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Investment Management/ ERISA Fiduciary Alert

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DOL Proposes Revamped Rule on Investment Advice

The U.S. Department of Labor ("DOL") has issued a new proposed regulation (the "Proposal") in the most recent installment of its ongoing efforts to implement the statutory exemption for participant advice added to ERISA and the Internal Revenue Code as part of the Pension Protection Act of 2006 ("PPA"). The Proposal, which deals solely with advice to plan participants (as opposed to plan sponsors), would replace the final regulation and related class exemption regarding participant advice that was issued in January 2009. Notably, the Proposal would cut back significantly on what would have been permitted under that regulation and class exemption, particularly as it would have applied to advice to IRAs.

The Proposal is subject to public comment, and the comment period ends May 5, 2010. Although DOL may make changes to the Proposal in the final rule, we believe that DOL is committed to addressing the issue of "conflicted" investment advice, likely to issue the final rule quickly, and likely to include much of the substance of the Proposal in the final rule.

Although the Proposal would not affect other DOL interpretations, regulations or exemptions relating to investment advice, if adopted as proposed, in practice it could significantly alter the way advice is provided to plan participants and IRAs.

Overview of Proposal

In accordance with the statutory exemption, the Proposal would allow investment advice to be given pursuant to an "eligible investment advice arrangement." Under the Proposal, such an arrangement must provide for either:

- <u>level compensation</u>, which means that any direct or indirect compensation received by the fiduciary adviser may not vary depending on the participant's selection of a particular investment option; or
- a <u>computer model</u>, which must be certified as unbiased by an independent party.

Fee-Leveling

Under the Proposal, a fee-leveling arrangement will qualify as an eligible investment advice arrangement only if the fiduciary adviser and its employees, agents, or registered representatives do not receive direct or indirect compensation (including payments or benefits from affiliates) based in any way on a participant's selection of a recommended investment. This requirement does not reverse DOL's position in Field Assistance Bulletin 2007-01, to the effect that the fee-leveling requirement may be satisfied even if an affiliate of the fiduciary adviser receives variable compensation. In the preamble to the Proposal, however, DOL purports to "clarify" the FAB by expressly prohibiting any sharing of compensation received by an affiliate with the fiduciary adviser.

A fee-leveling arrangement must also (1) be based on generally accepted investment theories, (2) take into account investment management and other fees and expenses relating to the recommended investments, and (3) take into account any pertinent or personal information (such as age, time horizons, risk tolerance, and other assets) provided by the plan or the participant.

As a practical matter, the fee-leveling arrangements described in the Proposal do not appear to add in any meaningful way to what is already permitted under prior DOL interpretations.

Computer Models

Under the Proposal, a computer model will qualify as an eligible investment advice arrangement only if the model:

- applies generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time;
- takes into account investment management and other fees and expenses with respect to the recommended investments;
- takes into account any pertinent or personal information (such as age, time horizons, risk tolerance, and other assets) provided by the plan or the participant;
- uses appropriate objective criteria to provide asset allocation portfolios made up of investment options available under the plan;
- does not inappropriately favor proprietary investments of the fiduciary adviser or any person with a material affiliation (in general, a 5 percent or greater ownership interest) or material contractual relationship (contractual relationships exceeding 10 percent of gross revenue) with the fiduciary adviser;
- does not inappropriately 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;
- takes into account all investment options available under the plan, except the model is not required to make recommendations regarding (1) investments primarily in employer securities, (2) target date or balanced funds, or (3) annuities; provided that, with respect to target date or balanced funds and annuities, the participant is also given a general description of such funds or annuities and how they operate; and
- does not give inappropriate weight to any investment option.

In addition, the computer model must be certified, in writing, by an "eligible investment expert" prior to the provision of any advice pursuant to the exemption. This certification must identify and explain the methodologies used in the computer model and describe any limitations imposed on such methodologies. The "eligible investment expert" must be a person with appropriate technical training or experience and proficiency, and must so represent in writing. No person with any material affiliation or material contractual relationship with the fiduciary adviser can serve as an eligible investment expert.

As stated above, the computer model may not "inappropriately 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 Proposal, DOL indicates that this limitation is intended, among other things, to prohibit the use of "differences in historical performance" in a computer model. Although DOL specifically invites comments on this point, this aspect of the Proposal, if adopted, could severely disadvantage actively managed funds. On the other hand, DOL may have something more limited in mind. This issue is likely to be the subject of spirited comment and discussion.

General Requirements Applicable to Both Fee-Leveling and Computer Models

Both types of arrangements must:

- be authorized by an independent plan fiduciary or IRA beneficiary;
- be subject to an annual audit by an independent auditor; and

- provide required disclosures. The appendix to the Proposal contains a model disclosure form.

In addition:

- any actual investment transaction must occur only at the direction of the advice recipient;
- the fiduciary adviser may receive only reasonable compensation; and
- the terms of the investment transaction must be at least as favorable to the plan as an arm's-length transaction.

Withdrawal of Class Exemption

As noted above, the investment advice regulation issued by DOL in 2009 included a class exemption that extended the relief for investment advice to circumstances beyond those described in the statutory exemption. This class exemption would have made it significantly easier to provide investment advice, particularly relating to IRA assets. Under the class exemption, IRA owners would have been permitted to receive individualized advice from a fiduciary adviser receiving variable compensation if the IRA owner requested the advice after receiving a computer model or specified investment educational material. The Proposal does not include any of the relief that would have been provided by the class exemption.

Continued Reliance on Prior DOL Guidance

It is encouraging that the Proposal specifically states that none of DOL's prior regulations, exemptions, or other guidance on the provision of investment advice is affected by the Proposal. Therefore, programs that comply with prior guidance, such as the SunAmerica advisory opinion (AO 2001-09A), should continue to be compliant with ERISA.

However, only eligible investment advice arrangements that meet the requirements of the Proposal would provide plan sponsors and other fiduciaries with the relief from fiduciary liability accorded by section 408(g)(10) of ERISA, which was enacted as part of the PPA. It is too early to tell whether plan sponsors will insist that investment advice programs comply with the new regulations as a condition to implementing participant advice programs or whether relying on prior guidance will be sufficient. Also, we believe that DOL is likely to view advisory programs that meet the requirements of the Proposal as the "gold standard" in this area.

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