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DOL Proposes Rules on Investment Advice for 401(k) Plans and IRAs

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On February 26, the U.S. Department of Labor (DOL) released reproposed regulations that would implement the prohibited transaction exemption for investment advice to participants in participant-directed individual account plans and beneficiaries of individual retirement accounts (IRAs). The regulations would provide guidance on the exemption's requirements for fee-leveling and computer model arrangements, and include a nonmandatory model form that advisers may use to satisfy the fee disclosure requirement. They are substantially the same as the prior proposed regulations, except they do not include a class exemption that would expand on the exemptive relief in the statute.

A. Pension Protection Act Exemption

The prohibited transaction rules of the Employee Retirement Income Security Act of 1974, as amended (ERISA), prohibit self-dealing and conflicts of interest by plan fiduciaries. The statute defines the term "fiduciary" to include persons who provide "investment advice" for a fee. As a result, under DOL interpretations of ERISA, an investment adviser, broker-dealer, or other financial professional is prohibited from providing fiduciary-type investment advice to plan participants that would result in the participants making investments that would pay fees to, or otherwise benefit, the adviser or its affiliates.

Over the years, DOL has identified categories of "investment education" that can be provided to plan participants responsible for the investment of their plan accounts without making the provider an ERISA fiduciary. The DOL has also described structures for providing investment advice to participants that avoid conflicts of interest that could violate ERISA's prohibited transaction rules, such as the use of fee offsets to avoid increased fees to the adviser and its affiliates. Nevertheless, many have felt that there are still too many barriers preventing participants from receiving the advice they need to be able to effectively manage their retirement savings. While there has always been the alternative of obtaining "non-conflicted" advice that would not violate ERISA's prohibited transaction rules, that advice has involved additional costs that plan sponsors and plan participants may not be willing to pay. As IRAs, while not covered by ERISA, are subject to parallel prohibited transaction rules under section 4975 of the Internal Revenue Code of 1986, as amended (Code), the same issues arose in advising IRA beneficiaries.

In response, as part of the Pension Protection Act of 2006 (PPA), Congress enacted a prohibited transaction exemption for investment advice, which was intended to provide greater flexibility for participants and beneficiaries in 401(k) plans and IRAs to obtain advisory services. Specifically, subject to the requirements of ERISA section 408(g), section 408(b)(14) of ERISA provides that certain transactions arising from the provision of investment advice to plan participants will be exempt from the

ERISA prohibited transaction rules. Section 408(g) in turn requires that the investment advice be provided to the participants by a "fiduciary adviser" (generally, either a registered investment adviser, bank trust department, insurance company qualified to do business under state law, or registered broker-dealer, or its affiliates, employees, agents, or registered representatives). In addition, the advice arrangement must meet either a "level fee" requirement or a "computer model" requirement. There are parallel provisions under the prohibited transaction rules that apply to IRAs.

Under the level-fee structure, the fiduciary adviser's fees or other compensation must not be affected by the investments selected by the participant as a result of the advice. Under the computer model arrangement, the advice must arise solely from the use of a computer model that meets a series of requirements, including that it be based on objective criteria and independently certified as meeting the conditions of the exemption. Either structure must be independently approved and subject to annual independent review to assure compliance with the exemption.

While no regulations were required to implement the level-fee provisions, DOL was required to take regulatory action in order for the computer model portion of the exemption to become available.

B. DOL Interpretations and Proposed Regulations

In August 2008, DOL published proposed regulations to implement the PPA exemption, explaining the conditions of the fee-leveling approach and the computer model approach. In addition, DOL proposed a class exemption to supplement the relief for advice provided pursuant to computer models. Whereas the PPA exemption limits relief under the computer model approach to the asset allocation recommendations generated by the computer model, the class exemption would have permitted advisers to provide follow-up advice to participants receiving computer model results. In addition, in the case of IRAs where computer modeling may not be feasible, the class exemption would have provided relief for advice in conjunction with furnishing certain investment education material on asset allocation.

In January 2009, in the final days of the Bush administration, DOL published final regulations and a final class exemption in the *Federal Register*, to be effective on March 23, 2009. However, the new administration requested that agencies consider reopening for comment final regulations that, like these, were not yet effective. In response, DOL postponed the effective date and reopened the matter for additional comment and consideration. Ultimately, in November 2009, DOL formally withdrew the regulations and class exemption, explaining that the Bush administration rules "went too far" in permitting investment advice arrangements not specifically contemplated by the underlying statute.

C. Reproposed Regulation

The reproposed regulations are, in DOL's words, "nearly identical" to the January 2009 final rule. However, DOL did not repropose the class exemption. As a result, there is no relief for individualized advice provided after the participant has been given recommendations generated by a computer model, or for asset allocation advice given to IRA beneficiaries for whom a computer model may not be available.

1. Fee-Leveling

The key requirement for a fee-leveling arrangement is that neither the fiduciary adviser providing the advice, nor any employee, agent or registered representative of the fiduciary adviser, may receive any direct or indirect fee or other compensation that is based in whole or in part on an investment option selection. The types of compensation covered include commissions, salary, bonuses, awards, promotions, or "other things of value."

One of the issues raised in comments on the original proposal, and on whether to withdraw the January 2009 final regulation, was DOL's interpretation of the scope of the fee-leveling requirement. In a 2007 field assistance bulletin, DOL had taken the position that the fee-leveling requirement applied only to fees received by the fiduciary adviser, and not to fees received by the fiduciary adviser's affiliates. On the basis of the statutory language and the fact that the use of fee-leveling across affiliates was an approach already available under pre-existing law, DOL upheld this position in the original proposal, the final regulation, and the reproposed regulation.

In the preamble to the reproposal, DOL noted that several comments had argued that permitting the receipt of fees by affiliates would create an economic interest for the fiduciary adviser or its employees to recommend investments that pay such fees. DOL responded, and clarified in the proposed regulation, that even though an affiliate of the fiduciary adviser may receive fees that vary depending on the investment options selected, none of those fees may flow to the fiduciary adviser or any of its employees, agents, or registered representatives. Thus, the provision of any financial or economic incentives by the affiliate to the fiduciary adviser or its employees to favor certain investments would not be permitted.

2. Computer Models

The reproposal follows the original proposal and final regulation in the rules it sets out for computer models. These describe the operation and design of the computer model, including what considerations it must take into account (such as investment management fees and the participant's age and risk tolerance, if provided). The rules also emphasize the importance of using appropriate objective criteria within the model, and the necessity of not inappropriately favoring investment options that would generate greater income to, or otherwise benefit, the fiduciary adviser or those in which it has a "material" interest. The computer model need not take into account investment options designed to invest in employer stock or that are target-date retirement funds or annuities. As required by statute, the rules also describe the requirements for initial and ongoing certification of the computer model by an "eligible investment expert" as meeting the requirements of the regulation.

DOL invited comments on a number of issues relating to computer models, including whether to be more specific about the investment theories and practices that must be applied in connection with giving advice and developing model parameters, what historical data should be taken into account in a model, and what types of criteria are appropriate and objective bases for asset allocations under a model. DOL also asked under what conditions it would be appropriate to recommend a fund with superior past performance over an alternative fund with average performance but lower fees, and whether the regulation should deal with that issue, as well as whether a model should ascribe different levels of risk to passively and actively managed investment options.

3. Additional Requirements Applicable to Both Types of Arrangements

The reproposal, like its predecessors, describes the requirements for authorization of the investment advice arrangement by an independent plan fiduciary or IRA beneficiary (with exceptions for plans of the fiduciary adviser and IRAs of the fiduciary adviser's employees), and the requirement for an annual independent audit of compliance with the requirements of the PPA exemption. In the case of an IRA, if the written audit report identifies noncompliance with the requirements of the regulation, the fiduciary adviser would be required to submit the report to DOL within 30 days following receipt of the report from the auditor. The reproposal also describes disclosure requirements under which the fiduciary adviser must provide certain information to the participants and beneficiaries prior to the initial provision of investment advice and on an ongoing basis. Accompanying the proposed regulations is an optional model disclosure form that can be used to meet the disclosure requirements.

4. Noncompliance

A provision in the original proposal that generated a number of comments described the effects of noncompliance with the conditions of the regulation. This provision has been retained in the reproposal.

The basic sanction for noncompliance is that the exemptive relief does apply to the transactions connected with the investment advice as to which the applicable conditions have not been satisfied. In addition, the proposal specifies that in the case of a "pattern or practice of noncompliance" with any applicable conditions, the relief does not apply to *any* transaction in connection with the provision of investment advice during the period over which the pattern or practice extended. This language had raised concerns as to what would be treated as a "pattern or practice" and of the risk of inadvertent loss of exemption coverage.

5. Public Comments and Effective Date

The reproposed regulation would become effective 60 days after publication in final form in the *Federal Register*. Comments are due by May 5, 2010.

6. Other Effects of the Statutory Exemption and Regulation

Early public comments had expressed concern as to whether the new rules would override prior DOL guidance on when fiduciary investment advice can be used to select investment options that pay fees to the adviser, without violating the ERISA prohibited transaction rules. The regulation states that nothing in the PPA exemption or the regulation invalidates, or otherwise affects, prior regulations, exemptions, or other guidance in this regard.

In addition, the regulation states that nothing in the statutory provision or regulation imposes an obligation on a plan fiduciary, or any other party, to offer, provide, or otherwise make available any investment advice to a plan participant.

D. Observations

The PPA exemption for participant investment advice represented a recognition by Congress that plan participants and IRA beneficiaries are increasingly responsible for managing the investments of their retirement accounts, and thus are in need of professional investment advice to assist them in this role. The provision itself represented a compromise between those who favored broad disclosure-based exemptive relief, and those who were concerned that such relief would leave participants overly vulnerable to adviser conflicts of interest. The consequence was a framework that limited relief to two specific approaches to providing advice, fee-leveling and computer models, raising questions as to whether the new rules would have much effect on current practices.

DOL's original proposal would have expanded on those approaches through adding a class exemption, which would have provided additional means of making investment advice available. However, in reaction to the intense criticism of the class exemption, including from many members of Congress, DOL has eliminated that additional flexibility. The question is whether what remains will be sufficient to meet the original goal of the PPA exemption by encouraging financial services firms and plan sponsors not currently offering participant investment advice to now do so.

Meanwhile, there is a parallel track on this issue in Congress. Rep. George Miller (D-Calif.), Chairman of the House Education and Labor Committee, was critical of the original DOL proposal. His committee has reported out legislation that would retain the computer model approach essentially in the form of the PPA exemption, but would change the fee-leveling approach to exclude any provider of a plan investment option, thereby severely restricting its availability. The legislation would also become the exclusive approach for providing participant investment advice, overturning past DOL guidance. The result would be to impose considerable restrictions on the ability of firms to provide investment advice to plan participants unless they are completely independent of any investment options offered under the plan. This bill, which remains pending, has been criticized as unnecessarily restrictive by other members of Congress.

Following the announcement of the reproposed regulation, the Education and Labor Committee issued a press release describing the new proposal as "welcome news" for those concerned about their retirement security, and expressing hope that the proposal will help ensure that investment advice is based on what is best for retirement security rather than the investment adviser. It remains to be seen whether Chairman Miller will view the revised proposal as eliminating the need for additional legislation on participant investment advice.

Another open issue is how the new rules will work for IRAs. At the time it enacted the PPA exemption, Congress was unclear as to how the computer model rules would apply to IRAs, as those rules are designed to deal with plans that have a fixed set of designated investment options for the model to consider. To address this point, Congress directed DOL to conduct a study on the feasibility of computer model programs for IRAs. While DOL concluded that the computer model approach would generally be feasible for IRAs, it also proposed additional relief in a class exemption, intended in part to address circumstances in which computer models may not be available for IRAs. However, the class exemption has now been withdrawn.

The ultimate question is to what extent financial services firms will develop new advisory services based on these new rules. Many had hesitated after the PPA exemption was enacted, awaiting DOL guidance, so that there has been little experience to date in utilizing the framework under this exemption.

If you have any questions about any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

Chicago

Louis L. Joseph	312.324.1726	louis.joseph@morganlewis.com

New York

Craig A. Bitman	212.309.7190	cbitman@morganlewis.com

Philadelphia

I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Vivian S. McCardell	215.963.5810	vmccardell@morganlewis.com

Steven D. Spencer	215.963.5714	sspencer@morganlewis.com
Marianne R. Yudes	215.963.5490	myudes@morganlewis.com
David B. Zelikoff	215.963.5360	dzelikoff@morganlewis.com

Pittsburgh

Lisa H. Barton	412.560.3375	lbarton@morganlewis.com
Lauren B. Licastro	412.560.3383	llicastro@morganlewis.com

Washington, D.C.

Benjamin I. Delancy	202.739.5608	bdelancy@morganlewis.com
Stuart P. Kasiske	202.739.6368	skasiske@morganlewis.com
Daniel R. Kleinman	202.739.5143	dkleinman@morganlewis.com
Donald J. Myers	202.739.5666	dmyers@morganlewis.com
Michael B. Richman	202.739.5036	mrichman@morganlewis.com

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