

# Regulatory Update

## Department of Labor Issues Proposed Regulations on the Provision of Investment Advice

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On March 2, 2010, the Department of Labor (DOL) published proposed regulations governing the provision of investment advice to participants and beneficiaries in individual account plans, such as 401(k) plans. The proposed regulations interpret Section 408(b)(14) and Section 408(g) of ERISA, both of which were added by the Pension Protection Act of 2006 (PPA) to provide a prohibited transaction exemption for investment advice arrangements and related transactions.

The proposed regulations will be of interest both to financial services firms looking to offer investment advice, as well as plan sponsors evaluating investment advice arrangements for their participants.

### **Background on the Regulations**

The investment advice regulations have followed a long and winding road to this point. The regulations were first proposed in August 2008. They were issued in final form in January 2009 with an effective date of March 23, 2009. After the change in administration, however, the effective date of the regulations was delayed numerous times until, on November 20, 2009, the DOL withdrew the regulations (the withdrawn regulations).

The delay, and ultimate withdrawal, appeared to be in response to concern that the withdrawn regulations posed conflicts of interest that had not been adequately addressed. On March 2, 2010, the DOL repropose the investment advice regulations with a few key departures from the withdrawn regulations (the new proposed regulations). This column will focus on the variations from the withdrawn regulations.

In January 2009, in addition to the withdrawn regulations, the DOL also issued a prohibited transaction class exemption that would have extended the prohibited transaction relief to situations that did not satisfy the requirements of the statutory exemption or the withdrawn regulations as long as they met other requirements set forth in the class exemption. The class exemption was also withdrawn in November 2009 and the DOL has not repropose it.

### **Background on Investment Advice**

As participant directed individual account plans continue to overtake more traditional pension plans as the primary retirement savings vehicle for American workers, good investment decisionmaking by participants is critical to financially sound retirements. The DOL notes, in the preamble to the new proposed regulations, however, that a relatively small percentage of plan participants receive professional investment advice through their plans.

One source of reluctance to provide investment advice is uncertainty regarding the investment advice arrangements under ERISA's prohibited transaction rules. To address such concerns, and encourage wider

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offerings of professional investment advice to plan participants, Congress added Section 408(b)(14) and Section 408(g) of ERISA as part of the PPA. Some plan sponsors have been making investment advice available under their plans prior to these new statutory provisions. Among those plan sponsors, some rely on a DOL advisory opinion from 2001 commonly referred to the “SunAmerica” opinion, under which investment advice is outsourced to an independent provider. Other plan sponsors reduce the amount due to the adviser by the amount received by the adviser as a result of the investment selections made under the plan to try to avoid prohibited transaction concerns. The PPA provisions, however, offer plan sponsors the ability to use investment advice provided by parties affiliated with the investment options offered under the plan (which would not be allowed under SunAmerica) and the ability to pay a fiduciary adviser for such services. Predictably, the devil is in the statutory and regulatory details.

Pursuant to Section 408(g) of ERISA, the prohibitions of Section 406 shall not apply to the provision of investment advice and related transactions (including the purchase, holding and sale of investments pursuant to the advice and the receipt of fees) if the advice is provided by a “fiduciary adviser” pursuant to an “eligible investment advice arrangement.”

A “fiduciary adviser” is defined as a “person who is a fiduciary of the plan by reason of the provision of investment advice . . . by the person to the participant or beneficiary of the plan” who meets certain qualifications set forth in Section 408(g) of ERISA.<sup>1</sup>

A “eligible investment advice arrangement” is an arrangement which either: (i) provides that any fees received by the fiduciary adviser do not vary depending on the basis of any investment option selected (the level fee method), or (ii) uses a computer model (the computer model method) that satisfies numerous detailed requirements, including a requirement that the computer model applies “generally accepted investment theories,” uses “relevant information about the participant,” and “operates in a manner that is not biased in favor of investments offered by the fiduciary adviser.”<sup>2</sup> An eligible investment advice arrangement must also satisfy numerous other conditions set forth in Section 408(g) of ERISA, including a requirement that the arrangement be authorized by a plan fiduciary independent of the advice provider and participant disclosure requirements.

### **New Proposed Regulations**

The new proposed regulations largely track the withdrawn regulations but there are three significant departures: (1) the elimination of the class exemption; (2) revisions to the level fee method requirements; and (3) additional requirements regarding the computer model method.

### **Elimination of the Class Exemption**

As previously noted, a proposed class exemption was issued at the same time as the withdrawn regulations. The proposed class exemption would have provided prohibited transaction relief under certain circumstances for individualized advice rendered to individual participants (or IRA owners) following the furnishing of investment recommendations generated by a computer model, even if such advice, on its own, would not have satisfied the requirements of the statute or the withdrawn regulations. The proposed class exemption also would have allowed for a more liberal application of the level fee requirement under certain circumstances. Both of these provisions would have expanded the types of arrangements that could benefit from the prohibited transaction relief.

According to the DOL, commenters argued that the class exemption would permit financial interests that would cause a fiduciary adviser to have conflicts of interest and that the class exemption did not contain

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adequate safeguards to mitigate those conflicts of interest. The DOL agreed and decided not to retain the class exemption. Thus, advice arrangements that intended to rely on the class exemption will need to be restructured to either fit within the statutory provisions and the new proposed regulations or fit within the pre-PPA approaches discussed briefly above.

### **Level Fee Approach**

Commenters expressed concern that the withdrawn regulations would permit the receipt of varying fees by an affiliate of the fiduciary adviser. According to these commenters, those fees would permit an affiliate of the fiduciary adviser to establish economic incentives for the individuals providing investment advice to recommend investments that pay varying fees to the affiliate.

In response, the DOL emphasized that receipt by a fiduciary adviser of any payment from any party that is based, in whole or in part, on investments selected by participants or beneficiaries would be inconsistent with the fee leveling requirement. In order to clarify, the DOL revised the language on this point to read as follows:

No fiduciary adviser (including any employee, agent, or registered representative) that provides investment advice receives from any party (including an affiliate of the fiduciary adviser), directly or indirectly, any fee or other compensation (including commissions, salary, bonuses, awards, promotions, or other things of value) that is based in whole or in part on a participant's or beneficiary's selection of an investment option.<sup>3</sup>

Previously, this provision of the regulations had read: "Any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice . . . do not vary depending on the basis of any investment option selected by a participant or beneficiary."<sup>4</sup>

Although the DOL characterizes the change as a clarification, it is arguably a tightening of the level fee requirement because, as proposed, it not only restricts the receipt of fees based on the investment option selected, it also prohibits affiliates of the fiduciary adviser from paying other parties, such as employees, agents, or registered representatives, based on the investment option chosen even if such other parties had no role in providing the investment advice. This proposed revision may further restrict the way investment advice providers may structure their compensation if they wish to rely on the statutory exemption.

This proposal may reflect the intense scrutiny of conflicts of interest that drove the withdrawal of the regulations in the first place. Those entities providing financial advice will need to review existing compensation structures to determine whether they comply with this requirement.

### **Computer Model Approach**

The new proposed regulations added another requirement to the already long laundry list of requirements imposed on computer models used to provide investment advice. The new requirement is that the computer model shall be designed and operated to avoid investment recommendations that "[i]nappropriately 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."<sup>5</sup> In the preamble to the new proposed regulations, the DOL states:

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While 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.<sup>6</sup>

The DOL's comment in the preamble is particularly instructive here and arguably proposes a view that fees should trump investment performance when evaluating investment options under the plan. If historical performance is not an appropriate basis for an investment recommendation among investment options in the same asset class, one could reasonably expect that fees and expenses would assume an even more central role in that recommendation. Perhaps shedding further light on this point, in the preamble to the new proposed regulations, the DOL solicits comments on the relationship between performance and fees and the appropriate weighting of each.

This proposal, if finalized, may have a significant effect on investment advice provided pursuant to the exemption. Although it is a fundamental principal of investing that past performance is not a guarantee of future returns, it is reasonable to expect that investment advisers may nevertheless consider historical performance as a factor among others in making investment recommendations. This change may also reflect the larger focus in Washington, both legislative and regulatory, on the fees and expenses borne by 401(k) plan participants.

#### **What's Next?**

The regulations are currently in proposed form and will not become effective until 60 days after the publication of the final regulations in the Federal Register. In the meantime, however, questions of investment advice have also garnered attention on Capitol Hill. It is not clear whether the proponents of a legislative response to perceived conflicts of interest in the provision of investment advice will defer to the DOL's proposed regulation or continue to advance previously introduced legislative covering many of the same matters.

#### **Notes:**

1. ERISA § 408(g)(11)(A).
2. ERISA § 408(g)(3)(B).
3. Prop. Reg. § 2550.408-g-1(b)(3)(i)(D).
4. 74 Fed. Reg. 3822, 3847 (Jan. 21, 2009) (§ 2550.408-g-1(b)(3)(i)(E) of the withdrawn regulations.
5. Prop. Reg. § 2550.408-g-1(b)(4)(i)(E)(3).
6. 75 Fed. Reg. 9360, 9361-9362 (Mar. 2, 2010) (emphasis added).

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