with the Impartial Conduct Standards
- Instituted policies and procedures which seek to prevent compensation arrangements which would reasonably be expected to cause the adviser to make recommendations that are not in the best interest of the client

The contract must also include disclosures of:

- The Best Interest standard of care owed by the adviser
- The services provided by the adviser and how the client will pay for those services
- Any material conflicts of interest
- Any fees or charges imposed by the adviser or its affiliate
- Any compensation received by the adviser or its affiliate from third parties in connection with the investments recommended to the client
- The client's right to obtain copies of the adviser's written description of its policies and procedures adopted to address material conflicts of interest and the Impartial Conduct Standards
- Any costs, fees, and compensation, including third party payments, regarding recommended transactions
- Whether the adviser offers proprietary products or receives third party payments in connection with any recommendation transaction

    - To the extent the firm limits a client's investment options to proprietary products or those which generate third party payments, the client must be so notified
- Contact information for a firm representative that the client can use to contact the firm with any concerns
- To the extent applicable, a statement explaining that the client can research the firm using BrokerCheck or the Investment Adviser Registration Depository
- Whether and to what extent the adviser will monitor the client's investments and recommend any relevant changes
- The adviser's website (discussed further below), identified via link or URL, and statements that inform the client that model contract disclosures are available and updated quarterly via the site, and that a written description of the firm's policies and procedures adopted pursuant to the Rule can be accessed free of charge through the site

Lastly, the contract must provide a link or URL address for a firm-maintained website, which is updated no less than quarterly, and contains:

- A discussion of the firm's business model and its material conflicts of interest
- A schedule of typical account fees
- A model advisory contract
- A copy of the client's actual advisory contract, that is accessible by the client
- The Fiduciary Acknowledgment, Impartial Conduct standards, warranties and disclosures discussed above
- A description of the firm's policies and procedures that describes or summarizes key components of the material conflict of interest compliance processes
- A list of all product manufacturers and other parties who provide third party payments to the firm with respect to investment products recommended
- A description of the above arrangements, including a description of whether and how they impact adviser compensation
- A description of the benefits provided by the adviser to such product manufacturers or other third parties
- Disclosure of the adviser's compensation arrangements with investment adviser representatives

Clearly, the Best Interest Contract is a lot to digest. But that's not all! In addition to the above, an adviser seeking to benefit from the Non-Level Fee Fiduciary version of the BICE is required to notify the DOL of its intention to rely on the BICE ***prior to*** receiving any compensation in connection with a recommended transaction. Notification can be made by email to e-bice@dol.gov.

## Custody: SEC Clarifies Adviser Obligations through No Action Relief and FAQ Updates

An Adviser has "custody" under Rule 206(4)-2 of the Investment Advisers Act of 1940 if a related person that is not operationally independent from the Adviser holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them in connection with advisory services provided to clients. Notably, the definition of "custody" includes any arrangement where an Adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the Adviser's instructions to the custodian.

An Adviser having custody of client funds or securities must comply with the obligations of Rule 206(4)-2, generally including the obligation to undergo an annual surprise examination conducted by an independent public accountant pursuant to a written agreement.

### Recent SEC Examination Findings

Over roughly past year, many Advisers have received SEC Staff comments during routine examinations that the Advisers "may" or "appear" to have custody based upon disbursement and transfer authorizations / standing letters of authorization incorporated into the custodial agreements between the Advisers' clients and their custodians ("SLOAs"). In many cases, these Advisers did not intend to accept custody and were dismayed by the prospect of undergoing annual surprise examinations. Luckily, the SEC Staff often permitted Advisers to respond to examination findings after considering that "a trade association and several custodians were seeking guidance from the Division of Investment Management" about such arrangements.

On February 21, 2017 the SEC released new guidance clarifying when Advisers will be deemed to have custody with respect to SLOAs, and when they will be required to undergo annual surprise examinations as a result. The guidance consists of: a No Action Letter directed to the Investment Adviser Association (ostensibly the "trade association" discussed in examination findings letters) regarding third-party SLOAs; and an amendment to an existing published FAQ regarding standing instructions for like-titled transfers.

## Like-Titled Transfers – Update to FAQ II.4

The SEC publishes its "Staff Responses to Questions About the Custody Rule" at the following link:
https://www.sec.gov/divisions/investment/custody_faq_030510.htm.

On February 21, 2017, Question II.4 was amended to add the language in bold below:

> Q: Does an adviser have custody if it has authority to transfer client funds or securities between two or more of a client's accounts maintained with the same qualified custodian or different qualified custodians?
>
> A: Under rule 206(4)-2(d)(2)(ii), an adviser has custody if it has the authority to withdraw client assets maintained with a qualified custodian upon the adviser's instruction to the custodian. We do not interpret the authority to withdraw assets to include the limited authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians if the client has authorized the adviser in writing to make such transfers and a copy of that authorization is provided to the qualified custodians, specifying the client accounts maintained with qualified custodians. **In the staff's view, "specifying" would mean that the written authorization signed by the client and provided to the sending custodian states with particularity the name and account numbers on sending and receiving accounts (including the ABA routing number(s) or name(s) of the receiving custodian) such that the sending custodian has a record that the client has identified the accounts for which the transfer is being effected as belonging to the client. That authorization does not need to be provided to the receiving custodian. Moreover, in the staff's view, an adviser's authority to transfer client assets between the client's accounts at the same qualified custodian or between affiliated qualified custodians that both have access to the sending and receiving account numbers and client account name (e.g., to make first-party journal entries) does not constitute custody and does not require further specification of client accounts in the authorization. (Modified February 21, 2017.)**

Before adding the bold language, SEC Staff could rely upon the above to determine an Adviser had custody if it was authorized to transfer funds from a client's custodial account to another like-titled account (e.g. checking account), unless the Adviser could confirm the client's written instructions are provided to both the sending and receiving account custodian. This interpretation, however, contravenes the basic premise of Rule 206(4)-2. When an Adviser is authorized to transfer funds between two client accounts held at different custodians, it is not holding, directly or indirectly, client funds or securities; nor does the Adviser have the authority to obtain possession of client funds connection with advisory services it provides to its clients. Instead, the adviser has the limited authority, as directed by its clients for their convenience, to instruct a custodian to transfer funds to their own like-titled accounts (as opposed to any account for which the Adviser or its representatives have access). In that scenario, only the client and the qualified custodians have access to the funds. Further, such authorization does not constitute an arrangement (including a general power of attorney) under which an Adviser authorized or permitted to withdraw client funds or securities maintained with a custodian upon its instruction to the custodian because the Adviser is not authorized to withdraw the funds, nor is it authorized to receive funds.

The updates in bold are therefore a welcome change. Advisers can now rest assured that they do not have custody of client funds under Rule 206(4)-2 if they are authorized to transfer funds between like titled accounts, as long as: "the written authorization signed by the client and provided to the sending custodian states with particularity the name and account numbers on sending and receiving accounts (including the ABA routing number(s) or name(s) of the receiving custodian."

## Third Party Transfers – Investment Adviser Association No Action Letter available February 21, 2017

This No-Action letter provides significant relief to Advisers who are authorized to initiate third-party transfers on behalf of their clients through custodial agreements. The SEC's Chief Counsel's Office issued the No Action Letter in response to a request from the Investment Adviser Association seeking clarification with respect to custody and SLOAs, which appears to serve as a reasonable compromise between the SEC and Advisers.

On the one hand, the No Action Letter confirms the Staff's position that an Adviser "with power to dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets." Therefore, Advisers whose clients execute SLOAs with custodians allowing the Adviser to initiate third-party transfers will still be deemed to have custody. Starting with the first annual ADV amendment after October 1, 2017, those Advisers must indicate on Form ADV Part 1, Item 9 that they have custody of such client assets in connection with the advisory services they provide to clients. However, those Advisers will not be required to undergo annual surprise examinations as a result of the arrangement, as long as the parties satisfy the following conditions:

1. The client provides an instruction to the qualified custodian, in writing, that includes the client's signature, the third party's name, and either the third party's address or the third party's account number at a custodian to which the transfer should be directed.
2. The client authorizes the investment adviser, in writing, either on the qualified custodian's form or separately, to direct transfers to the third party either on a specified schedule or from time to time.
3. The client's qualified custodian performs appropriate verification of the instruction, such as a signature review or other method to verify the client's authorization, and provides a transfer of funds notice to the client promptly after each transfer.
4. The client has the ability to terminate or change the instruction to the client's qualified custodian.
5. The investment adviser has no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the client's instruction.
6. The investment adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser.
7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

We are aware of several custodians that have proactively contacted Advisers to advise how they are already satisfying the above, and how they intend to amend their documentation or practices to help Advisers avail themselves of the No Action relief. While Advisers can easily satisfy the sixth factor on their own, all remaining obligations can be reasonably assumed by custodians. We therefore recommend that Advisers review existing SLOA authorizations incorporated into custodial agreements between clients and their custodians. Advisers should then contact applicable custodians as necessary to determine if any changes to the custodial agreements or the custodian's practices are required for the Adviser to avoid the necessity of undergoing an annual surprise examination.

# Amendments to Form ADV Part 1 & Advisers Act Rules (October 1, 2017 Requirement)

On August 25, 2016, the U.S. Securities and Exchange Commission ("SEC") published Release No. IA-4509 (the "Release"), adopting final amendments to Form ADV Part 1 and the Rules promulgated under the Investment Advisers Act of 1940. The final amendments adopted in the Release largely follow the initial proposal published by the SEC in Release No. IA-4091 with a few changes made in response to comments. The final amendments will become effective on October 24, 2016 and investment advisers must be in compliance by October 1, 2017.

## Amendments to Form ADV Part 1

The Release identifies several areas in which investment advisers will need to provide additional information on their Form ADV with the aim of improving the depth and quality of the information that the SEC collects from investment advisers. These areas include information pertaining to an investment adviser's separately managed accounts ("SMAs"), use of social media, Chief

Compliance Officer's employment and third party compensation status, client information, custodial relationships, wrap program participation, and additional information concerning branch offices.

It should also be assumed that the SEC will be using this new information to better target investment advisers engaged in business practices it deems high risk. Therefore it is of extreme importance that investment advisers provide accurate and complete information when responding to these new questions on Form ADV.

*Separately Managed Accounts*

The area of greatest concern for investment advisers will no doubt be the additional information that they must compile and report in their Form ADV relating to SMAs. The SEC defines SMAs as advisory accounts that are not pooled investment vehicles. This means that for purposes of completing Form ADV, any client account that is not a registered investment company, business development company or pooled investment vehicle must be treated as an SMA for reporting purposes.

The amendments will require advisers to categorize their regulatory assets under management ("RAUM") attributable to SMAs as a percentage of one of twelve asset categories. Advisers with less than $10 billion in RAUM attributable to SMAs will be required to report year end percentages, whereas advisers with more than $10 billion in RAUM attributable to SMAs will be required to report mid-year and year end percentages in their annual Form ADV filings.

Advisers with $500 million or more in RAUM attributable to SMAs will also be required disclose the number of accounts and average derivatives and borrowings information each year as part of their Form ADV annual amendment filing. Advisers with more than $10 billion in RAUM attributable to SMAs will be required to disclose mid-year and year end information on the number of accounts, average borrowings and average derivatives exposure across six categories of derivatives.

*Social Media Usage*

Investment advisers must disclose on Form ADV social media accounts (e.g. Facebook, LinkedIn, etc.) controlled by the adviser. Social media accounts utilized by employees of the adviser that are not subject to the adviser's control need not be disclosed on Form ADV, nor are social media accounts of unregistered affiliates. However, social media accounts which are controlled by the adviser are required to be disclosed, even if they are not used to promote the adviser's business.

*Chief Compliance Officer Disclosure*

Advisers must disclose whether their Chief Compliance Officer is compensated or employed by any third party. Ostensibly, the SEC is concerned that a CCO may not be able to adequately perform their duties to the RIA if they are required to perform similar functions for other firms. Firms that are utilizing an "outsourced" Chief Compliance Officer may be subjected to additional scrutiny pertaining to the potential risks associated with this practice.

*Client Information*

The final amendments require advisers to disclose the number of advisory clients, the types of advisory clients they service, the RAUM attributable to each category of client, the amount of RAUM attributable to non-U.S. persons, and the number of clients the adviser provides advisory services to that do not have RAUM. Advisers with fewer than five clients in a particular category are not required to disclose the number of clients attributed to that category. The aggregate total of RAUM from this Item *must* match the RAUM total disclosed in Item 5.F.

*Custodial Information*

Advisers must disclose on Form ADV each qualified custodian where ten percent or more of their RAUM attributable to SMAs are maintained and the amount of RAUM held at each disclosed custodian.

*Wrap Fee Program Participation*

While participation in a wrap fee program was already required to be disclosed on Form ADV, advisers will be required to disclose the amount of their RAUM attributable to acting as a sponsor or manager for a wrap fee program.

*Branch Office Information*

Advisers must report information about their 25 largest offices. Specifically, advisers with branch offices must report the branch office's CRD branch number, the total number of employees working from that branch office that perform investment advisory functions, and the business activities conducted from that location.

*Umbrella Registration*

The SEC permits Umbrella Registration in the event multiple advisers are controlled by one another or are under common control of a parent entity, and those advisers conduct a single advisory business. In this scenario, one adviser serves as the Filing Adviser while the others serve as Relying Advisers. In order to qualify for Umbrella Registration:

- The Filing Adviser and each Relying Adviser must advise only private funds and/or qualified clients, as defined by the SEC, whose accounts pursue investment objectives which are substantially similar to those of the private fund,
- The Filing Adviser must be located in the United States,
- The Filing Adviser and each Relying Adviser must be subject to all substantive provisions of the Investment Advisers Act of 1940,
- Each Relying Adviser and its employees are subject to the supervision and control of the Filing Adviser,
- Each Relying Adviser is subject to SEC examination, and
- The Filing Adviser and each Relying Adviser are governed by the same Code of Ethics and policies and procedures manual, which are administered and monitored by a single Chief Compliance Officer

The Filing Adviser must complete the Form ADV with responses that account for both the Filing Adviser and all Relying Advisers. In addition, for each Relying Adviser, the Filing Adviser must complete a Schedule R, which includes disclosure of the Relying Adviser's Identifying Information, criteria to establish SEC registration, Form of Organization, and Ownership schedule.

### Amendments to Books and Records Rules: Advisers Act Rule 204-2

Rule 204-2 under the Advisers Act currently requires retention of performance calculations and communications related to performance information that is distributed to ten or more persons. However, after October 1, 2017, advisers will be required to retain supporting documentation for performance calculations, including rates of return, of all managed accounts or security recommendations to any single person. These amendments signify the SEC's increased concern regarding performance calculations and reporting.

**Recommended Actions**: **If you have any questions, please contact your Stark & Stark attorney.**

## Time to Update Policies and Procedures

If you have not updated your Policies and Procedures in the last 6-12 months (or longer), now is the time to do so. Please contact cpike@stark-stark.com or jcanela@stark-stark.com to begin the process of bringing your Policies and Procedures up-to-date.

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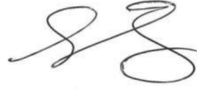
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