

Investment Advice for Participants: Prohibited Transactions and Level Fee Advice

By Fred Reish, Bruce Ashton and Jason Roberts

This is the second in a series of bulletins regarding the Department of Labor's (DOL) regulation on investment advice for participants. The first bulletin was published last week and provided an overview of the regulation. (A copy can be found on our website at <http://www.reish.com/publications/pdf/investadvfinaldol.pdf>.) This bulletin looks at the application of the regulation to "pure" level fee investment advisers.

The preamble to the DOL final regulation for investment advice for participants (the so-called "Fiduciary Adviser Rule") contains a number of interesting—and, in some cases, unexpected—statements. Those statements are valuable in understanding the DOL's thinking about critical issues for advisers to 401(k) plans.

Background

The Pension Protection Act of 2006 (PPA) created a statutory exemption from the prohibited transaction rules for fiduciary investment advice to participants. The scope and effect of that regulation on advisers—and particularly on registered investment advisers (RIAs)—is not fully understood in the 401(k) community.

The PPA added two sections to ERISA to expand the availability of investment advice for participants. Those are sections 408(b)(14) and 408(g). Among other things, those sections create an exemption from the general prohibited transaction rule that says a fiduciary cannot use its authority or control to affect its own compensation. For example, they create an exemption for mutual fund complexes and broker-dealers to offer advice where the advice could result in a participant's money being invested in affiliated mutual funds (thereby resulting in increased investment management fees) or in mutual funds that pay higher compensation to the broker-dealer.

The statute and the regulation create two types of exemptions: the first is called the computer model exemption and the second is inappropriately called the level fee exemption. (We say "inappropriately" because it applies only to situations where the fiduciary adviser's fees are level, but not to situations where the compensation of affiliates—or under the class exemption in the regulation, of supervisors—is level. In other words, it is an exemption for a "limited" level fee. This "limited" level fee

structure was first explained by the DOL in Field Assistance Bulletin (FAB) 2007-1 and is retained in the Fiduciary Adviser Rule.)

So, how do these new rules apply to registered investment advisers?

Unfortunately, there is confusion about that question in the 401(k) market place. However, from a legal perspective the answer is fairly clear—at least for "pure" level fee advisers. Since 408(b)(14) and 408(g) are exceptions to the prohibited transaction rules, it should be clear that, if investment advice to a participant would otherwise be a prohibited transaction, then an adviser needs to meet the conditions of the exemption. However, it should also be equally clear that, if the advice would not and could not result in a prohibited transaction, the exemption is not needed. In other words, you don't need to rely on an exception to a rule if you don't violate the rule.

What does that mean in practical terms?

Many RIAs, particularly those that are truly independent (with no broker-dealer or investment company affiliation), operate in a "pure" level fee environment (as opposed to a "limited" level fee environment). In other words, regardless of the advice given, the only compensation received by the adviser (or by any affiliate or other person in whom the adviser has an interest) is the fee that is being charged for the advice. (Under ERISA, the definition of compensation is broad . . . it includes money or

Pre-Conference Session at 401(k) Summit

Fred Reish, Bruce Ashton and Jason Roberts will present a pre-conference session, entitled "Disclosure Obligations in Times of Uncertainty," at the upcoming 401(k) Summit. The session will be aimed at financial services professionals and will address current legal requirements—the fiduciary rules, proposed 408(b)(2) regulation, the recently introduced Defined Contribution Fee Disclosure Act and any other major proposals between now and then—plus strategies for managing risk and "best practices." The session will be held at 8:00am on Sunday, March 22, in the Madeleine room, sections C and D. It is open to all registrants at the Summit.

any other thing of value.) Where that fee is level, like a percent of assets or a set dollar amount, there is not and cannot be a prohibited transaction. Therefore, a pure level fee RIA firm does not need the benefit of the new exemptions and, consequently, does not need to comply with the requirements in the regulation—for example, the annual audit of the investment advice and certification of the computer model by an independent expert, and so on. Obviously, that should substantially reduce the cost and complexity of the pure level fee investment advice program.

Preamble Statement

With that background, what does the DOL say in the preamble to the final regulation?

First, because of some concern in the 401(k) community that people might construe the regulation as applying even to “pure” level fee advice, the Department explains that:

“In response to the concerns of some commenters that the conditions of the final rule might be construed as being applicable to all investment advice arrangements, without regard to whether the provision of advice pursuant to such arrangements involves prohibited transactions, paragraph (a)(1) makes clear that the requirements and conditions of the final rule apply solely for the relief described in the final rule and, accordingly, that no inferences should be drawn with respect to the requirements applicable to the provision of investment advice not addressed by the rule.”

So, the DOL is telling us that, where the provision of advice does not constitute a prohibited transaction, the regulation should not be interpreted as applying to those advice providers.

Later in the preamble, the DOL gives additional guidance:

“The Department further explained that, consistent with earlier guidance in this area, if the fees and compensation received by an affiliate of a fiduciary that provides investment advice do not vary or are offset against those received by the fiduciary for the provision of investment advice, no prohibited transaction would result solely by reason of providing investment advice and thus there would be no need for a prohibited transaction exemption, such as provided under sections 408(b)(14) and 408(g).”

*See AO 97–15A and AO 2005–10A.”

In that explanation, the DOL is pointing out that, where the fiduciary adviser is a pure level fee adviser, no prohibited transaction would

result from the investment advice and, therefore, there would be no need for a prohibited transaction exemption, including the 408(b)(14) and 408(g) exemption. In other words, pure level fee investment advice can be given to participants without the burden of satisfying the requirements in the regulation.

Where an affiliate of the adviser (or other person in whom the adviser has an interest) receives additional compensation because of fiduciary advice to a participant, the advice is not “purely” level and, as a result, the PPA prohibited transaction exemption is needed. The relief—and the conditions of the relief—were discussed in detail in our last bulletin.

Conclusion

The DOL has done a service to the benefits community by explaining these differences. While the structure of the statute, and the application of the exemptions, should have been clear to ERISA attorneys, that type of technical analysis shouldn’t have been required for non-lawyers, like plan sponsors and advisers. As a reminder, “pure” level fee advice is that in which the adviser (including its affiliates or any other persons in whom the adviser may have an interest) cannot receive anything more than its stated fee or where, if the adviser – or an affiliate or person of interest – can receive income as a result of the advice, it is offset against a stated fee, such that the adviser can receive no more than the stated fee. In the preamble, the DOL has clarified that the fiduciary adviser exemption is needed only for advice that would otherwise be a prohibited transaction.

Keep in mind that even though the regulation limits the prohibited transaction exemption to the provision of non-discretionary advice to participants (and thus does not extend to discretionary investment management of participant accounts), the pure level fee arrangement also applies to investment management. So, if a fiduciary adviser offers discretionary investment management for participants, the pure level fee arrangement would also be permitted (that is, it would not be a prohibited transaction).

One final note: based on our experience, it appears that the DOL has markedly increased its examination and enforcement activity directed at broker-dealers and registered investment advisors. Moreover, some clients have recently reported being the subject of DOL/SEC joint or concurrent examinations. We believe that supervision will be a key area of concern in these examinations; therefore, we are working with clients to identify potential areas of exposure and recommending actions to mitigate or eliminate activities that may give rise to regulatory enforcement, especially in the area of investment advice to participants.

Any tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

©2009 Reish Luftman Reicher & Cohen, A Professional Corporation. All rights reserved. This bulletin is published as a general informational source. Articles are general in nature and are not intended to constitute legal advice in any particular matter. Transmission of this report does not create an attorney-client relationship. Reish Luftman Reicher & Cohen does not warrant and is not responsible for errors or omissions in the content of this report.