GROOM LAW GROUP

March 2, 2010

MEMORANDUM TO CLIENTS

RE: DOL Releases New Proposed Investment Advice Regulation

The Department of Labor ("DOL") has released a new proposed investment advice regulation that we expect will be published in the *Federal Register* on March 2, 2010 (the "Proposed Regulation"). **Comments on the Proposed Regulation are due no later than May 5, 2010.** The Proposed Regulation implements the statutory exemption for the provision of investment advice to participants in participant-directed individual account plans that was enacted as part of the Pension Protection Act of 2006 (the "PPA"). Under the statutory exemption, the investment advice must be provided by a "fiduciary adviser" under an "eligible investment advice arrangement," which may be structured in one of two ways: (1) a "level fees" approach, where the fiduciary adviser's fees do not vary depending on the investment option selected, or (2) pursuant to a "computer model" that is periodically certified by an "eligible investment expert."

The Proposed Regulation was issued in place of a prior set of regulations (published in the *Federal Register* on January 21, 2009, but never effective) which also included a class exemption. According to the DOL, the Proposed Regulation is intended to address public comments which "question the adequacy of the final class exemption's conditions to mitigate the potential for investment adviser self-dealing." Needless to say, the political reality is that this re-proposal became inevitable with the change in administrations last year. Moreover, it will be interesting to see whether Reps. Miller and Andrews of the House Committee on Education and Labor decide to pursue a legislative solution notwithstanding DOL's proposal. Thus far, there has been no indication on whether they intend to move forward with H.R. 2989 other than a brief statement in which they called DOL's proposal "welcome news."

Below, we summarize the provisions of the Proposed Regulation representing key changes from the prior regulation.

Relief Narrowed — No Class Exemption

As we expected, the proposed regulation significantly narrows the scope of exemptive relief that was provided under the prior regulation and, in particular, the prohibited transaction class exemption that was issued with the prior regulation. Specifically, the Proposed Regulation does not include a class exemption, and therefore does not provide any relief for:

- individualized "off model" advice following investment recommendations generated from a computer model, or
- any advice arrangement which would level fees only with respect to the individual employee, agent, or registered representative providing investment advice and not at the fiduciary adviser entity level.

Fortunately, the Proposed Regulation expressly states that DOL's prior regulations, exemptions, interpretive and other guidance regarding the provision of investment advice are not affected.

Changes to Level Fees Approach

While the Proposed Regulation is similar to the prior regulation, DOL revised an important condition under the "level fees" approach, which appears to further restrict a fiduciary adviser's ability to receive compensation in connection with the advice provided to participants. The prior regulation tracked the statutory exemption by requiring that any fees received by the fiduciary adviser for investment advice or with respect to the sale, holding or acquisition of any security or other property for purposes of investment of plan assets would not vary depending on the basis of any investment option selected by a participant. The prior regulation also required that any fees or other compensation received by any employee, agent or registered representative providing investment advice on behalf of a fiduciary adviser would not vary depending on the basis of any investment option selected by a participant.

The Proposed Regulation replaces these conditions with a new provision that appears to be more restrictive. This new provision requires that "[n]o fiduciary adviser (including any employee, agent or registered representative) that provides investment advice receives from any party (including an affiliate of the fiduciary adviser), directly or indirectly, any fee or other compensation (including commissions, salary, bonuses, awards, promotions or other things of value) that is based in whole or in part on a participant's or beneficiary's selection of an investment option."

In the preamble to the Proposed Regulation, DOL justified this change in response to comments asserting that a fiduciary adviser's affiliates would potentially establish "economic incentives for either the fiduciary adviser, or individuals providing investment advice on its behalf, to recommend investments that pay varying fees to the affiliates." DOL also cited Field Assistance Bulletin 2007-1 (Feb. 2, 2007), in which DOL interpreted the level fees requirement to mean that the fees or other compensation received, directly or indirectly from an employer, affiliate or other party, by a fiduciary adviser may not be based, in whole or in part, on investments selected by participants. While the Proposed Regulation is more restrictive, it did not absolutely prohibit the payment of varying fees to affiliates of a fiduciary adviser as some had predicted.

Changes to Computer Model Approach

While DOL did not make significant changes from the prior regulation regarding the framework for the computer model approach, DOL did add a new condition requiring the computer model to be designed and operated to avoid investment recommendations that "[i]nappropriately 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." In the preamble to the Proposed Regulation, DOL explained that while differences in fees and investment style are likely to persist in the future, differences in historical performance are less likely to persist, and therefore less likely to constitute appropriate criteria for asset allocation. Arguably, this could require the most substantial change to the way in which allocation recommendations are made.

As odd as it may seem, if past investment performance is not considered an appropriate criterion, doesn't this suggest that such recommendations will be based, at least in large part, on fees and expenses? If this is the case, doesn't this suggest further that most, if not all, recommendations will include the least expensive funds regardless of performance?

In a similar vein, in the preamble to the Proposed Regulation DOL requested comments on certain aspects of the computer model approach. In particular, DOL asked a number of specific questions with regard to generally accepted investment theories and whether the Proposed Regulation should specify practices that are acceptable or unacceptable. DOL also requested comments on the kinds of historical data that should be taken into account by a computer model and the types of criteria that are appropriate and objective.

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Please call one of the following, or your regular Groom attorney contact, if you have any questions about this matter. **Additionally, we will be forming a group to comment on the proposed regulation. Please contact us if you would like information about the comment group.**

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