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**Re: ERISA Opinion for ActiveAllocator**

Dear Messrs. Jain and Jones:

Active Allocator Holdings, LLC (the “Company”), a financial technology company, has developed an internet delivered asset allocation and portfolio construction software and methodology, ActiveAllocator, which may be utilized by broker-dealers and their registered representatives, registered investment advisers (“RIAs”) and their individual adviser representatives (“IARs”), or insurance companies and their agents (collectively, “Firms” at the institutional level or “Reps” at the individual representative level). ActiveAllocator is intended for Firms offering investment-related services through their Reps to retail investors. By using ActiveAllocator, Reps can assist the retail investor in constructing strategic asset allocations that include, where permissible,<sup>1</sup> certain types of “alternative investments”<sup>2</sup> such as private equity,

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<sup>1</sup> You have not requested our opinion, and we express no opinion, with respect to whether an investment by a Retirement Client in an alternative investment would satisfy the requirements of applicable federal and state securities laws including, without limitation, the Investment Company Act of 1940. Additionally, alternative investments would generally only be available in 401(k) plans or other defined contribution plans that provide for participant direction and a self-directed brokerage account. Additionally, some alternative investments that could not be structured as venture capital operating companies (Department of Labor (“DOL”) Regulation Section 2510.3-101(d)) or real estate operating companies (DOL Regulation Section 2510.3-101(e)) might limit the number of individual investors to ensure that they were not holding plan assets under ERISA Section 3(42) and the plan asset regulations because of significant participation by benefit plan investors. (DOL Regulation Section 2510.3-101(f)(2)). While the threshold for significant investment by benefit plan investors is 25% (DOL Regulation Section 2510.3-101(f)(1)), some funds use a smaller percentage as a cap to provide a margin for error. IRAs, although generally not subject to ERISA, are treated as benefit plan investors.

hedge funds<sup>3</sup>, real estate<sup>4</sup>, structured products<sup>5</sup> and managed futures.<sup>6</sup> These retail clients (collectively, “Retirement Clients”) typically include individuals with one or more individual retirement accounts (“IRAs”) and other similar tax-advantaged accounts that are subject to Title I or II of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”).

On April 8, 2016, the U.S. Department of Labor (the “DOL”) issued new regulatory guidance (the “New DOL Rule”) under ERISA with the goal of broadening the scope of advisors who would be deemed fiduciaries when advising individual clients with respect to their retirement accounts. The New DOL Rule has a delayed applicability date, at which point virtually all Firms offering investment-related services through their Reps will be deemed to be fiduciary advisors under the New DOL Rule. You have asked for our views on how Firms and their Reps may utilize ActiveAllocator to help protect themselves against fiduciary risk and any related fiduciary liability arising as a result of the application of the New DOL Rule.<sup>7</sup>

## I. EXECUTIVE SUMMARY OF ANALYSIS AND CONCLUSIONS

- ***Impact of New DOL Rule on Brokers and RIAs.*** Virtually all Firms and their Reps who provide investment-related services to Retirement Clients will be deemed fiduciary advisors as a result of the application of the New DOL Rule. As fiduciary advisors, Firms and their Reps will be prohibited from earning commissions or other forms of variable compensation which a Rep might receive for directing the Retirement Client into the alternative investment, unless they qualify for a DOL exemption, such as Prohibited Transaction Exemption 2016-01 (“PTE 2016-01”) also called the Best Interest Contract Exemption (“BICE”).
- ***BICE’s Best Interest Standard of Care.*** As required under the BICE, any fiduciary advice provided by a Firm’s Rep to a Retirement Client must meet the “Best Interest Standard of Care.” Thus, such advice must be provided: (i) with the care, skill, prudence and diligence that a prudent person who is familiar with such matters would use, (ii) based on the

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<sup>2</sup> While the term alternative investments may suggest new and obscure investments, alternative investments have existed and been established for decades. The principal characteristics of alternative investments are (i) historically low to moderate correlation with traditional asset classes; (ii) not listed on an exchange; (iii) typically available only to high net worth and institutional investors; and (iv) have reduced liquidity. The Company is aware that alternative investments are not for all investors, and that they may, in certain circumstances, possess risks beyond those that exist in traditional investments.

<sup>3</sup> Hedge funds are private investment funds investing primarily in the global equity and fixed income markets and typically employing sophisticated investment strategies, including leverage and derivative instruments.

<sup>4</sup> Real estate investments are negotiated private investments in real estate assets with the objective of generating current income and/or reselling at a higher value in the future.

<sup>5</sup> Structured products are pools of fixed income securities purchased with equity from investors and leveraged with the objective to provide spread income for investors.

<sup>6</sup> Managed futures are investments in global markets, including futures, options, and forwards on traditional commodities, financial instruments and currencies.

<sup>7</sup> You have not requested our opinion, and we express no opinion, as to whether under certain circumstances, with respect to ActiveAllocator, the Company may be a fiduciary under the New DOL Rule.

investment objectives, risk tolerance, financial circumstances and needs of the client, and (iii) without regard to the interests of the Firm or the Rep. Additionally, the Rep must give appropriate consideration to the client's needs and objectives, and to whether or not the recommended investment is reasonably designed to meet these needs and objectives.

- ***Using ActiveAllocator to Meet Best Interest Standard of Care.*** The DOL's new rule does not expressly approve of any particular type of questionnaire or interactive tool for client information-gathering purposes. **However, in our view, ActiveAllocator would qualify as an investment analysis and evaluation tool that a fiduciary advisor would be able to utilize in evaluating the possible inclusion of alternative investments as part of a strategic asset allocation in accordance with its duty to act with the care, skill, prudence and diligence of a prudent person under the BICE's Best Interest Standard of Care.** By utilizing ActiveAllocator to create a strategic asset allocation and construct an active portfolio, the software would enable the Rep to give appropriate consideration to the Retirement Client's needs and objectives. The objectively determined strategic asset allocation and active portfolio construction created by ActiveAllocator would also enable the Rep to give appropriate consideration to whether any resulting investment recommendations are reasonably designed to meet the Retirement Client's needs and objectives.
- ***Requiring Use of ActiveAllocator as BICE Compliance Policy.*** Under the BICE, Firms must adopt and comply with written compliance policies and procedures that are reasonably and prudently designed to prevent conflicts from causing any violations of the relevant fiduciary standards under the BICE. Firms have a great deal of flexibility in establishing and designing their compliance policies and procedures for BICE purposes. **In our view, when adopted as part of a complete set of compliance policies and procedures, the adoption of a written policy that requires Reps to utilize high quality analytic techniques and software such as ActiveAllocator, when advising Retirement Clients regarding the possible inclusion of alternative investments as part of a strategic asset allocation, would be consistent with the BICE's requirement for Firms to adopt compliance measures that are reasonably and prudently designed to prevent conflicts.**
- ***Using ActiveAllocator to Meet RIA's Prudent Man Standard of Care.*** Many RIAs do not earn any variable compensation in connection with the investment advisory services they furnish to Retirement Clients. Accordingly, they may not need to comply with the BICE or the BICE's Best Interest Standard of Care (although those that give advice on rollovers would be subject to elements of the BICE). However, any fiduciary advice provided by RIAs and their Reps to any Retirement Clients subject to Title I of ERISA would generally need to comply with the "Prudent Man Standard of Care" under ERISA. The Prudent Man Standard of Care and the Best Interest Standard of Care are substantially similar standards of care for fiduciary advisors. **In our view, ActiveAllocator would qualify as an analysis and evaluation tool that Firm and their Reps would be able to utilize in evaluating whether alternative investments should be part of a strategic asset allocation in**

**accordance with its duty to act with the care, skill, prudence and diligence of a prudent person under ERISA's Prudent Man Standard of Care.**

## II. FACTUAL OVERVIEW

You have informed us that despite the many benefits of adopting newer asset allocation approaches, many Reps continue to resist such practices. These Reps may be unaware of the benefits of the newer cutting edge asset allocation strategies or believe that the cost of changing their current approach is too high. However, for a variety of reasons, existing asset allocation models fail to meet the needs of Reps. For example, these tools may oversimplify the increasingly complex universe of investment types; fail to provide holistic recommendations by omitting alternative and illiquid asset classes; and oversimplify and under-optimize recommendations, which may, for example, allow for a limited number of model portfolios.

You have indicated to us that putting modern portfolio theory into practice with respect to alternative investments requires a number of significant and erroneous assumptions: (i) that historical asset returns are comparably measured; (ii) that levels of liquidity are relatively the same across all asset classes; (iii) that long histories of performance in asset classes exist and have been reliably observed; and (iv) that types and characteristics of risk in asset classes are similar and well understood. However, in order to create an optimized portfolio that includes alternative investments and actively managed funds as well as traditional passive asset classes, it was necessary to address these perceived gaps. You have indicated to us that, other than ActiveAllocator, existing tools for constructing portfolios often use somewhat arbitrary rules of thumb which lack scientific rigor and potentially harm investor portfolios.

ActiveAllocator is intended to allow a Rep to generate an implementable strategic asset allocation. ActiveAllocator analyzes and then optimizes what a Retirement Client already owns to determine the best portfolio consistent with the appropriate long term strategic asset allocation. These strategic asset allocations use several underlying asset classes including equities, bonds, cash and alternative investments. These strategic asset allocations are consistent with a client's risk tolerance, investment horizon, liquidity preference, and mix of asset class choices.<sup>8</sup> ActiveAllocator allocates simultaneously across multidimensional return sources including alpha (skills), beta (market exposure accessible inexpensively), downside risk (extreme but rare market movements) and illiquidity. ActiveAllocator analyzes the statistical properties of existing portfolios and improves strategic asset allocation by finding the best combination of liquid and illiquid asset classes to improve existing portfolios. This strategic asset allocation process takes place across more than fifty (50) asset subclasses. ActiveAllocator integrates passive and active, liquid and illiquid, traditional and alternative investment analysis in a manner

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<sup>8</sup> While the case law under ERISA has, to a large degree, absorbed the concepts of modern portfolio theory, see, for example, the decision of the Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459(2014) that development has occurred almost exclusively in the context of efficient markets. Therefore, an approach for constructing a strategic asset allocation that is intended to address perceived gaps in modern portfolio theory in dealing with alternative investments in an inefficient market is entirely consistent with concepts of prudence under ERISA.

that is personalized to particular investor preferences, constraints, and situations. ActiveAllocator allocates to non-traded assets, accounting for non-tradability, illiquid premiums, and marked to market risk. Additionally, ActiveAllocator allocates to investment managed structures while (i) appropriately calibrating returns; (ii) accounting for factor exposures and their implications for returns in the future; (iii) removing survivorship bias<sup>9</sup> and selection bias<sup>10</sup> in historical returns; (iv) appropriately estimates risk including skewness and kurtosis;<sup>11</sup> (v) incorporating pricing distortions, serial correlation and the impact on risk; (vi) managing strategy drift and unstable histories; and (vii) optimizing downside risk. The addition of non-traditional asset classes to investment portfolios can improve diversification, which offers a better reward to risk trade-off. Further, ActiveAllocator allows Retirement Clients to consider all of their financial assets in a unified framework and make informed, intelligent investment decisions about how much of each is appropriate for their objectives.

In addition to active asset allocation, the Company's active portfolio construction software enables investors to obtain the benefits of skills (alpha) based investing while mitigating the risks associated with discretionary active managers. This software will allow Reps to decide relative allocations between managers and funds and distinguish between true investing skills (alpha) and inexpensive passive market exposure (beta). In addition to analyzing past performance history, it helps Reps express their own future views. It has provisions to include the private opinions of Reps as well as soft qualitative due diligence views within a quantitative fund selection and manager allocation framework. It will allow a Rep to calculate the marginal impact of adding or changing an investment fund as well as enabling a Rep to compare fund manager performance on a like-for-like basis. ActiveAllocator also enables a Rep to contain the effect of a manager's strategy and style drift over long periods of time in illiquid investing.

### **III. LEGAL ANALYSIS AND CONCLUSIONS**

#### **A. IMPACT OF NEW DOL RULE ON FIRMS AND REPS**

Title I of ERISA requires fiduciaries of employer-sponsored retirement plans ("ERISA Plans") to act in accordance with a "Prudent Man Standard of Care."<sup>12</sup> The duty of prudence requires a Rep to provide advice based on the investment objectives, risk tolerance, financial circumstances and needs of the Retirement Client, which in turn requires the Rep to obtain this information before providing such investment advice. Additionally, the duty of prudence requires the Rep to obtain such information in the same manner that a prudent person would.

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<sup>9</sup> Survivorship bias is the tendency of mutual funds with poor performance to be dropped by mutual fund companies generally because of poor performance. This phenomenon results in an overestimation of the past results of mutual funds.

<sup>10</sup> Selection bias is the selection of groups or data for analysis in such a way that proper randomization is not achieved, thus ensuring that the sample obtained is not representative of the population intended to be analyzed.

<sup>11</sup> Kurtosis in probability theory and statistics is a measure of the "tailedness" of the probability distribution of a real-valued random variable. Data sets with high kurtosis tend to have heavy tails or outliers. Data sets with low kurtosis tend to have light tails, or lack of outliers, gleaned from historic returns.

<sup>12</sup> ERISA Section 404.

Longstanding DOL regulations provide that a fiduciary is deemed to comply with the duty of prudence if the fiduciary gives “appropriate consideration” to the facts and circumstances that the fiduciary knows or should know are relevant with respect to an investment action.<sup>13</sup> Therefore, it is generally understood that a fiduciary advisor must give appropriate consideration to the needs and objectives of the retirement client prior to making any investment recommendations. The DOL regulations further provide that giving “appropriate consideration” includes making a determination that the investment action is reasonably designed to further the purposes of the retirement client. Accordingly, in addition to giving appropriate consideration to the client’s needs and objectives, the fiduciary advisor must also give appropriate consideration to whether the recommended investment is reasonably designed to meet these needs and objectives.

Title I also includes a related set of “Prohibited Transaction Rules”<sup>14</sup> that prohibit ERISA Plan fiduciaries from engaging in certain types of activities. Among other restrictions, the Prohibited Transaction Rules generally prohibit a fiduciary from engaging in any fiduciary self-dealing or other transactions that involve conflicts of interest. A fiduciary violation of Title I of ERISA may result in personal liability for the breaching fiduciary, giving the client the right of rescission, restitution for any losses and disgorgement of profits.<sup>15</sup> In addition, the DOL may impose punitive civil penalties as well as other equitable remedies.<sup>16</sup>

Title II of ERISA includes a set of punitive excise tax rules that mirror the Prohibited Transaction Rules under Title I. These excise tax provisions are reflected in Section 4975 of the Internal Revenue Code of 1986, as amended (the “Code”), which was formally added to the Code by Title II of ERISA. ERISA plan fiduciaries are subject to the restrictions under both Titles I and II of ERISA. Conversely, fiduciaries to Retirement Client accounts that are not subject to Title I of ERISA are subject to the requirements of Title II of ERISA only (*i.e.*, the excise tax rules under Code Section 4975). Retirement Client accounts that are not subject to Title I of ERISA generally include IRAs and sole proprietor plans such as solo 401(k) plans.

Many Firms who offer investment-related services to Retirement Clients currently take the position that neither the Firm nor their Reps are acting in a fiduciary capacity. In other words, they typically take the position that the investment recommendations made by their Reps to Retirement Clients are non-fiduciary in nature, and do not include any fiduciary “investment advice” within the meaning of Title I or Title II of ERISA. However, virtually all Firms and their Reps who provide investment-related services to Retirement Clients will be deemed fiduciary advisors as a result of the application of the New DOL Rule. The New DOL Rule is specifically designed to broaden the scope of advisors who will be deemed to be fiduciaries with respect to any Retirement Clients, and many Firms and their Reps will be deemed to be offering fiduciary advice for the first time as a result of the New DOL Rule.

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<sup>13</sup> Section 2550.404a-1(b) of DOL Regulations.

<sup>14</sup> ERISA Section 406.

<sup>15</sup> ERISA Section 409.

<sup>16</sup> ERISA Section 502(l).

## B. “BEST INTEREST STANDARD OF CARE” AND BICE

Under the Prohibited Transaction Rules,<sup>17</sup> fiduciary advisors generally cannot earn any “variable compensation” that varies with the particular investment(s) that are selected in connection with the investment advice furnished to a Retirement Client.<sup>18</sup> An impermissible conflict of interest arises to the extent that a fiduciary advisor has a financial incentive to recommend a particular investment that results in a higher level of compensation for such advisor. Accordingly, when Firms and their Reps are deemed to be fiduciary advisors as a result of the application of the New DOL Rule, they will be prohibited from earning commissions, revenue sharing, 12b-1 fees, third party payments or other forms of variable compensation in connection with the investment advice that they provide to their Retirement Clients, unless they qualify for an exemption from the Prohibited Transaction Rules. As part of its New DOL Rule, the DOL has also issued a new prohibited transaction class exemption, PTE 2016-01, also entitled the BICE. In sum, the BICE would give Firms and their Reps the ability to earn variable compensation, such as the commission-based compensation described above, as long as the numerous conditions imposed under the BICE are satisfied.

Among the BICE’s conditions, any fiduciary advice provided by a Firm’s Rep to a Retirement Client must meet the “Best Interest Standard of Care”.<sup>19</sup> In other words, the advice must be provided (i) with the care, skill, prudence and diligence that a prudent person who is familiar with such matters would use, (ii) based on the investment objectives, risk tolerance, financial circumstances and needs of the client, and (iii) without regard to the interests of the Firm or the Rep. The exemptive relief under the BICE is potentially available with respect to all types of Retirement Clients advised by the fiduciary advisor. Thus, the BICE’s Best Interest Standard of Care may apply to an individual client with an ERISA Plan account (such as a 401(k) plan participant), an IRA account owner or a sole proprietor with a non-ERISA plan account (such as a solo 401(k) account). It should also be noted that in the case of an individual client with an ERISA Plan account, the fiduciary advice provided by the Firm through its Rep would also be subject to the Prudent Man Standard of Care under Title I of ERISA, which is generally imposed under the ERISA statute in addition to the Best Interest Standard of Care imposed under the BICE.

As noted by the DOL, the Best Interest Standard of Care is intended to be given the same meaning as the Prudent Man Standard of Care. Both fiduciary standards reflect a duty of prudence, which is generally viewed as incorporating objective standards of care, as well as a duty of undivided loyalty to the client. In support of the foregoing, the DOL noted the following in its preamble to the BICE:

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<sup>17</sup> For purposes of this letter, all references to the Prohibited Transaction Rules under ERISA Title I should be interpreted as also referencing the mirror excise tax provisions under ERISA Title II, except as the context otherwise clearly requires.

<sup>18</sup> Variable compensation is generally prohibited under the Prohibited Transaction Rules and the mirror excise tax rules. See ERISA Section 406(b) and Code Section 4975, respectively. See, also, the DOL preamble to the BICE (April 8, 2016).

<sup>19</sup> Section VIII(d) of the BICE.

The Best Interest standard, as set forth in the exemption, is intended to effectively incorporate **the objective standards of care and undivided loyalty that have been applied under ERISA for more than forty years**. Under these objective standards, the Adviser must adhere to a professional standard of care in making investment recommendations that are in the Retirement Investor's Best Interest. **The Adviser may not base his or her recommendations on the Adviser's own financial interest in the transaction**. Nor may the Adviser recommend the investment, unless it meets the objective prudent person standard of care. Additionally, the duties of loyalty and prudence embodied in ERISA are objective obligations that do not require proof of fraud or misrepresentation, and full disclosure is not a defense to making an imprudent recommendation or favoring one's own interests at the Retirement Investor's expense (**emphasis added**).

In addition to the Best Interest Standard of Care, the BICE also imposes a number of other operational conditions on Firms. For instance, the Firm must adopt written compliance policies and procedures that are reasonably and prudently designed to prevent conflicts from causing any violations of the relevant fiduciary standards under the BICE.<sup>20</sup> Of course, in addition to adopting these compliance policies and procedures, a Firm must also comply with their provisions in operation in order to qualify for the exemptive relief available under the BICE.

### **C. USING ACTIVEALLOCATOR TO MEET THE BEST INTEREST STANDARD OF CARE**

As a result of the application of the New DOL Rule, virtually all Firms and their Reps will be deemed to be fiduciary advisors when advising Retirement Clients. Once the new DOL Rule goes into effect, the duty of prudence requires a Rep to provide advice based on the investment objectives, risk tolerance, financial circumstances and needs of the client, which in turn requires the Rep to adequately analyze and evaluate investment products being considered for the client, pursuant to the specific needs of the client. The BICE does not expressly approve of any particular type of analysis or evaluation tool for analyzing investments. **However, in our view, ActiveAllocator would qualify as an analytic and evaluation tool that a fiduciary advisor would be able to utilize in accordance with its duty to act with the care, skill, prudence and diligence of a prudent expert under the BICE's Best Interest Standard of Care**. By utilizing ActiveAllocator to create a strategic asset allocation and construct an active portfolio, the Rep will be able to give appropriate consideration to the client's needs and objectives.

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<sup>20</sup> Sections II(d)(1) and II(g)(3) of the BICE.



#### **D. REQUIRING USE OF ACTIVEALLOCATOR AS BICE COMPLIANCE POLICY**

As discussed above, under the BICE, Firms must adopt and comply with written compliance policies and procedures that are reasonably and prudently designed to prevent conflicts from causing any violations of the relevant fiduciary standards under the BICE. Although the DOL's BICE includes high level guidance for Firms on how they may establish and design their required policies and procedures, the BICE does not expressly require any particular measure to be included in such policies and procedures. Instead, Firms have a great deal of flexibility in establishing and designing their compliance policies and procedures for BICE purposes.

For example, a Firm would be permitted to require their Reps to utilize high quality software, such as the ActiveAllocator, to create strategic asset allocations and active portfolio constructions for their Retirement Clients. **In our view, when adopted as part of a complete set of compliance policies and procedures, the adoption of a written policy that requires Reps to utilize high quality software such as the ActiveAllocator in evaluating whether alternative investments should be part of a Retirement Client's strategic asset allocation when advising Retirement Clients, would be consistent with the BICE's requirement for Firms to adopt compliance measures that are reasonably and prudently designed to prevent conflicts. ActiveAllocator is agnostic to the selection of investments by the Retirement Client.**

#### **E. USING ACTIVEALLOCATOR TO MEET RIA'S PRUDENT MAN STANDARD OF CARE**

Many RIAs do not earn any variable compensation in connection with the investment advisory services that they furnish to Retirement Clients. Accordingly, under the Prohibited Transaction Rules, many RIAs will not need to comply with the BICE or the BICE's Best Interest Standard of Care (although those that engage in rollover business would be subject to the elements of the BICE, as discussed above). However, even though the Best Interest Standard of Care would not apply, any fiduciary advice provided by RIAs to any Retirement Clients that are subject to Title I of ERISA would generally need to comply with ERISA's traditional Prudent Man Standard of Care. And as discussed above, the Prudent Man Standard of Care and the Best Interest Standard of Care are substantially similar standards of care for fiduciary advisors. Thus, our legal analysis in section III.C above concerning the use of ActiveAllocator and the Best Interest Standard of Care would be equally relevant for purposes of addressing the Prudent Man Standard of Care.

**Based on the foregoing analysis, in our view, ActiveAllocator would qualify as an analytic and evaluation tool for investments that Registered Investment Advisers and their Reps would be able to utilize in accordance with their duty to act with the care, skill, prudence and diligence of a prudent person under ERISA's Prudent Man Standard of Care. For these reasons, even if a RIA is not subject to the BICE or the BICE's Best Interest**

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Standard of Care, the RIA and its Reps may wish to consider utilizing ActiveAllocator when advising their Retirement Clients.

The opinions and views included in this letter represent our view of the outcome in a court of law if a challenge were to be made to the conclusions set out above and do not represent a guarantee as to the outcome. The legal analysis included herein is based on the facts presented and the existing laws and regulations in effect as of the date of this letter. The addition of facts other than those described above and any material changes in the law or regulatory guidance may affect the legal analysis and conclusions set forth herein. Our opinions and views expressed in this letter are furnished to you solely for your benefit. Although we understand that you may wish to provide copies of this letter to third parties for their information only, to which we provide our consent, the opinions and views expressed in this letter may not be relied upon by any person other than you without our prior consent.

Sincerely,

A handwritten signature in blue ink that reads "The Wagner Law Group". The signature is written in a cursive, flowing style.

The Wagner Law Group