Legal Alert: Participant Investment Advice Regulation Resurrected

3/1/2010

On February 26, the Department of Labor issued its long-awaited re-proposal of the Participant Investment Advice regulation that was issued last January, but which never went into effect, and which was eventually withdrawn on November 20, 2009. The new proposal is the result of the Department's reconsideration of a number of legal and policy issues relating to the prior regulation as well as various public comments that were received in response the Department's request.

The new proposal contains regulations applying the statutory prohibited-transaction exemption under Sections 408(b)(14) and 408(g) of ERISA, and sections 4975(d)(17) and 4975(f)(8) of the Internal Revenue Code, which were enacted by the Pension Protection Act of 2006. Those sections provide an exemption for certain transactions under which a plan fiduciary provides investment advice to participants either through use of a certified computer model, or under a "fee-leveling" arrangement.

Under the prior regulation, in order to qualify for the exemption, the advice must have been provided by a "fiduciary advisor" pursuant to an "eligible investment advice arrangement." An "eligible investment advice arrangement" could be either (i) a "fee-leveling" arrangement, or (ii) computer-model advice.

The general conditions that were applicable to all "eligible investment advice arrangements" were:

• The arrangement had to be authorized by a plan fiduciary who was independent of the fiduciary advisor;

• The arrangement must have been subject to an annual audit by an independent auditor;

• Rules were prescribed concerning maintenance of records;

• Employee disclosures were required to be provided:

• Initially, then annually if changed

• DOL model disclosure form was made available.

In order for a "fee-leveling" arrangement to qualify for the exemption, in addition to meeting the general conditions:

• The advice had to be based upon generally-accepted investment theories,

and was required to take participant-specific information into account.

• Compensation to the fiduciary advisor could not vary based upon the particular investments (or the investment category) recommended or selected.

In order for computer-modeling to qualify for the exemption, in addition to satisfying the general conditions:

• The computer model must have:

• Applied generally accepted investment theory

• Used participant-specific information

• Taken all designated investment options into account

• Provided asset allocation portfolios based upon objective criteria

• Not "inappropriately" recommended investments that generated greater income for the fiduciary or otherwise favored the fiduciary's interests

• Been certified as qualified

• Certification of computer model

• Must be in writing

• Must include description of the methodology utilized

• Must be by "eligible investment expert" who

• had appropriate training, expertise and experience

• was selected by the fiduciary advisor

• could not be related to the fiduciary advisor.

The new proposal is largely identical to the withdrawn final regulation, with a few significant changes.

First, in addition to applying the statutory exemption enacted by the PPA, the previous regulation had been accompanied by an administrative class exemption granting relief in addition to the relief afforded by the statutory exemption. Unlike the statutory exemption, the class exemption provided relief for individualized investment advice furnished to participants following receipt of general recommendations using a computer model pursuant to the statutory exemption. The computer-model recommendations were assumed to provide participants with a context in which they could sufficiently evaluate the individualized investment advice authorized by the class exemption. Also unlike the statutory exemption, the class exemption applied the fee-leveling limitations only to the compensation that was received by the individual employee, agent or registered representative who actually provided the advice on behalf of the institutional fiduciary adviser, as opposed to the compensation received by the fiduciary adviser on whose behalf the individual employee, agent or registered representative was acting (for example, a

registered representative providing advice on behalf of a broker-dealer).

The Department, after considering numerous public comments, was unable to determine that the class exemption offered protections sufficient to eliminate – or even to mitigate – an advisor's conflicts of interest, which could result in tainted advice. It also recognized that President Obama has announced a proposal for "21st Century Financial Regulatory Reform," which the Department believes should beneficially influence the market for investment advice. The Department therefore decided not to reissue the class exemption, and as a result, specifically noted that neither the statutory exemption nor the new proposed regulation provides relief for any individualized advice provided to participants following the furnishing of computer-model investment recommendations unless the subsequent advice, on its own, satisfies the requirements of the statutory exemption (such as being rendered under an acceptable fee-leveling arrangement).

Second, the new proposed rule clarifies that the fee-leveling requirement of the statutory exemption prohibits fiduciary advisors from receiving any compensation based on the investments selected by plan participants, and that the limitation "applies both to an entity that is retained to render advice, and to any employee, agent, or registered representative of such an entity." Further, the prohibition against receipt of compensation for favoring or recommending particular investments applies to a fiduciary adviser if the advisor receives no such fees but an affiliate of the fiduciary adviser might receive fees that vary depending on the investment options selected.

Concerning the earlier final regulation, Rep. George Mitchell, Chairman of the House Education and Labor Committee, had stated that the rule was "harmful," and could result in participants receiving "potentially conflicted investment advice." Of the current proposed rule, Rep. Miller said that it would help provide investment advice that is best for an individual's retirement, "not the investment adviser's commission."

Comments on the new proposal are requested by May 5, 2010. The text of the new proposal can be found at
http://www.dol.gov/ebsa/pdf/frinvestmentadvice.pdf .

If you have any questions regarding this Alert, or would like additional details concerning the final regulation or other matters concerning your participant contribution arrangements, you can contact the author of this Alert, Jeffrey Ashendorf, 212-453-5926, jashendorf@fordharrison.com, any member of Ford & Harrison's Employee Benefits practice group or the Ford & Harrison attorney with whom you usually work.