K&LNG Alert

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Investment Management/ERISA Fiduciary

Advice . . . at a Price: Investment Advice and Related Defined Contribution Plan Fiduciary Provisions of the Pension Protection Act

The Pension Protection Act of 2006 (the "Act"), which the President is expected to sign shortly, provides clear guidance about the circumstances in which a bank, broker-dealer, investment advisor or insurance company may give fiduciary investment advice to plan participants, particularly in cases in which the fiduciary advisor receives indirect compensation that may vary depending on the nature of the advice.

The guidance comes at a considerable price, however. Somewhat surprisingly, the investment advice provisions were among the most controversial provisions of a bill that generated more than its share of controversy. The end result is an unusually detailed and specific set of rules, layering protective condition on protective condition. Moreover, Congress has essentially punted on investment advice to individual retirement accounts ("IRAs"), establishing an ambitious procedure requiring the Department of Labor to determine the conditions under which advice to IRAs will be permitted.

This Alert is intended to provide a roadmap through the investment advice provisions and some preliminary observations about their practical effect. Conclusions and interpretations will continue to evolve as the industry gains experience with these provisions.

We also discuss related changes that will make it easier for plan sponsors to provide for investment advice and to provide for "automatic" enrollment in Section 401(k) plans. These provisions establish conditions for the availability of the relief from fiduciary duty provided under section 404(c) of the Employee Retirement Income Security Act ("ERISA") in cases where participant account balances are "mapped" over to new investment options and where the accounts of participants who have failed to make affirmative investment elections are invested in a "default" option. In addition, the legislation makes it clear that state laws that might inhibit automatic enrollment in section 401(k) plans are preempted with respect to automatic enrollment arrangements that meet certain requirements.

PROHIBITED TRANSACTION EXEMPTION FOR INVESTMENT ADVICE

New section 408(b)(14) of ERISA provides relief for "any transaction in connection with the provision of investment advice" to a participant or beneficiary of a participant-directed individual account (defined contribution) plan. The exemption covers the advice itself, the acquisition, holding or sale of a security or other property pursuant to the advice, and the direct or indirect receipt of fees or other compensation by the fiduciary or an affiliate (including employees, agents and registered representatives) in connection with the advice.

The new exemption is available only with respect to advice provided pursuant to an "eligible investment advice arrangement," a term that encompasses considerable component conditions. First, an eligible investment advice arrangement must be a *nondiscretionary* investment advisory arrangement under which either—

- the direct and indirect compensation received by the fiduciary advisor does not vary depending on the nature of the advice; *or*

- provides for advice based exclusively on a computer model that meets certain specified requirements discussed below.

As a practical matter, only the second element adds in a meaningful way to what is permitted by the law prior to the Act.[1]

PERMITTED ADVISORS[2]

The new exemption for investment advice is available only to—

- An investment advisor registered under the Investment Advisers Act of 1940 or under the laws of the state in which it has its principal place of business;
- A bank or similar financial institution (including a savings association), but only if the advice is provided through a trust department that is subject to periodic examination and review by federal or state banking authorities;
- An insurance company qualified to do business under the laws of any state;
- A U.S. registered broker-dealer;
- An affiliate of any of the foregoing; and
- An employee, agent or registered representative of any of the foregoing who satisfies the requirements of applicable insurance, banking, and securities laws relating to the provision of the advice.

GENERAL REQUIREMENTS FOR COMPUTER MODELS

The computer model used to provide advice must meet several requirements:

- The model must apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
- The model must take into account relevant information about the participant, which may include the participant's age, life expectancy, anticipated retirement age, risk tolerance, other assets or sources of income and preferences as to certain types of investments;
- The model must use prescribed objective criteria to provide advice to participants about allocating their individual account assets among the investment options available under the plan;
- The model must operate in a manner that is not biased in favor of investments offered by the fiduciary advisor or by a person with a material affiliation or contractual relationship with the fiduciary advisor; and
- The advice must take into account all investment options available under the plan and may not be "inappropriately weighted" with respect to any investment option.

CERTIFICATION REQUIREMENT

An "eligible investment expert" must certify that the computer model meets the requirements outlined above prior to the first use of the model in reliance on the exemption and at the time of each material modification of the model. The eligible investment expert may not have any material affiliation or contractual relationship with the fiduciary advisor, any person "related" to the fiduciary advisor, or any employee, agent or registered representative of the fiduciary advisor or such "related" person. The Secretary of Labor is also authorized to adopt regulations establishing additional qualification requirements for an eligible investment expert.

In addition, an independent auditor who has appropriate technical training or experience and proficiency, and so represents in writing, must conduct an annual audit of the arrangement for compliance with the requirements outlined above. The independent auditor must issue a written report to each fiduciary who has authorized a plan's participation in the arrangement presenting the auditor's specific findings.

It is not clear from the legislative language whether the independent auditor must be an independent professional accountant. Such a requirement might be inferred, however, from the different terminology used in the Act—"eligible investment expert," in the case of the certifications required prior to first use of the program and any material modification, and "independent auditor," in the case of the required annual audit.

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[1] Generally, where the compensation received by a fiduciary advisor does not vary depending on the nature of the advice provided, it is usually relatively easy to avoid prohibited transactions. Consequently, this Alert will focus most closely on the requirements relating to computer-generated advice where the advice may vary depending on the nature of the advice provided.

[2] The new legislation adds fuel to the "adviser/advisor" debate. For purposes of convenience, we will use "advisor," the spelling that has generally been used under ERISA.

AUTHORIZATION AND DISCLOSURE REQUIREMENTS

The new investment advice exemption also requires that an independent plan fiduciary expressly authorize a plan's participation in the eligible investment advice arrangement.[3] In addition, the new exemption requires that specified matters be disclosed to each plan participant receiving advice prior to the initial provision of the investment advice.

Required disclosures include—

- The role of any party that has a material affiliation or contractual relationship with the financial advisor in the development of the investment advice program and in the selection of investment options available under the plan;
- The past performance and historical rates of return of the investment options available under the plan;
- All fees or other compensation relating to the advice (including payments by third parties) that the fiduciary advisor or any affiliate will receive in connection with the provision of the advice or in connection with the sale, acquisition, or holding of any security or other property pursuant to the advice;
- Any material affiliation or contractual relationship of the fiduciary advisor or its affiliates in any security or other property;[4]
- The manner, and under what circumstances, any participant or beneficiary information provided under the arrangement will be used or disclosed;
- The types of services provided by the fiduciary advisor in connection with the provision of investment advice;
- That the advisor is acting as a fiduciary of the plan in connection with the provision of advice; and
- That the participant may separately arrange for the provision of advice by another advisor that has no material affiliation with, and receives no fees or other compensation in connection with, the security or other property.
- The disclosure must be clear and conspicuous and calculated to be understood by the average plan participant. The Act directs the Secretary of Labor to issue a model form of notice that meets these requirements. The fiduciary advisor must also ensure that such disclosure materials are accurate and must provide the disclosures to the recipient of the advice, without charge, no less frequently than annually and at the participant's request. Disclosure of any material change to the information required to be disclosed must also be provided, without charge, at a time "reasonably contemporaneous" with the change.

In view of the specificity and breadth of these disclosure requirements, it is doubtful that existing disclosure (for example, in Form ADV under the Investment Advisers Act of 1940) will be sufficient.

STILL MORE REQUIREMENTS

The new exemption is also subject to other substantive conditions. These include—

- The fiduciary advisor must provide appropriate disclosure in connection with the sale, acquisition, or holding of the security or other property, in accordance with all applicable securities laws;
- As noted above, any sale, acquisition or holding must occur solely at the direction of the recipient of the advice;
- The compensation received by the fiduciary advisor and its affiliates in connection with the sale, acquisition or holding of the security or other property must be reasonable; and
- The terms of the sale, acquisition or holding of the security or other property must be at least as favorable to the plan as an arm's-length transaction would be.

RECORDKEEPING REQUIREMENT

A fiduciary advisor relying on the exemption must maintain, for six years, the records necessary for determining whether the requirements of the new exemption have been met. As in the case of a number of existing prohibited transaction exemptions, the Act provides that a prohibited

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[3] The Department of Labor has historically construed similar language in prohibited transaction class exemptions as requiring *affirmative* authorization by an independent plan fiduciary, although the text of the new statutory exemption does not explicitly state that affirmative authorization is required.

[4] In several places, the new exemption refers simply to "security or other property"; presumably that is intended to refer to securities or other property acquired pursuant to the advice.

transaction will not be deemed to have occurred solely because such records are lost or destroyed due to circumstances beyond the control of the fiduciary advisor.

THE STRANGE, STRANGE STORY OF ADVICE TO IRAS

The contentious character of the debate about investment advice is most clearly demonstrated by the Act's treatment of advice to IRAs. Most IRAs, of course, are not subject to ERISA, but transactions involving IRAs are subject to the prohibited transaction excise tax provisions of the Internal Revenue Code. Thus, a financial institution risks engaging in the same types of prohibited transactions in providing fiduciary investment advice about IRA investments as it does in providing advice to participants in ERISA-covered plans.

Historically, the Department of Labor has imposed fewer requirements with respect to IRAs in its class exemptions.[5] Nonetheless, Congress apparently determined that the risks of "conflicted" advice are at least as substantial for IRAs as those faced by ERISA plans and that the "computer model" solution reflected in the new exemption might not work for IRAs.

In order to address these concerns, the portion of the new exemption relating to advice provided pursuant to independently certified computer models *is not available* for transactions involving IRAs.[6] Instead, Congress has established a byzantine procedure under which the Department of Labor is to determine the circumstances under which fiduciary advice may be provided with respect to IRA assets. Briefly, these procedures require—

- *First*, the Secretary of Labor, in consultation with the Secretary of the Treasury, must solicit information as to the feasibility of computer model advice programs for IRAs from at least the top 50 "trustees" of such plans and from other persons offering computer model investment advice programs based on nonproprietary programs. Financial institutions that do not respond to any such request within 60 days may not, except in cases where there is reasonable cause and not willful neglect, rely on any class exemption issued by the Department of Labor (discussed below) in establishing conditions in lieu of the use of computer models.
- *Second,* the Secretary of Labor must determine, not later than December 31, 2007, whether there is any computer model investment advice program that may be used to provide investment advice to IRAs which—
  - — Uses relevant information about the account beneficiary, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments;
  - — Takes into account the full range of investments, including equities and bonds, in determining the options for the investment portfolio of the account beneficiary;
  - — Allows the account beneficiary, in directing the investment of assets, sufficient flexibility in obtaining advice to evaluate and select investment options.

  The Secretary of Labor is required to notify the Congressional committees with ERISA jurisdiction of this determination.
- *Third*, if the Secretary of Labor determines that there is no computer model advice program suitable for IRAs, the Secretary of Labor must issue a class exemption for investment advice involving IRAs subject to conditions that—
  - — Are in the interests of the IRA and its account beneficiary and protective of the rights of the account beneficiary;
  - — Conform to the requirements of the new statutory exemption relating to investment advice, other than those relating specifically to computer models; and

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[5] Most notably, PTE 86-128, which permits a broker to manage plan assets on a discretionary basis or to provide fiduciary investment advice with respect to such assets, even though the broker receives commissions with respect to the plan's purchases and sales of securities,-imposes extensive conditions with respect to transactions involving ERISA covered plans, but provides unconditional relief with respect to transactions involving IRAs.

[6] Technically, the new exemption does provide relief for the provision of fiduciary investment advice to IRAs in cases where the direct or indirect compensation received by the fiduciary advisor and its affiliates does not vary based on the nature of the advice, but, as discussed above, that provision adds little, if any, relief to that available under pre-Act law.

- Ensure that the investment advice provided under the exemption uses prescribed objective criteria to provide asset allocation portfolios comprised of securities and other property available as investments under the plan.

At any time after the initial determination, the Act permits the Secretary of Labor—on his or her own motion or at the request of any person—to determine that a satisfactory computer model exists. If the Secretary makes this determination, then any class exemption issued pursuant to the direction included in the legislation will not be available after the later of two years from the date of such determination or three years from the date of issuance of the exemption.

RELIEF FOR PLAN SPONSORS

The Act also includes limited relief from fiduciary liability for plan sponsors who enter into an eligible investment advice arrangement on behalf of their plan if: (i) the terms of the eligible investment advice arrangement require compliance by the fiduciary advisor with the requirements of the new exemption, and (ii) under the terms of the arrangement, the fiduciary advisor acknowledges that it is acting as a plan fiduciary.

Where these requirements are met, the plan sponsor is not treated as having failed to meet any of the fiduciary responsibility requirements of ERISA solely by reason of the provision of advice pursuant to the arrangement. This relief apparently includes relief from the potential imposition of attributed liability under the ERISA "co-fiduciary" liability provisions.

Notwithstanding this provision, the Act makes it clear that plan sponsors and other authorizing fiduciaries continue to have fiduciary responsibility for the prudent selection and periodic review of the fiduciary advisor. These responsibilities do not require plan sponsors to monitor the specific investment advice given to plan participants by the fiduciary advisor.

AUTOMATIC ENROLLMENT AND AUTOMATIC CONTRIBUTIONS

The Act also includes important provisions relating to the relief from fiduciary responsibility provided by participant directed plans under Section 404(c) of ERISA and facilitating automatic enrollment in those plans. These include—

- **Clarification of Continued Availability of Relief During Blackout Periods**. Although the Act contains a provision making it explicit that the relief from liability provided by section 404(c) generally is not available during blackout periods, it also establishes standards under which section 404(c) relief is available during blackout periods. In order for such relief to continue during a blackout period—
  - The account of each participant or beneficiary must be reallocated among one or more remaining or new investment options offered in lieu of one or more investment options offered immediately prior to the effective date of the change;
  - The stated characteristics of the remaining or new investment options, including characteristics relating to risk and rate of return, must be reasonably similar to those of the existing investment options;
  - At least 30 days, and no more than 60 days, prior to the change, the plan administrator must furnish written notice of the change to participants and beneficiaries, including information comparing the existing and new investment options, together with an explanation that, in the absence of affirmative investment instructions to the contrary, the participant's account will be invested in the new or remaining investment options;
  - The participant or beneficiary has not provided affirmative contrary investment instructions prior to the effective date of the change; and
  - The participant or beneficiary has exercised control over the selection of those investments held in his or her individual plan account immediately prior to the effective date of the change.

—These new standards are effective for plan years beginning after December 31, 2007 (subject to special delayed effective date for collectively bargained plans).

- **Default Investments**

  The Act directs the Secretary of Labor to issue final regulations extending section 404(c) relief to "default" investments, within six months from the date of enactment. These regulations will be effective for plan years beginning after December 31, 2006. The Act also provides that section 404(c) relief for default investments will only be available if plan participants receive an annual notice explaining the participant's right under the plan to designate how contributions and earnings will be invested and explain how, in the absence of an affirmative election, such contributions and earnings will be invested, and each participant has a reasonable period of time after receipt of the notice and before the beginning of the plan year to make an alternative designation.

- **Preemption of State Laws Precluding Automatic Contributions**

  The Act also includes a provision expressly extending ERISA's broad preemption provisions to state laws—generally those that prohibit employers from withholding from employee wages without the employee's affirmative consent—that would inhibit automatic enrollment in, and automatic contributions to, defined contribution plans.[7] This new preemption provision applies to "automatic contribution arrangements," which must have the following features—

- Under the arrangement, the participant may elect to have the plan sponsor make payments as contributions to the plan or to receive such payments in cash;

- Under the arrangement, a participant is treated as having elected to have the plan sponsor make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects a different percentage contribution);

- The participant's automatic contributions are invested in accordance with the Secretary of Labor's regulations relating to default investments discussed above; and

- Notice relating to automatic contributions is provided to participants in substantially the same manner as the required notices relating to automatic investments, described above.

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Please contact any member of the ERISA Fiduciary group listed on the next page if you have further questions or if you would like copies of the pertinent provisions of the Act.

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[7] Many of these laws include criminal penalties and therefore may not be preempted under current law which saves criminal laws of general application from the existing broad preemption provisions of ERISA. See ERISA § 514(b)(6).

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