
Robo-Advisers to Retirement Plans: ERISA Fiduciary Duties and Prohibited Transactions; SEC Guidance and Compliance

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Today's faculty features:

Margaret Sheehan, Partner, **Ashurst**, Washington, D.C.

William H. Woolston, Partner, **Covington & Burling**, Washington, D.C.

David C. Kaleda, Principal, **Groom Law Group**, Washington, D.C.

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Robo-Advisers to Retirement Plans

ERISA Fiduciary Duties and Prohibited Transactions; SEC Guidance and Compliance

David C. Kaleda
dkaleda@groom.com

Overview

- Introduction
- ERISA & Code Issues/Provider Perspectives
- Advisers Act/Provider Perspectives
- ERISA & Code Issues/Plan Sponsor Perspectives



Introduction

Use of “Robo-advisers”

- Use of “robo-advisers” to provide investment advice and discretionary management services is increasing
 - Related technologies are advancing
 - Regulators are taking note
 - Recent SEC *Guidance Update* addresses Investment Advisers Act of 1940 (Advisers Act) issues
 - DOL’s investment advice regulation (Advice Regulation) & Best Interest Contract Exemption (BICE)

What is a robo-adviser?

- No clear definition from regulator
- In BICE, DOL states, “Investment advice to a Retirement Investor generated solely by an interactive Web site in which computer software-based models or applications provide investment advice based on personal information each investor supplies through the Web site *without any personal interaction or advice* from an individual Adviser.”

What is a robo-adviser? (cont.)

- Robo-advisers often provide technology used by other financial firms (e.g., RIAs, BDs) to provide investment advice.
 - Such technology may aid in ERISA & Code compliance
- SEC acknowledges a number of business models that include a range of human involvement
 - Recent SEC guidance focused on robo-advisers with no human involvement

When do ERISA, Code & Advisers Act Apply?

- ERISA-governed retirement plans & their participants – ERISA’s fiduciary duty and prohibited transaction provisions & Code’s prohibited transaction provisions apply
- IRAs, HSAs, Archer MSAs, Coverdell ESAs – Code prohibited transaction provisions apply
- Above accounts & taxable accounts – Advisers Act or comparable state law



ERISA/Code Issues – Provider Perspective

Is the Robo-adviser a Fiduciary?

- “**Fiduciary**” under ERISA section 3(21) and Code section 4975(e)(3)
- A person who:
 - Exercises any authority or control respecting management or disposition of a plan’s assets, or
 - Renders **investment advice** with respect to plan assets for a fee or other compensation, or has any authority or responsibility to do so

Is the Robo-adviser a Fiduciary?

- Effective June 9, 2017, DOL Final Regulation significantly broadened “**investment advice**” definition
- Person provides “investment advice” under ERISA and the Code if “Covered Advice” & “Relationship Condition” unless “Exception/Exclusion” applies
- Covered Advice:
 - recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property of the plan, IRA, etc.;
 - recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from a plan, IRA, etc.;

Is the Robo-adviser a Fiduciary?

- Covered Advice (cont.):
 - recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., brokerage versus advisory); or
 - recommendations with respect to rollovers, transfers, or distributions from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer, or distribution should be made
- Recommendation -“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.” 29 C.F.R. § 2510.3-21(b)(1).
 - May be initiated by either a person or computer software program

Is the Robo-adviser a Fiduciary?

- Relationship Condition
 - person represents or acknowledges that he or she is acting as a fiduciary within the meaning of ERISA or the Code;
 - person renders the advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the advice recipient; or
 - he or she directs the advice to a specific advice recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or the IRA.

Is the Robo-adviser a Fiduciary?

- Exclusion & Exception - 3 most relevant to robo-advisers:
 - General communications
 - Investment education
 - Arms-length transaction with an Independent, Sophisticated Fiduciary exclusion

Is the Robo-adviser a Fiduciary?

- General Communications: furnishing or making available to a plan, IRA, fiduciary to a plan or IRA, plan participant or beneficiary, or IRA owner general communications that a reasonable person would not view as an investment recommendation is not a “recommendation” (e.g., general market data (including data on market performance, market indices, or trading volumes), price quotes, performance reports, prospectuses).

Is the Robo-adviser a Fiduciary?

- Investment Education: Provision of certain categories of investment-related information and materials to a plan, IRA, fiduciary to a plan or IRA, plan participant or beneficiary is not a “recommendation” so long as “the information and materials do not include:
 - Recommendations with respect to specific investment products, or specific plan or IRA alternatives, or
 - Recommendations with respect to investment or management of a particular security or securities or other investment property”
- Categories of “investment-related information and materials”:
 - Plan information
 - General financial, investment, and retirement information
 - Asset allocation models
 - Interactive investment models

Is the Robo-adviser a Fiduciary?

- Investment Education - Asset Allocation Models
 - Information and materials that provide plan participant or beneficiary or IRA owner with models of asset allocation portfolios of hypothetical individuals with different time horizons and risk profiles
 - Ex: pie charts, graphs, case studies
 - Must meet DOL regulation requirements
 - May not populate models with investment options available under an IRA
 - Viewed as recommendations, and thus investment advice
 - May do so with “plans” under certain conditions

Is the Robo-adviser a Fiduciary?

- Investment Education - Interactive Investment Materials
 - Questionnaires, worksheets, software, and similar materials that provide plan participant or beneficiary or IRA owner the means to:
 - Estimate future retirement income needs and assess impact of different asset allocations on retirement income,
 - Evaluate distribution options, products, or vehicles by providing information set forth in DOL investment advice regulation, or
 - Estimate retirement income stream that could be generated by an actual or hypothetical account balance
 - Must meet certain DOL regulation requirements
 - Ex: must not include or identify any specific investment alternative or distribution option available under the plan or IRA, unless specified

Is the Robo-adviser a Fiduciary?

- Independent Fiduciary Exclusion (IFE)
 - Provision of any advice to a
 - fiduciary of a plan,
 - plan participant or beneficiary,
 - plan IRA, or
 - IRA owner
 - with respect to an arm's length
 - sale,
 - purchase,
 - loan,
 - exchange, or
 - other transaction related to investment of securities or other investment property, under certain conditions

Is the Robo-adviser a Fiduciary?

- IF must either be a:
 - U.S. bank,
 - U.S. insurance company,
 - U.S. registered investment adviser, or
 - U.S. registered broker-dealer
 - Alternatively, plan fiduciary has total assets of at least \$50 million under its control
 - Includes plan and non-plan assets (e.g., corporate assets)
 - Cannot be a plan participant or beneficiary or IRA owner
 - \$50 million threshold unavailable for sales to these parties

Is the Robo-adviser a Fiduciary?

- IFE Conditions:
 - Person **knows or reasonably believes the independent fiduciary is capable of evaluating investment risks independently**
 - Both in general and with regard to particular transactions and investment strategies
 - Person **fairly informs independent fiduciary that person is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity**, in connection with the transaction **and fairly informs independent fiduciary of the existence and nature of person's financial interests**
 - Person **knows or reasonably believes that the independent fiduciary is a fiduciary** under ERISA or the Code, with respect to the transaction **and is responsible for exercising independent judgment** in evaluating the transaction; and
 - Person **does not receive a fee or other compensation directly** from the plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner for provision of investment advice

Is the Robo-adviser a Fiduciary?

- IFE helpful to robo-advisers who provide advice to other intermediary financial institutions who also act as fiduciaries
 - May not want to be fiduciaries
 - Hard to comply with ERISA and Code requirements without knowing client identities
 - Can exempt robo-advisers from being fiduciaries to intermediary, representatives and clients
 - This is the case where an intermediary provides advice and compensates robo-adviser with client fees pursuant to agreement

Is the Robo-adviser a Fiduciary?

- DOL guidance re: whether model portfolio developers provide “investment advice”
- A registered investment adviser does not provide investment advice if adviser who develops model portfolio:
 - provides a non-client specific model portfolio to an unaffiliated registered investment adviser, bank, or broker-dealer financial institution;
 - does not individualize the model to the needs of any specific plan or IRA client of the financial institution;
 - does not contract with the plan or IRA client;
 - does not execute trades in the plan or IRA client’s portfolio;
 - does not agree with the financial intermediary to assume fiduciary status;
 - does not have any control over whether its model is used in managing any specific client account, and
 - does not receive any fee or compensation directly from such plan or IRA clients for use of the model

Is the Robo-adviser a Fiduciary?

- Robo-advisers who are advisers for purposes of the Advisers Act are already fiduciaries
 - Probably no issue with being a fiduciary for purposes of ERISA and the Code.
- May be fiduciaries in situations they do not intend to be
 - Ex: robo-adviser is a fiduciary both where it provides discretionary asset management and also where it solicits distributions from a prospective investor who has a balance in an ERISA-governed plan or an IRA with a brokerage account
- Acting as a discretionary fiduciary versus an advice fiduciary may dictate how advisor complies with prohibited transaction provisions

What are my Fiduciary Responsibilities to a Plan?

- Robo-adviser acting as fiduciary must exercise:
 - Duty of Prudence
 - Discharge duties “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims”
 - Duty of Loyalty
 - Discharge duties with respect to the plan solely in the interest of the participants and beneficiaries for the “exclusive purpose” of providing benefits to participants and their beneficiaries and defraying reasonable expenses of the plan
 - Duty to Diversify
 - Discharge duties “by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so”
 - Duty to Follow Plan Documents
 - Discharge duties “in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [ERISA]”

What are my Fiduciary Responsibilities to a Plan?

- Personally liable for plan losses caused by breach of fiduciary duty
 - Plan's named fiduciary may:
 - Bring causes of action against a plan fiduciary to restore losses
 - Pursue other remedies under ERISA
 - May not use exculpatory language to avoid liability - void as against public policy

What are my Fiduciary Responsibilities to a Plan?

- Robo-advisers providing advice and discretionary management services to plan's named fiduciary or participants
- Must comply with fiduciary duties or else risk liability
 - Consider whether technology generates investment advice or manages account assets in accordance with duties
 - Obtain information a prudent fiduciary would obtain to make prudent recommendation

What are my Fiduciary Responsibilities to a Plan?

- ERISA focuses on “procedural” prudence
 - Process by which fiduciary gathers appropriate facts and information to make reasoned determination under ERISA standards
- Should also consider “substantive” or “objective prudence”
 - Thorough process may not overcome bad decisions that result in large losses
 - Court may consider outcomes of fiduciary investment activity

What are my Fiduciary Responsibilities to an IRA?

- Robo-adviser providing services with regard to assets held in an IRA
- Generally not subject to ERISA's fiduciary duty requirements
- Exceptions:
 - Where IRA is considered an "employee benefit plan" as defined in ERISA (rare)
 - Where robo-adviser makes a recommendation to take a distribution from ERISA-governed plan so that the assets may be rolled over to an IRA to which robo-adviser provides services
 - Where compliance with certain prohibited transaction exemptions requires compliance with Impartial Conduct Standards

What are the Prohibited Transaction Provisions?

- Fiduciaries to ERISA-governed plans must comply with the prohibited transaction provisions in ERISA & the Code
- Fiduciaries to IRAs must comply with prohibited transaction provisions in Code sec. 4975.
 - Generally mirror those of ERISA
- If PT, either:
 - Comply with a prohibited transaction exemption, or
 - Otherwise eliminate the PT.

What are the Prohibited Transaction Provisions?

- **Party in Interest/Disqualified Person Prohibited Transactions** – a fiduciary may not engage in a transaction that constitutes a direct or indirect:
 - Sale or exchange of property between the plan and a party in interest
 - Lending of money or other extension of credit between the plan and a party in interest
 - Furnishing of goods, services, or facilities between the plan and a party in interest
 - Transfer to, or for the use by or for the benefit of, a party in interest of plan assets
 - Cause the plan to purchase employer securities or employer property

What are the Prohibited Transaction Provisions?

- Fiduciary Prohibited Transactions: A fiduciary may not
 - deal with assets of the plan in his own interest or account (i.e., no self-dealing)
 - act in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan or the plan's participants and beneficiaries (i.e., no conflicts of interest)
 - receive consideration for his own personal account from any party dealing with the plan in connection with a transaction involving plan assets (i.e., no kickbacks)
- An IRA fiduciary is not subject to the second PT described above

Is Service Provider Exemption Available?

- ERISA section 408(b)(2) and Code section 4975(d)(2) exempt:
 - “Contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor.”
 - Context: compensation for providing investment advice or management services

Is Service Provider Exemption Available?

- Requirements under ERISA section 408(b)(2):
 - Services are helpful and appropriate for carrying out plan purposes,
 - Arrangement is terminable by the plan on reasonable notice without penalty, and
 - Plan does not pay more than reasonable compensation for services
 - *Requires significant disclosure*
- Requirements under Code section 4975(d)(2):
 - Office space or service is necessary for establishment or operation of plan,
 - Office space or service is furnished under reasonable contract or arrangement, and
 - No more than reasonable compensation is paid
 - *Much less burdensome – no specific disclosure requirements*

Is Service Provider Exemption Available?

- Sections 408(b)(2) & 4975(d)(2) cont.
 - Neither 408(b)(2) nor 4975(d)(2) exempts the above-described fiduciary self-dealing, conflict of interest and kick-back prohibitions
 - DOL views as separate transactions
 - Must comply with different exemption or eliminate the fee conflict
- Primary DOL Concern: fiduciary using authority to increase own compensation or that of party in which it has an interest

Is Service Provider Exemption Available?

- Possible prohibited transactions by robo-advisers:
 - Recommending or investing in mutual funds that are advised by adviser or affiliate
 - Prohibited under ERISA 406(b)(1) or corresponding Code provision
 - Receiving payments from the mutual fund
 - Prohibited under ERISA 406(b)(1) and 406(b)(3) or corresponding Code provisions
 - Recommending to take a distribution from an ERISA-covered plan and rollover the proceeds so that the adviser may provide advice or management services
 - Incentive to make recommendations not in best interest
- 408(b)(2) and 4975(d)(2) do not address these
 - Look to other exemptions or DOL guidance

What Other Exemptions or Options are Available?

- Best Interest Contract Exemption/BICE
- ERISA section 408(b)(14) and Code section 4975(d)(17)
- SunAmerica Advisory Opinion
- PTE 77-4
- Frost Advisory Opinion

What Other Exemptions or Options are Available?

- Robo-adviser that complies with conditions of an exemption will not be held liable for a non-exempt prohibited transaction
- Robo-adviser that complies with Advisory Opinion guidance will operate without fiduciary self-dealing or similar conflict
 - No need to comply with exemption other than 408(b)(2) or 4975(d)(2)

What is the BICE?

- Issued at the same time as the DOL “investment advice” regulation
- Addresses conflicts that arise when an adviser or party in which it has an interest, e.g., an affiliate, receives “prohibited compensation” in connection with investment advice
- **“Prohibited compensation”** is paid:
 - To a fiduciary adviser that varies based on its investment advice
 - From third parties to the adviser or a party in which it has an interest in connection with its provision of investment advice.
 - Ex:
 - ERISA-covered plan distribution recommendations
 - Recommending move from commission to fee-based account
 - Investment in affiliated funds
 - Receipt of revenue sharing from fund complexes

What is the BICE?

- Transition period from June 9, 2017 to January 1, 2018
 - During transition period, adviser need only comply with Impartial Conduct Standards (to be discussed)
 - On January 1, 2018, conditions become much more extensive (though extension likely)
 - But, would not apply to robo-adviser that is able to otherwise rely upon the “Level Fee” BIC Exemption (to be discussed)
- An extension of the Transition Period is likely. If so, compliance with the ICS could extend to July 1, 2019.

Can a Robo-adviser use the BICE?

- Excludes certain robo-advisers
 - Does not exempt prohibited transactions arising in connection with “investment advice to a Retirement Investor generated solely by an interactive Web site in which computer software-based models or applications provide investment advice based on personal information each investor supplies through the Website without any personal interaction or advice from an individual Adviser.”
- DOL rationale:
 - ERISA 408(b)(4) prohibited transaction exemption covers computer generated advice
- However, above exclusion does not apply to Level Fee Fiduciaries complying with applicable conditions

Can a Robo-adviser use the BICE?

- Robo-adviser as a “Level Fee” Fiduciary
 - Only fee received in connection with providing services must be a “Level Fee” disclosed in advance to investor
 - “**Level Fee**”: fee or compensation that is provided on the basis of a fixed percentage of the value of assets or a set fee that does not vary with the particular investment recommended, rather than a commission or other transaction-based fee

Can a Robo-adviser use the BICE?

- May be challenging to apply in practice
 - Likely not met if adviser recommends or invests in proprietary mutual funds
 - Likely not met with receipt of third party payments from mutual funds
 - Might argue that rebating fees to investor accounts creates a “Level Fee” (but no DOL guidance confirms this)

Can a Robo-adviser use the BICE?

- Even if robo-adviser is not excluded, BIC Exemption only exempts transactions with advice to “**Retirement Investors**”
 - Participant or beneficiary of ERISA-covered participant directed individual account plan
 - IRA owner
 - Named fiduciary to employee benefit plan or such fiduciary that has assets under its control of less than \$50 million
- In effect, applies when advice is provided to “retail investors”

Can a Robo-adviser use the BICE?

- If BIC Exemption is available to a robo-adviser, adviser must comply with “Impartial Conduct Standards”:
 - Best Interest Standard
 - Reasonable Compensation
 - No Materially Misleading Statements

Can a Robo-adviser use the BICE?

- Best Interest Standard
 - Fiduciary must provide advice in the best interest of the Retirement Investor at the time of the recommendation
 - Act with the “care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims would exercise based on investment objectives, risk tolerance, financial circumstances, and the needs of the Retirement Investor without regard to the financial or other interests of the Adviser, Financial Institution, or any” affiliates or parties in which they have an interest. Best Interest Contract Exemption, § II(c)(1).
 - Professional standard incorporates ERISA’s objective care and loyalty standards
 - After Transition Period, must also disclose fiduciary status and possibly details about the “Level Fee”

Can a Robo-adviser use the BICE?

- Reasonable Compensation
 - Recommended transaction may not cause adviser, its employees or representatives, or their affiliates to receive, directly or indirectly, compensation for their services in excess of reasonable compensation within the meaning of ERISA section 408(b)(2) and Code section 4975(d)(2). Best Interest Contract Exemption, § II(c).

Can a Robo-adviser use the BICE?

- Not Materially Misleading
 - Fiduciary may not make “materially misleading” statements about the recommended transaction, fees, “Material Conflicts of Interest,” and any other matters relevant to investment decisions
 - **“Material Conflict of Interest”** when fiduciary has a financial interest that a reasonable person would conclude could affect exercise of its best judgment as fiduciary in rendering advice to Retirement Investor. Best Interest Contract Exemption, § II(c).

How do I apply BICE to Rollover Transactions?

- In connection with recommending to take a distribution from an ERISA-covered plan, robo-adviser should consider alternatives to rollover
 - Includes leaving the money in the investor's plan, if permitted
 - Account for:
 - (i) fees and expenses associated with plan and IRA,
 - (ii) whether employer pays for some or all of plan's administrative expenses, and
 - (iii) different levels of services and investments available under each option
 - Consider Retirement Investor's individual needs and circumstances, as described in FINRA Regulatory Notice 13-45
 - Factors for consideration:
 - (i) investment options;
 - (ii) fees and expenses;
 - (iii) services;
 - (iv) penalty-free withdrawals;
 - (v) protection from creditors and legal judgments;
 - (vi) required minimum distributions; and
 - (vii) employer stock

How do I apply BICE to Rollover Transactions?

- Financial institutions and advisers must make diligent and prudent efforts to obtain information about existing ERISA plan
 - Disclosures provided to ERISA plan participants under section 404(a)(5)
 - Summary plan descriptions
 - Plan participant account statements
- If financial institution cannot obtain the information “despite prudent efforts” or if investor is unwilling to provide it:
 - Rely on alternative data sources such as the plan’s Form 5500 or reliable benchmarks
 - Explain limits of alternative data or benchmarks and document how it determined either was reasonable

How do I apply BICE to IRA transfer Transactions?

- Conflict when robo-adviser recommends to move from commission- to fee-based account
 - Incentivized to make a recommendation to get paid
 - In making recommendation, consider:
 - (i) whether type of account is appropriate in light of the services provided;
 - (ii) projected cost to the customer;
 - (iii) alternative fee structures available; and
 - (iv) customer's fee structure preferences, in addition to non-price factors.

Should I consider BICE?

- If robo-adviser does not use humans to provide advice and the “Level Fee Fiduciary” requirement cannot be met, must rely on another exemption
- These other exemptions may not address prohibited transactions in connection with the distribution and transfer recommendations
 - Could prevent adviser from avoiding non-exempt prohibited transactions if it wishes to make rollover or transfer recommendations because no clear path to exemptive relief exists
 - Waiting on DOL guidance to address this

What about ERISA 408(b)(14) and Code 4975(d)(17) work?

- ERISA section 408(b)(14) and Code section 4975(d)(17)
 - Provide for exemptions from prohibited transactions under ERISA sections 406(a) and 406(b) and Code section 4975 re: investment advice programs that meet the requirements of ERISA section 408(g), Code section 4975(f)(8), and regulations promulgated thereunder

What about ERISA 408(b)(14) and Code 4975(d)(17) work?

- Only available for investment advice programs that are “**eligible investment advice arrangements.**”
- Eligible investment advice arrangement must utilize:
 - Fee leveling,
 - Computer model, or
 - Combination thereof
- No discretionary investment management by robo-adviser

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- Requirements for eligible investment advice arrangement based upon **fee leveling**:
 - Investment advice must:
 - Be based on generally accepted investment theories that take into account historic risks and returns of different asset classes over defined periods of time;
 - Account for investment management and other fees and expenses attendant to the recommended investments;

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- Account for information relating to:
 - Age
 - Time horizons (e.g., life expectancy, retirement age)
 - Risk tolerance
 - Current investments in designated investment options,
 - Other assets or sources of income, and
 - Investment preferences of the participant or beneficiary or IRA beneficiary (must request but don't have to consider if not provided)

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- No fiduciary adviser that provides investment advice may receive from any party, directly or indirectly, any fee or other compensation that varies depending on selecting particular investment option
 - “Level fee” provision requires that fee only be level with regard to fee paid to firm providing investment advice and to employee/representative acting on behalf of firm (if any)
 - Adviser affiliate may receive non-level compensation assuming conditions can be met

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- Requirements for eligible investment advice arrangement based upon **computer model**
 - A computer model must:
 - Apply generally accepted investment theories as described above for “level fee” eligible investment advice arrangements;
 - Take into account investment management and other fees and expenses attendant to the recommended investments;
 - Appropriately weight the factors used in estimating future returns of investment options;
 - Request from plan participant or beneficiary or IRA beneficiary and, to the extent furnished, utilize the same information considered for “level fee” eligible investment advice arrangements, e.g., age, time horizons, risk tolerance, etc.
 - Utilize appropriate objective criteria to provide asset allocation portfolios comprised of investment options available under plan;

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- Avoid investment recommendations that:
 - (i) inappropriately favor investment options offered by the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser over other investment options, if any, available under the plan or IRA, and
 - (ii) inappropriately favor investment options that may generate greater income for the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser; and
- Except with regard to fixed annuity options and assets specifically excluded by the participant and beneficiary or IRA beneficiary, take into account all “designated investment options,” as defined in the regulation, available under the plan without giving inappropriate weight to any investment option.
- Prior to utilization, fiduciary adviser must obtain written certification from “**eligible investment expert**” that requirements are met

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- **“Eligible investment expert”**
 - A person with the “appropriate technical training or experience and proficiency to analyze, determine and certify...whether a computer model meets” requirements. 29 C.F.R. § 2550.408g-1(b)(4)(iii).
 - No “material affiliation or material contractual relationship with:
 - The fiduciary adviser,
 - A person with a material affiliation or material contractual relationship with the fiduciary adviser, or
 - Any employee, agent, or registered representative of the foregoing; or develops a computer model utilized by the fiduciary adviser.”
 - Must be completely independent of adviser
 - Goal: avoid adversely affecting judgment

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- Computer model arrangement provides more adviser flexibility
 - Designate proprietary investment options as plan and IRA investments
 - Designate investment options that pay adviser or affiliate revenue sharing and other revenue

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- Exemption Conditions:
 - Apply regardless of which “eligible investment advice arrangement” is used:
 - Authorization of Arrangement
 - Authorized by an independent plan fiduciary for plans or by a beneficiary for IRAs
 - Annual Audit
 - Financial advisor must at least annually engage an independent auditor with appropriate technical training or experience to prepare a report
 - Report should:
 - Describe the advice arrangement
 - State why arrangement complies with exemption
 - Be delivered to plan fiduciary and delivered to or made available on a website to IRA beneficiary

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- Disclosure to Participants & IRA Beneficiaries
 - Fiduciary adviser must provide required disclosures prescribed in regulation
 - At no charge
 - Before initial provision of investment advice
 - In “a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant and must be sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of the information required to be provided in the notification.”
 - Model notice is provided in the regulation
 - Can be provided electronically
- Disclosure to Fiduciaries
 - Fiduciary must provide the authorizing fiduciary with a written notice informing the fiduciary that:
 - (i) the fiduciary adviser intends to comply with the conditions of the exemption
 - (ii) the advice arrangement will be audited annually, and
 - (iii) the auditor will furnish the authorizing fiduciary a copy of findings within 60 days of audit completion

How do ERISA 408(b)(14) and Code 4975(d)(17) work?

- Other Requirements

- Fiduciary adviser must comply with disclosure requirements under securities laws,
- Any sale, acquisition, or holding of security or other property must occur solely at the direction of advice recipient,
- Compensation received by the fiduciary adviser and affiliates must be reasonable, and
- Terms should be at least as favorable to plan or IRA as an arm's length transaction

BICE vs. 408(b)(14)/ 4975(d)(17)?

- BIC excludes robo-adviser that provides investment advice without humans unless “Level Fee Fiduciary” requirement is met
- DOL thinks robo-advisers should consider 408(b)(14) and 4975(d)(17) exemptions
 - Issue:
 - Exemptions do not address whether prohibited transactions that arise in connection with investment advice related to plan distributions or IRA transfers are covered
 - Issued before DOL regulation

BICE vs. 408(b)(14)/ 4975(d)(17)?

- If exemptions do not apply:
 - Robo-adviser may want to consider if it can rely on the BIC Exemption only with regard to these rollover & transfer recommendations
 - Then, could rely on section 408(b)(14) for the provision of investment advice with regard to account assets
 - DOL's outright exclusion of robo-advisers that do not use humans suggests this may not be the case
 - Seems odd since DOL has characterized it as the alternative to the BIC Exemption

What is the SunAmerica Opinion?

- Advisory Opinion 2001-09A (Dec. 14, 2001) (SunAmerica Opinion)
 - Issued pre-ERISA sections 408(b)(14) and 408(g)
 - DOL: plan service providers who offer participant investment advice programs, based on the investment advice of an independent financial expert, will not be exercising the authority, control or responsibility that makes them a fiduciary so as to violate ERISA's prohibited transaction rules

What is the SunAmerica Opinion?

- DOL conclusion: to extent SunAmerica acted as fiduciary, no per se violation of self-dealing and anti-kickback prohibitions under ERISA section 406(b) by offering asset allocation program despite receiving compensation connected to recommendations
 - Rationale: not exercising discretionary authority, control, or responsibility as a fiduciary re: individual investment decisions or recommendations under program
 - Recommendations would be result of methodologies developed, maintained, and overseen by independent financial expert
 - Arrangement would preserve expert's ability to develop models solely in interest of plan participants (not affected by SunAmerica's compensation from allocation funds)
 - Plan fiduciaries responsible for selecting the program would be fully informed about and would approve program
 - Reasonable to assume that rationale extends to IRAs

Should I use SunAmerica Opinion?

- SunAmerica is the preferred method for advisory firms and other providers to give investment advice to plans and IRAs
 - Less demanding compliance requirements than 408(b)(14) and 408(g)
- Most robo-advisers are not interested in relying upon another financial expert
 - Advisory firms may turn to robo-advisers and their technology for purposes of complying with SunAmerica

What is DOL PTE 77-4?

- Class exemption that provides relief from ERISA and Code prohibited transaction provisions for purchase or sale by plan or IRA of shares of an open-end investment company (i.e., a mutual fund), where fund's investment adviser or affiliate is also a fiduciary to plan or IRA
 - If conditions are met:
 - Fiduciary not responsible for prohibited transactions in connection with recommending to invest or investing as a fiduciary account assets in proprietary mutual funds

What is DOL PTE 77-4?

- Conditions:
 - Plan may not pay a redemption fee in connection with the sale of the shares (other than one paid to and disclosed in the prospectus in effect at the time shares were purchased);
 - Plan may not pay a “sales commission” in connection with purchases or sales of shares of the fund, including any so-called 12b-1 fees;
 - Plan may not pay “double fees” for investment management;
 - Does not pay investment management, advisory, etc. fee with respect to plan assets invested in such shares for entire investment period
 - Does not preclude payment of investment advisory fees by fund under terms of investment advisory agreement

What is DOL PTE 77-4?

- Conditions (cont.):
 - Plan fiduciary, independent of and unrelated to the mutual fund adviser, approves the investment or a program of investments in the fund, after receiving detailed disclosure;
 - Approving fiduciary is notified of any change in any of the rates of fees required to be disclosed and approves in writing continuation of the purchases and sales and the plan's continued holding of fund shares before the change in fees occurs, and
 - Effective June 9, 2017, PTE 77-4 requires compliance with Impartial Conduct Standards

What is DOL PTE 77-4?

- Permitted fee arrangements
 - Investment adviser or manager may:
 - Charge an account-level fee and then credit to the Plan or IRA the account's pro rata share of investment advisory fees paid by the proprietary fund to fund's adviser; or
 - Waive its account-level investment management fees to the extent that plan assets are invested in a proprietary mutual fund

What is DOL PTE 77-4?

- Detailed disclosure requirements:
 - Must provide the following to a second, independent plan fiduciary (“Second Fiduciary”), e.g., plan sponsor, IRA owner:
 - Current prospectus (or summary prospectus);
 - Full and detailed disclosure of the fees charged to or paid by the plan and mutual fund;
 - Explanation of why the investment adviser may consider such purchases appropriate for the plan; and
 - Whether there are any limitations on the investment advisers, and if so, the nature of such limitations
 - Must obtain written consent from Second Fiduciary to invest in the Proprietary Funds after receiving prospectus and disclosures
 - Do not need to obtain consent for each trade
 - Proprietary Fund disclosure can be included in an investment advisory agreement or other document.
- Second Fiduciary must provide affirmative consent to extent required under exemption
 - Some advisers obtain an individual prohibited transaction to avoid this requirement

Should I use DOL PTE 77-4?

- Useful exemption for robo-adviser that recommends or invests account assets in proprietary funds
- Compliance may be challenging, however
 - DOL reluctant to allow adviser to use negative consent to obtain required consent
 - Use of affirmative consent may not be compatible with delivery of services by a robo-adviser
 - DOL has not stated whether PTE 77-4 exempts prohibited transactions that arise in connection with distribution or transfer recommendations
 - Unclear whether PTE 77-4 extends to a recommendation of an advisory program that includes proprietary funds
 - If not, robo-adviser that provides advice without humans may not have appropriate exemptive relief

What is the Frost Advisory Opinion?

- ERISA section 408(b)(2) and Code section 4975(d)(2) exempt only violations of ERISA section 406(a) and Code sections 4875(c)(1)(A)-(D)
- Violations of ERISA section 406(b) and Code sections 4875(E)-(F) are non-exempted separate transactions
 - To rely on 408(b)(2) and 4975(d)(2), fiduciary advisor cannot cause itself or a party in which it has an interest to:
 - Be paid additional compensation, or
 - Change timing of when compensation is paid unless exemptions other than services exemptions apply

What is the Frost Advisory Opinion?

- Generally, when fiduciary adviser receives compensation pursuant to assets under management (“AUM”) formula and no other compensation is paid to adviser or party in which it has an interest:
 - Not a prohibited transaction under 406(b) or 4975(c)(1)(E) and (F)
 - May rely on 408(b)(2) and 4975(d)(2) exemptions
- However, transaction may be prohibited if:
 - Adviser recommends or invests in proprietary mutual funds or other products, or
 - Adviser or party in which it has interest receives revenue from products or product issuers

What is the Frost Advisory Opinion?

- DOL Advisory Opinion 97-15A (May 22, 1997) (“Frost Opinion”)
 - Addressed when the payment of 12b-1 or other fees by nonproprietary mutual funds to a plan fiduciary may violate ERISA sections 406(b)(1) and (3).
 - DOL:
 - Where a fiduciary advises a plan to invest in mutual funds that pay additional fees to advising fiduciary, fiduciary generally violates 406(b)(1) and (3)
 - However, no violation to extent that fiduciary uses every dollar of fees the mutual funds pay the fiduciary to offset fees that plan is otherwise legally obligated to pay fiduciary
 - Rationale: fiduciary is not considered to be dealing with plan assets for his own account
- Expanded on reasoning in Advisory Opinion 2005-10A (“Country Trust Opinion”)
 - Addressed payment of fees to IRA fiduciary by proprietary funds and nonproprietary mutual funds

Should I use the Frost Advisory Opinion?

- Application to robo-advisers
 - Address fee conflicts by charging AUM fee and not investing proprietary funds or products, or those that pay compensation to it or a party in which adviser has an interest
 - “Levelize” compensation by using any additional revenue it receives to offset AUM fee to which it is entitled
- Frost/Country Trust opinions likely do not extend to distribution and transfer recommendation conflicts

Securities Regulatory Issues for Robo Advisers

STRAFFORD WEBINAR OUTLINE

OCTOBER 2017

MARGARET SHEEHAN

MARGARET.SHEEHAN@ASHURST.COM

Must all robo-advisers register as investment advisers?

DEFINITION OF INVESTMENT ADVISER

One who provides advice or reports about securities for compensation

BROKER-DEALER EXCLUSION

Requires that the broker-dealer:

- gives investment advice that is **solely incidental** to its brokerage business, and
- receives no **special compensation** for the investment advice

IMPACT OF REGISTRATION

- No new regulatory requirements or special rules for robo-advisers
- Principles-based regulation
- How do robo-advisers comply with existing rules and what special issues do they need to address?
 - Robo-car analogy
 - Business model entirely different than the one the statute and rules were designed to address
- Contrast with the state of Massachusetts approach

What's unique about robo-advisers?

Lack of human involvement

- Due diligence/KYC
- Suitability of recommendations
 - Questionnaire without IAR input or review
 - Limited input from investor (e.g., no debt or other assets considered)
 - Totally self-selecting
 - Unaddressed inconsistencies
 - Unsuitable portfolios made available
 - Algorithm without human intervention or discussion
 - Built or bought? (Diligence)
 - Level of internal understanding of assumptions, methodologies, data points
 - Testing output, initially and ongoing
 - Consistency with adviser's non-robo strategy
- Supervision
 - Testing/Monitoring may be non-existent
 - Has the investor's situation changed?
 - Is the market activity and forecast changing?
 - Is the portfolio performing as expected?

What's unique about robo-advisers?

Strictly online environment

- Disclose the nature of robo-advice
 - Explain in plain English the business model (particular business practices and risks) and algorithms (inputs, assumptions, methodologies)
 - Describe fully the scope and limitations of service (e.g., not a financial plan, rebalancing, tax efficient asset placement, tax loss harvesting)
 - Identify market, technology and operational risks and limitations
- Disclose conflicts of interest
 - Product-level fees
 - Trading practices
- Make disclosures prominent
 - Consider using pop-ups, interactive text and FAQs
 - Consider timing (prior to, at, or after the sign-up process)

What's unique about robo-advisers?

Target Market

- Investor Characteristics
 - Retail
 - Young
 - Inexperienced
- Program Features
 - Low account minimums
 - Limited asset types
 - Low hassle onboarding process
 - 24/7 availability and easy access
- Regulatory implications
 - Encourages democratization of investment advice
 - Enhanced investor protections and scrutiny
 - Significance of education through disclosure

What else should robo-advisers be thinking about?

Goals-oriented advice

- helpful path to investing or means to skirt true suitability?

Marketing

- don't overhype and under-describe; no testimonials!

Fees

- low-cost alternative or cheap product?

Data Protection

- how much is enough?

Just Say No

- is investing sometimes a bad idea, and what do you do about it?

Compliance Program

- make it robo-specific, make it robust, address the entire process

Responsiveness

- what happens in the event of customer/market emergency?

Account aggregation and Digital ID

- how to simplify access safely

What happens next?

Perception is
reality

Light touch
approach is fragile

Consider developing industry
standards for fee and performance
disclosure to allow comparison
shopping

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Robo-Advisers to Retirement Plans Issues and Perspectives for Plan Sponsors

Will Woolston

COVINGTON

BEIJING BRUSSELS DUBAI JOHANNESBURG LONDON LOS ANGELES NEW YORK
SAN FRANCISCO SEOUL SHANGHAI SILICON VALLEY WASHINGTON

www.cov.com

What Does the Plan Sponsor Hope to Achieve?

- Like many aspects of retirement plans, plan sponsors and fiduciaries are engaged in a balancing act between:
 - Better retirement savings and investment outcomes for employees
 - Cheaper advice
 - More understandable advice
 - Optimized advice
 - While limiting potential for liability
 - Fiduciary selection and monitoring duties
 - Service provider exemptions
 - Litigation uncertainties
 - Practical complexities of implementation
 - Negotiation of vendor contracts
 - Integration with existing recordkeeping systems (or not)
 - Employee communication and outreach efforts

Approaches to Fiduciary & Litigation Risk Management

- Investment education vs investment advice vs investment management
 - One is not a fiduciary activity, the others are
 - Instinct may be to limit robo-advisers to non-fiduciary education activities, but there are trade-offs
- “Investment education” does not constitute an investment recommendation for purposes of the DOL’s fiduciary rule, which exempts investment education from coverage
- “Investment advice” is a fiduciary act involving specific investment recommendations from the adviser
- “Investment management” is a fiduciary act where the investment manager takes an active hand in managing investment allocations over time

Risk Management

- Irrespective of the type of robo-adviser relationship a plan implements, there will be liability associated with the selection and monitoring of the service provider
 - However, the more active a hand the robo-adviser takes, the monitoring obligations becomes more administratively burdensome and the potential litigation exposure increases
 - That said, managing exposure in this area is generally uncharted territory, as the case law on robo-advisers has not yet developed
- A robo-adviser offering only investment education services should create the least exposure, but the information provided must be limited
 - Plan/investment option information
 - General financial, investment, and retirement information
 - Hypothetical asset allocation models
 - Interactive investment materials
 - Cannot identify specific investment options in brokerage window or outside plan

Risk Management

- Investment advice is a middle ground between pure education and investment management
 - Advisers offer specific investment recommendations, but implementation is the participant's decision
 - Holistic versus narrow approach to offering advice
 - More burdensome monitoring obligations
- Investment management is the most “hands off” approach to plan investing for participants
 - Investment manager oversees investments using algorithms
 - E.g., managed accounts with automatic reallocations
 - Same decisions to be made about holistic versus narrow advice
 - Most need for monitoring and oversight by plan fiduciaries
- But, is there really a substantial difference in potential liability between investment advice and investment management?
 - Time will tell

Practical Considerations for Implementation

- Selection of a robo-adviser vendor
 - Fiduciary decision
 - Prudent process
 - What does the algorithm consider in its determinations?
- Negotiating vendor contracts
 - Compliance with service provider selection requirements, just like any other vendor providing services to the plan
- Systems integration is not always easy
 - Historically, some third-party recordkeeping systems have limited integration to certain select robo-advisers, limiting choice
 - But is integration with your system necessarily what you want? If so, can there be “too much” integration?
 - Does integration create implicit endorsements of other services?
- Communicating with participants and beneficiaries

More Questions?

Contact:

William Woolston
Covington & Burling LLP
wwoolston@cov.com
(202) 662-5844

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