

Pension Protection Act: DOL Interprets Participant Investment Advice Rules

By Fred Reish and Bruce Ashton

In the Pension Protection Act of 2006 (PPA), Congress sought to encourage investment advice for participants in participant directed plans. It did so by adding a new prohibited transaction exemption under ERISA and the Internal Revenue Code. (We discussed the exemption in detail in our Bulletin, "The Pension Protection Act of 2006: Investment Advice Provisions," dated October 19, 2006 which is posted on our website at <http://www.reish.com/publications/pdf/penproct2006.pdf>.) The exemption is set out in new ERISA Section 408(b)(14); conditions to be met in order to qualify for the exemption are set out in Section 408(g). The Code contains essentially identical provisions in section 4975.

The new exemption raised many questions – perhaps more than it answered – and it was widely hoped that the Department of Labor (DOL) would issue guidance to provide clarification. On February 2, 2007, the Department of Labor (DOL) did just that, addressing a number of open issues in Field Assistance Bulletin (FAB) 2007-01. While the FAB is welcome and helpful in clarifying a number of points, it unfortunately leaves many questions unanswered and raises some new questions.

Before discussing what the FAB says, we will provide some background to the new exemption and then discuss areas where we believe further guidance is needed.

BACKGROUND

The PPA adds the concept of an "eligible investment advice arrangement." There are two types: (1) arrangements in which the compensation received by the adviser cannot be affected by the advice given (the "level fee" arrangement); and (2) arrangements in which the advice is based solely on a computer model, in which case the compensation for the adviser and affiliates may vary (the "variable fee" or "computer model" arrangement). In order to qualify for the exemption, a number of conditions must be satisfied, including notice to the participants, approval of the arrangement by the general plan fiduciaries and an annual audit of compliance with the requirements of Section

408(g). In addition, if the computer model exemption is being used, the model must be certified as unbiased.

If the advice arrangement (whether level fee or computer model) satisfies all of the conditions, the general plan fiduciaries are not treated as failing to meet the fiduciary requirements of ERISA by making investment advice available (which is an awkward way of saying that making advice available is not a breach of fiduciary duty) and are not responsible for the advice given, though they remain responsible for the prudent selection and monitoring of the adviser. (This provision is sometimes referred to as the fiduciary "safe harbor" that comes along with offering an "eligible investment advice arrangement.")

It is important to recognize, however, that DOL regulations under ERISA that pre-date the PPA already address the level fee advice arrangement. The regulation says that it would be a violation of the self-dealing prohibitions in ERISA Section 406(b) for a fiduciary to use the authority that makes it a fiduciary to affect the amount of its compensation or the compensation of "a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary." DOL Reg. §2550.408b-2(e)(1).

Thus, even prior to the enactment of the PPA, if the compensation for giving plan or participant-level investment advice received by a fiduciary investment adviser or persons in which it has an interest (which we refer to as "interested persons") was not affected by the advice given – i.e., was level and any payments from third parties were offset against its stated fee – there was no prohibited transaction. The DOL acknowledges as much in the FAB when it states that

"if the fees and compensation received by an affiliate of a fiduciary that provides investment advice do not vary or are offset against those receive by the fiduciary for the provision of investment advice,

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no prohibited transaction would result...and thus there would be no need for a prohibited transaction exemption.”

While the focus of this statement is on the compensation of affiliates and the DOL’s citations are to Advisory Opinions that address the concept of offsetting of fees, it appears the DOL is acknowledging that no prohibited transaction exists and the PPA exemption is not needed where the fees of a fiduciary adviser, all affiliates and all interested persons is level. (As discussed later in this Bulletin, the PPA exemption is thus somewhat broader than prior law in that the fees of affiliates and interested persons may not have to be level in order for the PPA level fee exemption to apply.)

WHAT THE FAB COVERS

The DOL seeks to answer three questions:

Question: Did enactment of the investment advice provisions of the PPA invalidate or otherwise affect prior guidance issued by the Department concerning investment advice?

Short Answer: No, prior guidance remains in effect.

Question: To what extent are the standards for selecting and monitoring a fiduciary adviser (as defined in the PPA) different from the standards applicable to plan fiduciaries who offer investment advice for which the new exemption is not required?

Short Answer: The same fiduciary duties and responsibilities apply to both situations, with some exceptions.

Question: Is an affiliate of a fiduciary adviser subject to the level fee requirement of the new exemption?

Short Answer: No, with a couple of exceptions: (1) in the case of a fiduciary adviser entity which is acting through an employee, agent or registered representative, both the individual and the entity are treated as the fiduciary adviser subject to the level fee requirement; and (2) where an affiliate is also providing investment advice to plan participants.

OPEN QUESTIONS

Question One: Impact on Prior Guidance

The DOL states that new sections 408(b)(14) and 408(g) “do not alter ERISA’s framework for determining fiduciary status or recast otherwise permissible forms of investment advice as prohibited for purposes of section 406.” The DOL further points out that the following remain unchanged: Interpretive Bulletin 96-1 that addresses investment education vs. investment advice; Advisory Opinions 97-15A (the Frost Opinion) and 2005-10A (the Country Trust Bank Opinion), dealing with the offsetting of amounts

received by a fiduciary investment adviser from third parties; and Advisory Opinion 2001-09A (the SunAmerica opinion), which dealt with the provision of investment advice using methodologies developed, maintained and overseen by an independent party.

In stating that the new sections do not alter ERISA’s existing framework, the DOL adds the following: “Except for providing that persons who develop or market computer models described in section 408(g)(3) or who market investment advice programs using such models are fiduciaries, and requiring advisers to expressly acknowledge their fiduciary status....” This exception is curious in that while the new sections add a host of requirements that must be satisfied in order for the exemption to be available, they do not change the definition of “fiduciary.” A person’s conduct dictates whether or not they will be considered a fiduciary, and that was true both before and after the PPA. What the new sections say is that what would have been a prohibited transaction prior to the enactment of the new law is no longer a prohibited transaction – so long as all the conditions of the exemption are met.

Question Two: Selection and Monitoring

The DOL states that

“the same fiduciary duties and responsibilities apply to the selection and monitoring of an investment adviser for participants and beneficiaries in a participant directed individual account plan, regardless of whether the program of investment advice services is one to which the statutory exemption applies.”

The FAB then addresses each of the “safe harbors” given to the general plan fiduciaries. The PPA says the fiduciaries do not breach their duty by offering investment advice. The DOL says this is consistent with prior law. The PPA says that fiduciaries are not relieved of the duty to prudently select and monitor the fiduciary adviser. The DOL states that the plan fiduciaries have always had to act prudently in selecting investment advisers for the participants. That requirement does not change just because an arrangement meets the conditions for “fiduciary advisers” and “eligible investment advice arrangements” under the new exemption.

Finally, the PPA says that the fiduciaries have no duty to monitor the advice given by the fiduciary adviser to individual participants. Again, the DOL says that so long as the general plan fiduciary prudently selects and monitors an investment advice provider, the fiduciary will not be liable for the advice furnished to the participants and has no duty to monitor the advice given. (This statement may reflect the practical view that the general plan fiduciary is not receiving and is likely not even aware of the specific

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advice being given to any individual participant.) However, the DOL does carve out an exception. It states in the FAB that if participants complain about the quality of the advice being given to them, then the fiduciary would be required to review the specific advice. In our view, this has always been a requirement; that is, if participants complain about the service they are receiving – from an investment adviser or other service provider – the general plan fiduciaries have a duty to look into the matter.

Conceptually, it is difficult to distinguish between monitoring the adviser and monitoring the advice. Would a fiduciary be fulfilling its obligations under ERISA if it fails to consider, in the course of monitoring the fiduciary adviser, the results of the advice that is being given? The effectiveness of the advice being given? The extent to which advice being given to a young participant vs. a participant nearing retirement age is appropriate for the stage of their careers? The extent to which advice is appropriate for the stated risk tolerance of a given participant? We would hope the DOL will clarify the distinction between monitoring the advice vs. monitoring the adviser in future guidance.

The FAB outlines various steps that the plan fiduciaries should take in selecting and monitoring an investment advice provider, including an analysis of the extent to which advice will be based on general accepted investment theories. The latter reference is significant in that the PPA provisions require that computer models use generally accepted investment theories, but nowhere else does the law specifically reference them. Thus, the DOL has effectively added this analysis (not inappropriately, in our view) to the selection and monitoring provision of the PPA. This is consistent with the position the DOL has taken in the past, and that has been accepted in a number of court cases, that investment fiduciaries must take into account generally accepted investment theories, such as modern portfolio theory and strategic asset allocation.

Also of interest is that, while the DOL states that the fiduciaries must avoid self-dealing and conflicts of interest in making their selection, it does not state that the fiduciaries should review issues of conflicts of interest the adviser might have in giving its advice. In theory, because of the requirement that a computer model be unbiased, the conflict of interest issue is not present in the computer model arrangement. However, in the level fee arrangement, such conflicts might arise in a variety of ways, such as, for example, where a provider, which is related to the fiduciary adviser, insists that some of their proprietary funds be included in the advice model. Possibly the DOL will determine either that the mutual fund management company is a fiduciary adviser in that case or has asserted enough control that the fiduciary adviser would not be considered independent.

The FAB also does not address the impact of the audit requirement under the exemption. As noted earlier, a

fiduciary adviser is required to conduct a compliance audit to plan sponsors on an annual basis and have the auditor deliver a written report of its findings to the plan sponsor. The scope of the audit and contents of the report are unclear from the statute, and it would have been helpful for the DOL to have addressed this requirement in some detail. Unfortunately, the FAB does not do so (with one exception noted under the discussion of Question Three). Further, in the discussion of monitoring, it would have been helpful for the DOL to have indicated the extent to which a fiduciary could rely on the written report from the auditor in fulfilling its monitoring requirement, at least in the absence of participant complaints. Again, this is not addressed in the FAB. Presumably, that will be covered by regulations issued by DOL.

Question Three: The Level Fee Requirement

One of the major areas of controversy surrounding the new exemption has been the meaning of the level fee requirement. While the fees of advisers and affiliates may vary if the computer model arrangement is used, the PPA requires that, in the non-computer model context (that is, the level fee context) the adviser's compensation must be the same regardless of the advice given. The question, however, is who is the fiduciary adviser. More specifically, does the level fee requirement extend to affiliates of the adviser, such as a mutual fund family or insurance company, and, if so, to what extent?

The DOL states in the FAB that

“it is clear...that only the fees or other compensation of the fiduciary adviser may not vary [and] in contrast to other provisions ..., [the section] references only the fiduciary adviser, not the fiduciary adviser or any affiliate.”

The DOL then goes on to point out that a person can only be a fiduciary adviser if the person is a fiduciary of the plan by reason of providing investment advice. Therefore, an affiliate of an RIA, bank, insurance company or other financial institution would be subject to the level fee requirement “only if that affiliate is providing investment advice to plan participants and beneficiaries.”

This statement begs the question in our view. The real question is, who is actually providing the advice? What if the adviser is told explicitly by an affiliate what advice he must give or what software to use? What about the situation where a fund company requires that its proprietary funds be included in the asset allocation? Presumably, the DOL's response would be that the question of who is actually providing the advice is a facts and circumstances question, and the statements in the FAB do not preclude this analysis. We would hope that in final regulations or other guidance, the DOL will address the situation in which an entity

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exercises actual, affirmative control over the advice being given and clarify that the entity's compensation must meet the level fee requirement.

The FAB does acknowledge that in the level fee context, when an individual acts as an employee, agent or registered representative on behalf of an entity that is engaged to provide advice, the individual and the entity must be treated as the adviser, and both are subject to the level fee requirement. Thus, for example, if a brokerage or investment advisory firm is engaged to provide the advice, both the entity and the employee, agent or representative who actually interacts with the participants would be considered fiduciary advisers. This means that the compensation of both the individual and the firm itself must meet the level fee requirement. (However, the determination of level fees would not include the revenues of other related entities.) In part, this addresses the issue raised in the prior paragraph, though there may be a number of other situations falling outside the employer-employee arrangement in which the influence of an affiliated entity is sufficiently significant that it should be viewed as the adviser.

Finally, the DOL notes that it is up to the party claiming an exemption to demonstrate that the exemption is available. It admonishes investment advice providers to establish policies and procedures designed to ensure that the level fee requirement is met. It further states that it anticipates that these policies and procedures will be reviewed as a part of the annual compliance audit by the independent auditor required by the PPA.

FINAL OBSERVATIONS

With the enactment of the PPA, we now have three types of fiduciary investment advisers at the participant level, one that does not rely on the new exemption and two that do:

1. A level-fee fiduciary adviser that does not seek to rely on the new exemption – though the compensation of the adviser and any affiliates (and “interested persons”) must be level in order to avoid a prohibited transaction. (We refer to this as a non-PPA level fee arrangement.)
2. A level-fee fiduciary adviser that does seek to comply with the new exemption – given the interpretation in the FAB, the definition of “level” compensation is more favorable than under prior guidance because the FAB makes clear that only the person or entity

engaged to provide the advice is considered the fiduciary adviser whose compensation must meet the level fee requirement. (The exception to this is in the context of a firm being engaged to provide advice that is delivered by an employee, agent or registered representative. In that case, both the firm and the individual are considered fiduciary advisers and are subject to the level fee requirement.)

3. A variable fee adviser that will use a computer model complying with the requirements of the exemption to provide advice – this is now permitted if the conditions of the exemption are satisfied but was in all events prohibited under the pre-PPA law.

Keep in mind that the new exemption only applies to participant level advice and that only the first category applies in the case of plan level advice.

Consider the non-PPA level fee arrangement, where the compensation received by the adviser and all other interested persons does not vary depending on the advice given. This would preclude, for example, an affiliated broker-dealer from receiving bonus payments for production or persistency. But if a non-PPA level fee arrangement does exist, there is little reason for the adviser to go to the effort of complying with the numerous requirements of the new exemption. That said, there may be a competitive advantage to being able to tell plan sponsors that the adviser is “PPA compliant.” And, of course, compliance with the new requirements will be essential if the compensation of the adviser and interested persons is not completely level.

In terms of plan sponsor obligations, the FAB is helpful in making it clear that the monitoring duties of the fiduciaries are essentially identical regardless of which of the three approaches is used. Indeed, in the PPA compliant cases, the annual audit and report may assist the fiduciaries in meeting their audit responsibilities. That said, the fiduciaries do have the added responsibility of ensuring that the requirements for the exemption are met as a part of the monitoring of an “eligible investment advice arrangement.”

Overall, [FAB 2007-01](#) provides useful guidance in an area that is complex and sometimes confusing. We applaud the DOL for issuing this clarification on such a timely basis.

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