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DOL's Advice on Advice and Investment Professionals: Take Two

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Introduction

On Feb. 26, 2010, the Department of Labor issued a new set of proposed regulations (the "New Proposed Regulations"), which banks, broker-dealers, mutual fund complexes and other financial institutions that deal directly or indirectly with participant directed retirement plans, such as 401(k) plans and individual retirement accounts (collectively, "participant directed plans") should find of interest.

The New Proposed Regulations are designed to enable investment professionals at financial institutions dealing with participant directed plans to provide meaningful investment advice to those plans without implicating the broad conflict of interest rules under the Employee Retirement Income Security Act of 1974, as amended, and Section 4975 of the Internal Revenue Code of 1986, as amended (the "tax code").

The DOL previously issued proposed regulations in the summer of 2008 under the Bush administration. These were finalized and scheduled to become effective in March 2009, when, in the opening days of the Obama administration, Chief of Staff Rahm Emanuel issued an order that resulted in a delay of the effective date. Ultimately, the final regulations were withdrawn altogether.¹ The New Proposed Regulations, which are the

¹ Prior to the withdrawal of the final regulations, some legislators introduced bills aimed at regulating what were perceived to be "conflicted" investment advice practices. A House subcommittee approved the 401(k) Fair Disclosure for Retirement Security Act of 2009 (H.R. 1984) and the Conflicted Investment Advice Prohibition Act of 2009 (H.R. 1988), many of the elements of which have since been subsumed into the 401(k) Fair Disclosure and Pension Security Act of 2009 (H.R. 2989). Congressman George Miller (D. Calif.) was quoted as saying that "[the Pension Protection Act of 2006 ("PPA") provisions and the withdrawn final regulations were] a special-interest giveaway to Wall Street at the expense of workers. [They] would have opened the door to unscrupulous advisers to make recommendations based on their financial stake and not in the best interest of workers. The Obama administration was right to pull this misguided proposal, and we hope they move forward on protections to ensure that investment advice given to workers [is] in the workers' best interests." <http://online.wsj.com/article/SB10001424052748704779704574554152990770372.html>.

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subject of this article, suggest a renewed attempt by the DOL to reconcile a demand for sophisticated investment advice with the need to protect plans from the potential for self-dealing, inadvertent or otherwise, by the increasingly interconnected institutions providing the advice.²

Overview and Reasons for Reform. In 2006, Congress enacted the Pension Protection Act in part to address what was perceived as a critical public policy concern: participant directed plans were prevented from obtaining investment advice they needed in order to meet the retirement goals of participants. The heart of this quandary is that certain provisions of ERISA and analogous provisions of the tax code, which are designed to protect the assets of plans, impose restrictions at odds with commercial practices, preventing plans from obtaining services routinely available to other investors.

In particular, ERISA and the tax code provide that persons who provide tailored investment advice to participant directed plans cannot generally also offer their own products or services, or otherwise do anything that could cause them to earn a fee, directly or indirectly, absent very limited exceptions. Thus, investment professionals engaged by participant directed plans face questions such as:

- How do I assure that I am only providing investment education and not providing advice that will render me unable to sell the products and services to the participant directed plan that would benefit them?
- If I provide asset allocation advice based on generally accepted models, what is the consequence of using input that varies from the model? What is permissible where the client requests such specialized advice?
- Can I provide advice in a manner that avoids conflicts under ERISA but that does not restrict availability of the products and services best suited to my participant directed plan client?

These questions are all the more salient because, as a practical matter, most participant directed plan participants do not have the resources to engage an investment adviser of their own who is independent of the financial institution from which they seek products or

² In May 2009, the DOL announced: "The Department believes that the complexity and significance of the issues involved justify delaying the effective and applicability dates of the final rule for an additional 180 days in order to afford the Department time for further review." Phyllis Borzi, assistant secretary for the Department of Labor's Employee Benefits Security Administration, was quoted as saying, "We believe the [withdrawn final regulations] went too far in permitting advice arrangements not specifically contemplated by the statutory exemption . . . We are taking a fresh look . . . and are looking to bring [the regulations] more closely in line with [the language of the PPA]."

services. The result of the financial industry having to navigate these issues is suboptimal for plans. Prior existing guidance by the DOL³ has provided helpful, but limited mechanisms for serving participant directed plans.

In keeping with prior DOL guidance, some institutions unaffiliated with banks, brokers and other financial service providers to participant directed plans offer outsourced "independent investment advice" to participant directed plans, and also employ computer models. Even where compliant computer programs add value, however, some participants in participant directed plans prefer the direct interaction and personal comfort that a program cannot provide. Alternatively, some institutions offer a "fee neutral" setting. "Fee neutral" means the fees and compensation earned by the firm do not vary based on the products and services sold on the basis of the advice given, rendering neutral any inclination to recommend one's own products in order to obtain a larger fee.

The business and compliance challenges of these arrangements, however, are enormous, and as a result they have been more the exception than the rule. Thus, many participant directed plans face exclusion from products and services other market participants are offered, and Congress recognized that more practical alternatives were needed. Subject to certain conditions, the final (withdrawn) regulations provided exemptive relief from the prohibited transaction provisions of ERISA and the tax code for financial institutions that:

- provided products and services of affiliates of the entity giving the investment advice, so long as the entity providing the investment advice (and the individual giving it on behalf of that entity providing the investment advice) remained fee neutral;⁴

- provided products and services following from investment advice given under a conforming computer model; and

- provided products and services through an investment professional-employee after furnishing certain initial advice through a computer model, so long as the investment professional (as distinguished from his employer and its affiliates) remains fee neutral. This relief also contemplated the possibility of ongoing investment advice after the provision of the initial model-generated advice.

The New Proposed Regulations. Although the New Proposed Regulations contain most of the features of the final (withdrawn) regulations, they have not retained

³ This includes, for example, guidance on the use of independent computer models like that described in Advisory Opinion 2001-09A (Dec. 14, 2001) <http://www.dol.gov/ebsa/regs/AOs/ao2001-09a.html>, (the "Sun America" Letter), and on other fee leveling arrangements such as those described in Advisory Opinion 97-15A (May 22, 1997), <http://www.dol.gov/ebsa/programs/ori/advisory97/97-15a.htm>, and Advisory Opinion 2005-10A (May 11, 2005), <http://www.dol.gov/ebsa/regs/aos/ao2005-10a.html>.

⁴ The final (withdrawn) regulations built upon the previously issued guidance and the principles of a 2007 Field Assistance Bulletin ("2007 FAB"): http://www.dol.gov/ebsa/regs/fab_2007-1.html. The 2007 FAB clarified that where a firm seeks to assure fee neutrality under an investment advice program, the fees need only be "flat" at the entity (and for the individual) providing the actual investment advice, but not at the level of any of the entity's affiliates.

those provisions that would have exempted fee leveling across all group companies or for ongoing investment advice following initial advice generated from a computer model meeting certain conditions. This means that the New Proposed Regulations would require that the entity providing the investment advice—and its investment professionals, though not necessarily its affiliates—remain fee neutral when it or its affiliates offer products and services based on that advice under a fee-leveling arrangement. For investment professionals employed by entities providing both advice and product-related sales and execution, this will continue to raise operational challenges.

For some institutions, the New Proposed Regulations may present opportunities where they are willing, for example, to divide their interactions with participant directed plans between two separate affiliated entities: one that provides investment advice (e.g., asset allocation) for which it, and its employees, are compensated strictly on a level-fee basis, and another that offers products and services without the necessity of fee-leveling. It remains to be seen whether, and to what extent, financial firms may consider reordering their business structures to take advantage of this guidance. Many financial firms have business, legal, accounting, and financial considerations that may make such an organizational adjustment impractical.

Like the final (withdrawn) regulations, the New Proposed Regulations require that when investment advice is given under a level-fee arrangement, the advice must take into account (to the extent furnished by a plan, participant or beneficiary) (i) information relating to age, time horizons (e.g., life expectancy, retirement age), risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences of the participant or beneficiary; and (ii) investment management and other fees and expenses attendant to the recommended investment. The advice must be based on generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time (and any additional considerations). No adviser (nor any of its representatives) may receive, directly or indirectly, any fee (including commissions, salary, bonuses, awards, promotions, or other things of value) based on which investment option is selected, and each adviser and its representatives must maintain proper records of any advice for at least six years.

The following additional requirements apply:

- The arrangement must be authorized by a plan fiduciary, or by the plan sponsor if the plan sponsor is, or is affiliated with, the person offering the arrangement, provided such person offers the same arrangement to unaffiliated plans in the ordinary course of business.

- The investment professional must engage an independent auditor to conduct a compliance audit of the arrangement and issue a written report setting forth its findings.

- Before the initial provision of advice (and at least annually thereafter), the investment professional must provide written disclosure that includes a discussion of:

- the role of any party that has a material affiliation or contractual relationship with the adviser in the development of the program and in the list investment options under the plan;
- historical rates of return, to the extent not otherwise provided;

—all fees or other compensation the adviser or his affiliate will receive in connection with (i) the provision of the advice, (ii) the sale, acquisition, or holding of any security or other property pursuant to the advice, or (iii) any rollover or other distribution of plan assets or the investment of distributed assets in any security or other property pursuant to such advice;⁵

—any material affiliation or material contractual relationship of the adviser or its affiliates in the security or other property;

—the manner in which, and under what circumstances, any participant or beneficiary information under the arrangement will be used or disclosed;

—the types of services provided by the adviser in connection with the provision of investment advice by the adviser, including, with respect to a computer model, any limitations on the model to take into account an investment primarily in qualifying employer securities;

—that the adviser is acting as a fiduciary in connection with the provision of the advice; and

—that the recipient of the advice may separately arrange for the provision of advice by another unaffiliated, uncompensated adviser.

Similarly, as in the final (withdrawn) regulations, the New Proposed Regulations require that computer models must apply generally accepted investment theories that take into account the factors discussed above and must avoid recommendations that inappropriately favor options (i) offered by the entity providing the investment advice or a person with a material contractual relationship with the entity, or (ii) may generate greater income for the entity or a person with a material contractual relationship with the entity. In addition, the use of the computer model requires certification by an independent expert that the model meets these requirements.⁶

⁵ An actual sale, acquisition and holding of securities and other property must (i) only occur at the direction of the advice-recipient, (ii) comply with securities law, (iii) result only in reasonable compensation to the adviser, and (iv) have terms at least as favorable to the plan as in an arm's-length transaction.

⁶ The DOL has invited comments on the following:

■ "What investment theories are generally accepted for purposes of [the computer model approach] and what investment practices are consistent or inconsistent with such theories? Should this regulation specify such theories and require their application?"

■ "Should the regulation dictate the bases for model parameters such as the probability distribution of future returns to assets classes or particular investments?"

■ "Should the regulation specify certain practices as required by generally accepted investment theories, or certain other practices as proscribed by such theories?"

■ "What are examples of investment theories that are not generally accepted? Should this regulation expressly proscribe the application of certain such theories?"

■ "What historical data should be taken into account in determining a model's expectation for future performance of asset classes and specific investment alternatives? Should the regulation specify minimum standards for the data, such as a minimum number of years of experience to be included in the data?"

■ "What types of criteria are appropriate and objective bases for asset allocation pursuant to [the proposed rule]? Should this regulation expressly designate some criteria as appropriate and objective and/or other criteria as not appropriate or not objective? Should it do both thereby establishing a list of criteria that models must consider to the exclusion of all

The conditions applicable to fee-leveling also apply to the computer model approach, i.e., an independent fiduciary of the participant directed plan must authorize the investment advice, the entity providing the investment advice must give participants and beneficiaries without charge, prior to the initial provision of investment advice and annually thereafter, a written notification describing fees and other compensation received, relationships among relevant parties, the fiduciary status of the adviser, the services/products being offered, and product limitations and availability of other advisers, etc.⁷ The computer model is not required to include recommendations of investment options that are primarily in qualifying employer securities, target funds, or annuities.

Observations. In assessing the impact of the New Proposed Regulations, the following are among the key issues for investment professionals, and the firms that employ them, to consider:

■ Although an affiliate of an entity providing investment advice may receive fees that vary depending on investment options selected, any provision of financial or economic incentives by an affiliate (or any other party) to such an entity or any individual employed by such entity (e.g., an employee providing advice on its behalf or an individual responsible for supervising such an employee) to favor certain investments would be impermissible.

■ The compensation neutrality requirement for investment professionals employed by an entity offering tailored investment advice to a participant directed plan will continue to remain a challenge.

—Investment professionals and the firms that employ them should consider the express references in the New

others? For example, the regulation could provide that computer models must consider only the historical risks and returns of different asset classes as a whole, information about the participants, and the expenses and asset allocation of each investment option under the plan."

■ "Is a fund's past performance relative to the average for its asset class an appropriate criterion for allocating assets to the fund?"

■ "Under what if any conditions would it be consistent with generally accepted investment theories and with consideration of fees pursuant to [the proposed rule] to recommend a fund with superior past performance over an alternative fund in the same asset class with average performance but lower fees? Should the regulation specify such conditions?"

■ "On what if any bases can a fund's superior past performance be demonstrated to derive not from chance but from factors that are likely to persist and continue to affect performance in the future? Should the use of a fund's superior past performance as a criterion for allocating assets to the fund be conditioned on such demonstration? How, if at all, should a model take into account investment management style? For example, all else equal, should a model ascribe different levels of risk to passively and actively managed investment options?"

⁷ In addition to this disclosure, the entity providing the investment advice must provide disclosure in accordance with all applicable securities laws, all purchases and sales of securities arising out of the investment advice must occur solely at the direction of the recipient of the advice, the compensation received by the entity providing the investment advice and its affiliates must be reasonable, and the terms of any transaction arising out of the investment advice must be at least as favorable to the plan as they would be to unrelated parties in an arm's-length transaction.

Proposed Regulations to an investment professional's "commissions, salary, bonuses, awards, promotions, or other things of value that [are] based in whole or in part on a participant's or beneficiary's selection of an investment option" as compensation that can have an adverse impact on fee neutrality.

—In the preamble to the final (withdrawn) regulations, the DOL suggested that bonuses offered on the basis of an entity's general profitability "may be permissible to the extent that it can be established that the participant directed plan and IRA investment advice and investment option components were excluded from, or constituted a negligible portion of the [fiduciary adviser's] profitability."

—Requiring exclusion of revenues from participant directed plans would be a major departure from the compensation structure of most investment professionals. If, when determining compensation, promotion, or awards, broker-dealers are required to exclude revenues from products and services sold to participant directed plans, investment professionals may simply decline to give advice to participant directed plans — an outcome contrary to the one intended by Congress in enacting the Pension Protection Act.

■ Financial firms will continue to focus on how investment professionals legitimately may offer participant directed plans the opportunity to move assets from a legacy institution (or employer plan) to the financial firm. In the prior final (withdrawn) rules, the DOL considered such efforts as being potentially abusive, and that in certain instances they could violate the self-dealing provisions of ERISA and the analogous provisions of the tax code.

■ For advice programs that make use of independent computer programs, the New Proposed Regulations stipulate that a computer model must be designed and operated to avoid investment recommendations that "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." The DOL notes in this regard that "[w]hile some differences between investment options within a single asset class, such as differences in fees and expenses or management style, are likely to persist in the future and therefore to constitute appropriate criteria for asset allocation, other differences, such as differences in historical performance, are less likely to persist and therefore less likely to constitute appropriate criteria for asset allocation."

Conclusions. The challenges financial institutions face in providing participant directed plans with the resources, tools and investment advice they need without running afoul of the conflict provisions of ERISA and the tax code remain substantial. Many financial institutions will want to continue to review their existing practices in light of the New Proposed Regulations. Although helpful in some regards, the New Proposed Regulations also highlight many of the ongoing issues financial institutions confront in serving their participant directed plan clients, without resolving many of the legal and regulatory constraints imposed by ERISA and the tax code. It remains to be seen how, and to what extent, the New Proposed Regulations will shape future practice.