

Regulation and Compliance—Plan Fiduciaries and Investment Advice

Back in 2006, President George W. Bush signed the Pension Protection Act of 2006 (PPA) into law. Among the changes enacted by the PPA was an exemption to ERISA’s prohibited transaction rules for advice provided by a “fiduciary adviser” under an “eligible investment advice arrangement.”

The exemption extended to advice provided to participants in certain retirement plans including most prominently 401(k) plans and IRAs, but not advice to the plan itself. To qualify for the exemption, the advisory arrangement could take one of two routes: (1) provide that the fees or other compensation received by the fiduciary adviser do not vary (level fees) depending on the investment option chosen or (2) use an unbiased computer model under an investment advice program meeting certain criteria.

Not so Final Final Regulations

The prohibited transaction exemption (PTE) languished as priorities shifted and Presidential administrations changed. Then, in January of 2009, the Department of Labor issued “final regulations” and a class exemption to implement the law change made in 2006. As published, these rules were to be effective on March 23, 2009. However, based on public comments, the effective date of the final regulation was delayed and eventually withdrawn. Then, on February 26, 2010, new proposed regulations were issued.

The new proposed regulations replace the old final regulations and withdraw the class exemption, based on comments received. The class exemption would have allowed individualized follow-up advice to participants who previously received computer-generated advice or IRA participants who received investment education advice (“off-model advice”). For institutional advisers the class exemption would have provided an exemption at the fiduciary-adviser-entity level under certain circumstances.

Driving Forces

In part, the issuance of regulations under the PPA exemption stems from a long standing effort by the DOL. However, that effort appears to have received new stimulus under the Obama Administration. The proposed regulations fall under other initiatives of a White House Task Force headed up by Vice President Joe Biden.

The DOL's regulatory impact analysis (RIA), as adopted by the Task Force, found that 401(k) and IRA participants often make costly investment errors due to the lack of investment advice available through employers. The Department estimated that the PPA statutory exemption and regulations thereunder would extend investment advice to 21 million previously unadvised participants and beneficiaries, generating \$13 billion in annual financial benefits at a cost of \$5 billion, for a net annual financial benefit of \$8 billion.

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The Proposed Regulations

One of the ways to qualify for the exemption is for the fiduciary to offer advice under a level fee advisory arrangement. In addition to removing the class exemption, the proposed regulation clarifies the requirements for a level fee arrangement.

Specifically, in order to qualify, the fees received by a fiduciary adviser (including any employee, agent, or registered representative of the adviser) from another party (including an affiliate of the adviser) cannot vary based on the investment option selected by the

participant. In addition, the compensation must be based on generally accepted theories that take into account at least the following factors:

- The historic risks and returns of different asset classes over defined periods of time;
- The investment management and other fees and other expenses related to the recommended investments; and
- To the extent such information is furnished to the adviser, information relating to the participant's age, life expectancy, retirement age, risk tolerance, current investments, investment preferences, and other sources of income.

The proposed regulation also clarifies requirements for the computer model approach. Under this alternative, the computer model must meet the following generally accepted investment theories that take into account:

- The historic risks and returns of different asset classes over defined periods of time;

- The investment management and other fees and expenses attendant to the recommended investments; and
- 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.

In addition, the computer model must utilize appropriate objective criteria to provide asset allocation portfolios comprised of investment options available under the plan and avoid investment recommendations that inappropriately:

- Favor investment options offered by the fiduciary adviser over other investment options, if any, available under the plan;
- Favor investment options that may generate greater income for the fiduciary adviser; or
- Distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future.

Under the computer model alternative, advisers must undergo an annual audit and disclose all fees the adviser will receive.

Furthermore, the computer model must take into account all designated investment options available under the plan without giving inappropriate weight to any investment option, although the model need not make recommendations concerning employer securities, target funds, guaranteed annuity options, or self-directed brokerage accounts.

Finally, prior to use of the model, the adviser must receive certification from an “investment expert” that the model meets the requirements of the regulation. The adviser must also receive authorization from the plan fiduciary to provide investment advice, undergo an annual audit, and make a number of disclosures including all fees the adviser will receive.

Bottom Line

As implemented by the regulations, the statutory exemption creates opportunities both for advisers and plan participants. The DOL is accepting public comments through May 5, 2010. The regulation will become effective 60 days after the final version is published in the Federal Register.

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