GROOM LAW GROUP

MEMORANDUM

February 5, 2007

TO: Financial Institution Clients

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RE: DOL Guidance Interpreting PPA "Investment Advice" Provisions – Answered Questions, New Opportunities and Outstanding Issues

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In response to multiple questions about the "investment advice" exemption ("Exemption") of the Pension Protection Act of 2006 ("PPA"), the Department of Labor ("Department") has just released Field Assistance Bulletin 2007-01 ("FAB") (Feb. 2, 2007), addressing issues of significant importance to financial institutions servicing employee benefit plans and individual retirement accounts ("IRAs"). The FAB resolves some of the uncertainties created by the PPA and creates a new option for service providers that wish to provide investment advice without fee offsets or reliance on computer models.

This memorandum outlines —

- Pre-PPA common industry approaches to structuring investment advice programs, based on the Department's advisory opinions and other guidance.
- The scope, requirements and the issues created by the Exemption.
- Issues resolved by the FAB.
- Opportunities created by the FAB.
- Unresolved issues.

Background

The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), imposes a number of substantial rules on "fiduciaries." The term "fiduciary" generally would include persons providing investment advice for a fee to 401(k) and other retirement plans ("plans").[1] Fiduciaries must act prudently and for the benefit of plan participants and beneficiaries. ERISA § 404. Fiduciaries also must avoid prohibited transactions, e.g., certain transactions between the plan and "parties in interest," and transactions involving fiduciary self-dealing and conflicts of interest. ERISA §406. Providing investment advice to plans, while

[1] Nearly identical prohibited transaction rules apply to "disqualified persons" with respect to IRAs under section 4975 of the Code. Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this memorandum to specific sections of ERISA should also be taken as references to the corresponding sections of the Code.

receiving fees in connection with that advice, may subject financial institutions to liability under ERISA.

Prior to the PPA enactment, the Department has issued various forms of guidance concerning when a person would be a fiduciary by reason of rendering investment advice and when the provision of investment advice may result in prohibited transactions under ERISA. Some of this guidance is discussed below.

I. Pre-PPA Approaches for Investment-Related Services

A. Interpretive Bulletin 96-1 – Educational Materials Approach

In Interpretive Bulletin 96-1, 29 CFR § 2509.96-1 ("IB 96-1"), the Department identified safe harbors for four categories of information, the provision of which categories of investment-related information and materials to participants would not constitute investment advice.

B. "Fee Leveling or Offset" Approach – Frost Bank and COUNTRY Bank Opinions

One of the popular approaches to avoiding ERISA violations is the so-called "fee leveling or offset" approach, sanctioned by DOL in Advisory Opinion 97-15A (May 22, 1997) (Frost Bank). In Frost Bank, the Department opined that, where a fiduciary advises a plan to invest in mutual funds that pay additional fees to the advising fiduciary, the advising fiduciary generally would violate section 406(b)(1). However, to the extent that the fiduciary uses every dollar of fees the mutual funds pay the fiduciary to offset fees that the plan is otherwise legally obligated to pay the fiduciary (e.g., for trustee services), section 406(b)(1) will not be violated because the fiduciary is not considered to be dealing with plan assets for his own account. Similarly, DOL has stated that there is no violation of section 406(b)(3) if the fiduciary's compensation is not received "for his personal account" and, instead, fees are received on behalf of a plan.

In the subsequent opinion issued to the COUNTRY Trust Bank, the Department has confirmed that the "fee leveling or offset" approach may be applied where advisory services are delivered to an IRA and where fees are paid from either affiliated or unaffiliated mutual funds. DOL Adv. Op. 2005-10A (May 11, 2005) (COUNTRY Bank).

B. "Independent Financial Expert," or SunAmerica Approach

Another commonly used model for providing investment advice to plans has originated with the Department's Advisory Opinion issued to SunAmerica in 2001. DOL Adv. Op. 2001-09A (Dec. 14, 2001) (SunAmerica). In SunAmerica, the Department concluded that a financial services firm may serve as a fiduciary and offer an investment advisory program without violating section 406(b) of ERISA where the investment recommendations are under the control of an independent financial expert. The SunAmerica product involved affiliated and unaffiliated investment vehicles offered to participant-directed defined contribution plans. SunAmerica received varying levels of fees from affiliated and unaffiliated investment vehicles in connection with plan investments - there was no fee leveling. SunAmerica offered investment advice and discretionary management services to plan participants under the program in return for an additional asset based fee.

Under the program, an independent financial expert constructed a number of "model" portfolios suitable for individuals with different risk profiles and investment horizons by combining the plan's investment options (selected by the plan's named fiduciary). Although SunAmerica's own representatives actually administered the program and recommended the portfolios, the Department concluded that, because the recommended portfolios were constructed by an independent party, SunAmerica would not commit a violation of the self-dealing and anti-kickback prohibitions under ERISA section 406(b) by offering the program and receiving various fees from investment options. SunAmerica representatives could not provide any investment recommendations not specified by the model.

II. PPA's Exemption

Congress added the Exemption to ERISA in order to foster new advice programs that did not exist under current law. However, a number of uncertainties exist in the statutory language, as finally passed. We discuss the Exemption and the corresponding issues below.

A. Scope of Relief

As amended by the PPA, new section 408(b)(14) of ERISA and section 4975(d)(17) of the Code provide relief for a "fiduciary adviser" for the following transactions:

- the provision of investment advice to participants and beneficiaries (not plan fiduciaries);

- the acquisition, sale or holding of any security or other property pursuant to such investment advice; and

- the direct or indirect receipt of compensation by the "fiduciary adviser or an affiliate thereof (or any employee, agent, or registered representative) in connection with the provision of the advice . . ."

ERISA § 408(b)(14)(A). A "fiduciary adviser" is defined to mean (1) a person who is a fiduciary by reason of providing investment advice who is a (2) registered investment adviser, bank, insurance company, broker dealer, and any of their affiliates and all of their employees and agents (including employees and agents of affiliates). ERISA § 408(g)(11)(A).

B. Eligible Arrangements

The Exemption requires that advice be given pursuant to an "eligible investment advice arrangement." There are two approaches by which a fiduciary adviser may offer an eligible arrangement.

The first approach is the so-called "level fees" option. Under that alternative, the statute requires that the arrangement must "provide[] that any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property do not vary depending on the basis of the investment option selected . . . ." ERISA § 408(g)(2)(A)(i).

The second type of eligible arrangement must utilize a computer model. The computer model must use generally accepted investment theories, utilize relevant participant information (which may include age, retirement age, life expectancy, risk tolerance), be objective and unbiased, and "take into account all investment options under the plan in specifying how a participant's account balance should be invested and is not inappropriately weighted with respect to any investment option." ERISA § 408(g)(3)(B). The model also must be periodically "certified" by an "eligible investment expert" as meeting the requirements of the Exemption. The expert must meet criteria established by the Department and must have "no material affiliation or contractual relationship" with the fiduciary adviser. ERISA § 408(g)(3)(C).

Numerous added conditions are imposed on all eligible arrangements, regardless of whether the arrangement uses the fee leveling or a computer model option. Among other things, these conditions require that (1) the arrangement be expressly authorized by a plan fiduciary other than the person providing the advice program; (2) the fiduciary adviser obtain an annual audit from an independent expert demonstrating compliance with the conditions of the exemption; (3) comprehensive disclosures be given periodically to participants or beneficiaries, and (4) transactions be on arms' length terms and for reasonable compensation.

C. Plan Sponsor Relief

In addition to providing relief to fiduciary advisers, the exemption also provides liability relief to plan sponsors and other plan fiduciaries who enter into an eligible arrangement with a fiduciary adviser if the adviser acknowledges fiduciary status. ERISA § 408(b)(10). Plan sponsors must, in any event, make a prudent selection and periodically monitor the performance of the adviser. But the sponsor need not monitor the specific investment advice given to any participant.

III. Exemption's Ambiguities and the FAB

A. Pre-PPA Approaches

The Exemption expressly preserves the application of prior Department's exemptions, but it does not expressly preserve the Department's prior non-exemption guidance, for example, in the form of advisory opinions. Thus, the Exemption created an ambiguity as to whether advisory programs that involve fee leveling/offsets (Frost Bank) or independent computer models (SunAmerica advice programs) remain viable.

In the FAB, the Department expressly stated that "the new provisions do not invalidate or otherwise affect prior guidance of the Department relating to investment advice and that such guidance continues to represent the views of the Department." The Department clarified that the Exemption provides relief for transactions that actually are prohibited transactions to begin with, while prior approaches, such as IB 96-1, SunAmerica or Frost, were grounded on the premise that underlying transactions were not prohibited transactions to begin with. This pronouncement alleviates significant concerns created by the Exemption's ambiguity.

B. <u>Level Fees</u>

The Exemption's level fee condition is ambiguous. One possible interpretation is that the condition only applies to a single entity that determines what advice is given, but not to that entity's affiliates. Another possible interpretation was that all fees received by an adviser and its affiliates must be leveled. This, of course, would effectively mimick the requirement of the Frost Bank letter.

The FAB confirmed that the fee leveling requirement applies only to the fiduciary adviser, not to any of the affiliates. This clarification potentially presents new opportunities for delivering "investment advice" to plan and plan participants, depending on how the business is redistributed among various affiliates. However, the FAB indicates, that in most cases the level fee requirement will apply to both the <u>entity</u> and the <u>individual</u> providing advice. The Department broadly defined the compensation received by an individual advisor that is subject to this rule.

C. <u>Liability of Plan Sponsors</u>

The Exemption provides express limits on liability for plan sponsors and other plan fiduciaries who arrange for advice through a program that meets the conditions of the Exemption. One concern was that this liability relief would encourage plan sponsors to seek out products that qualify under the Exemption as opposed to other products (like fee leveling and independent computer models). The FAB clarified that duties and liability of a plan sponsor selecting an advisor are the same regardless of whether it uses an advisor that relies on the Exemption or an advisor that has a product outside of the Exemption.

The Department utilized the FAB's forum to remind plan sponsors that under any of the approaches plan sponsors remain liable for prudent selection and monitoring of fiduciary advisors. In fact, the Department identified a number of factors that plan sponsors should consider in order to comply with the prudent selection and monitoring requirements.

Among the factors to consider in the selection process are the adviser’s registration in accordance with applicable federal and/or state securities law, the willingness of the adviser to assume fiduciary status and responsibility under ERISA with respect to the advice provided to participants, and the extent to which advice to be furnished to participants and beneficiaries will be based upon generally accepted investment theories.

For "monitoring" purposes, plan sponsors should consider, among other things, participants' satisfaction with the services and the advisor's continued compliance with its contractual representations, including representations regarding its status (i.e., registered investment adviser) and its investment products.

IV. Outstanding Issues

The FAB's guidance is valuable and timely and we expect service providers to look at their business models to see if products and/or corporate forms might be structured to take advantage of the fact that affiliates can receive varying fees without offsets. We also expect clients to carefully evaluate the disclosure and audit burden of relying on the Exemption. Yet, more guidance is needed for the effective utilization of the Exemption by the industry. In particular, a number of unresolved issues relating to computer models still require guidelines. For example —

- Off Model Advice. The Exemption's computer model condition expressly provides that participants can request advice not generated by the model. However, it is not clear from the Exemption whether an adviser can respond to such a request by providing specific investment recommendations that are not generated by the model (so-called "off model" advice), or whether the adviser must rerun the model.

- Investment Options Available in the Plan. The Exemption requires that a computer model take into account all of the investment options available under the plan. A variety of issues are raised in light of this requirement, including how employer stock can be addressed and how self-directed brokerage accounts are treated.

- IRA Computer Models/Class Exemption DOL is determining whether computer models are feasible for IRAs. If DOL determines they are not feasible, then DOL is directed to issue a class exemption that could provide more favorable relief to IRAs.

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