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Additional Guidance on Fiduciary Rule as it Applies to Investment Advisers

By: Rich May, Thomas H. Bilodeau, III, David Glod, Scott A. Stokes

In light of some uncertainty surrounding the application of the Department of Labor ("DOL") Fiduciary Rule to investment advisers who advise private funds and managed accounts, we are providing this supplement to our recent Client Alert on June 2, 2017 titled Update on Applicability of the DOL's Fiduciary Rule.

1. REMIND ME AGAIN, WHAT IS THE FIDUCIARY RULE?

The Fiduciary Rule was adopted by the DOL to address conflicts of interest between certain investment advisers and broker-dealers and their customers that are retirement plans with less than $50 million in assets, plan participants and IRA owners ("Retail Retirement Plan Investors").

The Fiduciary Rule redefines what constitutes "investment advice" that makes the advice provider (including an investment advisory firm) a "fiduciary" to Retail Retirement Plan Investors under the Employee Retirement Income Security Act of 1974 ("ERISA") and the prohibited transaction rules of Internal Revenue Code (the "Code") section 4975.

2. OK, SO WHAT DOES IT MEAN TO BE SUBJECT TO THE FIDUCIARY RULE?

Basically, if you are subject to the Fiduciary Rule you are subject to ERISA with respect to your investment "recommendations" and cannot receive compensation from Retail Retirement Plan Investors unless you comply with the rule or exceptions to it.

3. IF I AM A STATE OR FEDERAL REGISTERED INVESTMENT ADVISER (AN "RIA"), DOES THE FIDUCIARY RULE APPLY TO ME?

Yes, to the extent you provide investment advice to a Retail Retirement Plan Investor, a state or federal registered investment adviser is subject to the Fiduciary Rule.

4. IS A PRIVATE INVESTMENT FUND A RETAIL RETIREMENT PLAN INVESTOR FOR PURPOSES OF THE FIDUCIARY RULE?

No. A private investment fund is not considered a Retail Retirement Plan Investor. However, the private investment fund could still be considered Plan Assets (and thus



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Thomas H. Bilodeau, III

David Glod

Scott A. Stokes

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subject to ERISA) if it meets the 25% significant participation test.

If the RIA provides investment advice directly to a Retail Retirement Plan Investor outside of the private investment fund, however, that would be covered by the Fiduciary Rule. In this regard, certain actions by the RIA in marketing the private investment fund to a potential investor that is a Retail Retirement Plan Investor could be considered investment advice making the RIA subject to the Fiduciary Rule (see Q6. below).

5. SO THERE IS NOTHING TO WORRY ABOUT IF AN RIA ADVISES ONLY PRIVATE INVESTMENT FUNDS?

Not exactly. While the private investment fund itself is outside of the Fiduciary Rule, certain actions by the RIA in marketing the private investment fund to a potential investor that is a Retail Retirement Plan Investor could be considered investment advice making the RIA subject to the Fiduciary Rule. This is true even if your fund is currently otherwise exempt from ERISA (e.g. under the 25% significant participation test or a venture capital operating company).

6. SO WHAT ARE THE ACTIONS REFERENCED IN 4 AND 5 THAT AN RIA SHOULD BE WORRIED ABOUT WITH RESPECT TO ITS PRIVATE INVESTMENT FUNDS?

Marketing the adviser and soliciting on behalf of a private investment fund. An RIA can tout the quality of its own advisory or investment management services or those of its affiliates without triggering fiduciary obligations. However, there is a line between marketing the value of your own advisory or investment management services, on the one hand, and making recommendations on how to invest on the other.

So how does this line get crossed? It can be crossed where the RIA makes a “hire me” pitch that is coupled with a pitch to invest in a certain strategy or a particular private investment fund. When you solicit a person or entity to put money into your fund, the decision to invest in the fund is an investment in securities (namely the security that represent the investor’s interest in your fund).

As a result, soliciting a Retail Retirement Plan Investor to invest in the adviser’s private investment fund is considered providing investment advice (i.e. advising the client to invest in the fund) thus triggering the Fiduciary Rule.

7. WHAT ABOUT MANAGED ACCOUNTS?

The Fiduciary Rule applies to RIAs that enter into agreements to manage an account for a Retail Retirement Plan Investor.

8. WHAT IF I AM ALREADY AN ERISA FIDUCIARY?

The Fiduciary Rule does not affect your existing fiduciary duties to your existing ERISA clients. However, to the extent that you look to solicit new Retail Retirement Plan Investors (or have existing such investors increase their assets under management) it appears that you would need to comply with the Fiduciary Rule in addition to any other obligations you may have under ERISA.

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9. SO WHAT DO I DO IF I WANT TO AVOID HAVING TO THE FIDUCIARY RULE APPLY TO MY FIRM?

You have 3 options. Option 1 is to not solicit new Retail Retirement Plan Investors and to not take any additional funds from existing Retail Retirement Plan Investors during the transition period and afterwards if the Fiduciary Rule becomes fully enforceable as is.

Option 2 is to advise or solicit only Retail Retirement Plan Investors that are represented by an independent third-party fiduciary with financial expertise.

Option 3 is to continue to solicit new Retail Retirement Plan Investors and to take additional funds from existing Retail Retirement Plan investors and comply with the requirements of the Best Interest Contract ("BIC") exemption or Level Fee exemption.

Since Retail Retirement Plan Investors may be unlikely to engage an independent third-party fiduciary to represent them in engaging your firm, Options 1 and 3 would seem to be the most viable.

10. SO IF I SELECT OPTION 3, WHAT ARE THE REQUIREMENTS FOR THE BIC EXEMPTION?

The BIC exemption requires that you meet each of the following conditions:

- The individual providing the advice (the "associated person") is an employee, independent contractor, agent or representative of a "Financial Institution" (generally an RIA or registered broker-dealer, among certain other institutions).
- The Financial Institution discloses in writing its and the associated person's fiduciary status.
- The Financial Institution and Associated Person comply with the following "Impartial Conduct Standards":

– The advice is in the "Best Interest" of the investor. A fiduciary acts in the "Best Interest" when it acts 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, based on the investment objectives, risk tolerance, financial circumstances, and needs of the investor, without regard to the financial or other interests of the fiduciary, any affiliate or other party.

– Compensation received by the Financial Institution, its Associated Person and affiliates is not in excess of "reasonable" compensation, within the meaning of ERISA and the Code prohibited transaction rules.

– Statements about recommended investments, fees and compensation, material conflicts of interest, and any other matters relevant to investment decisions, are not materially misleading at the time they are made. A "material conflict of interest" exists when a

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fiduciary has a financial interest that a reasonable person would conclude could affect the exercise of its best judgment as a fiduciary in rendering advice to the investor.

- Disclose important information relating to fees, compensation and material conflicts of interest (such as commissions, 12b-1 fees, revenue sharing).
- Adopt policies and procedures designed to ensure that its associated persons adhere to the Impartial Conduct Standards;
- Retain records demonstrating compliance with the exemption and notify the DOL of your reliance upon the BIC exemption.
- Not include in any contract exculpatory provisions for a violation of the contract's terms, waiver or qualification of the investor's right to participate in a class action, or agreement to arbitrate or mediate an individual claim in a distant or unreasonable venue.
- If the investor is an IRA or non-ERISA Plan, enter into a written contract with the investor. The contract must not contain provisions that disclaim or limit the liability of the Financial Institution or its Associated Person, or waive or qualify the right to bring or participate in a class action.
- If the Retail Retirement Plan Investor intends to roll over funds from an ERISA Plan into an IRA that you will manage or that will invest in your fund, then you will need to provide written documentation of the reasons why you considered the roll over recommendation to be in the Best Interest of the investor.
- If the RIA is soliciting Retail Retirement Plan Investors for one of its funds, it may need to comply with the additional disclosure and other requirements applicable to RIAs that restrict investment recommendations to "Proprietary Products" including written documentation of the reasons why you considered the investment in the fund to be in the Best Interest of the investor.

11. SO IF I SELECT OPTION 3, WHAT ARE THE REQUIREMENTS FOR THE LEVEL FEE EXEMPTION?

The Level Fee exemption is available only to a Financial Institution, its Associated Person and their affiliates.

A "Level Fee" is 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.

The Level Fee exemption requires that you meet each of the following conditions:

- You charge only a Level Fee to the Retail Retirement Plan Investor in

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connection with your investment management services.
- The Financial Institution discloses in writing its and the Associated Person's fiduciary status.
- The Financial Institution, Associated Person and affiliates comply with the Impartial Conduct Standards (see Q10. above).
- Disclose important information relating to fees, compensation and material conflicts of interest (such as commissions, 12b-1 fees, revenue sharing).

Note that the Level Fee exemption may not be available to the extent an RIA is determined to be recommending only "proprietary products". In such case, the RIA would need to utilize the BIC exemption.

So what are the benefits of the Level Fee exemption over the full BIC exemption? Under the Level Fee exemption you do not have to enter into a contract, provide written disclosures at the time of transaction of through a website, or notify the DOL of your reliance on the BIC exemption.

12. ARE THE BIC AND LEVEL FEE EXEMPTIONS AVAILABLE ONLY TO RIAS? WHAT IF I AM NOT REGISTERED OR AN EXEMPT REPORTING ADVISER ("ERA")?

In general, to take advantage of the BIC and Level Fee exemptions, you must either be a state or federal registered investment adviser or a registered broker-dealer. There are other possible categories but those generally do not apply to investment advisers.

If you are an ERA, you are not eligible to use these exemptions. The DOL has indicated it will offer ERAs the option to seek an individual prohibited transaction exemption, although that could be fairly onerous and thus of limited value.

13. WHAT ABOUT PRE-EXISTING CLIENTS THAT ARE RETAIL RETIREMENT PLAN INVESTORS?

Generally, Retail Retirement Plan Investor clients as of April 10, 2017 are grand-fathered. Additional amounts added to an account or any new investment by such a grand-fathered client would be considered a new investment decision and would be subject to compliance with the Fiduciary Rule.

14. WHAT ARE THE KEY DATES?

April 10, 2017 – existing Retail Retirement Plan Investor clients as of this date are grand-fathered.

June 9, 2017 – effective date of Fiduciary Rule.

June 9, 2017 to January 1, 2018 – the DOL will not pursue claims against fiduciaries who are working "diligently and in good faith" to comply with the Fiduciary Rule and related exemptions or treat those fiduciaries as being in violation of the Fiduciary Rule and related

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exemptions. The DOL explained that its general approach to implementation will emphasize assisting plans, plan fiduciaries, and financial institutions with compliance, rather than citing violations and imposing penalties. See our prior Client Alert on Update on Applicability of DOL's Fiduciary Rule for further information.

15. WHAT SHOULD WE DO NOW?

RIAs should consider holding off from taking on any new Retail Retirement Plan Investors or taking any additional funds from such clients if they are pre-existing clients until further guidance is forthcoming from the DOL.

If you must take on a new Retail Retirement Plan Investor client or allow an existing such client to increase its assets under management, then you will need to (i) require the use of an independent fiduciary representative, (ii) rely on the BIC exemption, or (iii) rely on the Level Fee exemption. This will require revisions to advisory agreements, subscription agreements and questionnaires and the creation of additional policies and procedures.

ERAs should not take on any new Retail Retirement Plan Investors or take any additional funds from such clients until further guidance, if any, is forthcoming from the DOL.

Given the uncertainty and the time, expense and possible disruption with implementing compliance to a rule that may be revised or eliminated, many investment advisers are adopting a wait and see approach. If by the beginning of the fourth quarter of 2017 the DOL has not clarified the situation or it is otherwise apparent that enforcement of the Fiduciary Rule will go fully into effect at the end of the transition period, then RIAs should undertake the necessary drafting and revisions referenced above to enable them to use the BIC and Level Fee exemptions, and the independent fiduciary representative exception, as applicable, prior to the January 1, 2018.

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