

## Employee Benefits & Executive Compensation ADVISORY

May 3, 2010

### DOL Issues Proposed Investment Advice Regulations

On March 2, 2010, the Department of Labor (DOL) issued proposed participant investment advice regulations (the “Proposed Regulations”) following its withdrawal in November 2009 of the investment advice regulations and class exemption that had been issued by the prior administration. The Proposed Regulations implement the statutory exemption for “eligible investment advice arrangements” established under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (the “Code”), created by the Pension Protection Act of 2006 (PPA). Although these regulations are only in proposed form, we believe that the final regulations will be substantially identical to the Proposed Regulations. Notwithstanding, the DOL is accepting written comments on the Proposed Regulations until May 5, 2010.

We expect that the Proposed Regulations will impact how participant investment advice will be provided to participants in defined contribution plans governed by ERISA and IRAs.<sup>1</sup> The following summary of the Proposed Regulations offers some of our thoughts on how investment managers, investment advisers, broker-dealers, banks, mutual funds and other types of entities providing advice services (“Advice Providers”) should factor the Proposed Regulations into their future business plans. In particular, we note that fee arrangements under current advice programs that use fee-leveling may not qualify for the statutory exemption. Although the Proposed Regulations do not nullify current advice arrangements, there may be strong business reasons to comply with the statutory exemption and the regulations promulgated thereunder.

### Overview of Investment Advice Proposed Regulations

The Proposed Regulations were issued in order to give guidance on the implementation of the statutory exemption under ERISA § 408(b)(14) (and a parallel provision under the Code) for certain investment advice arrangements. ERISA § 408(b)(14) provides that in the event that investment advice is provided to participants in a defined contribution plan pursuant to an “eligible investment advice arrangement” and the requirements of the exemption are otherwise met, a prohibited transaction will not occur in delivering such advice. Congress added this statutory exemption to ERISA in order to further promote the adoption of advice arrangements by plan sponsors and other fiduciaries. The exemption also applies to IRAs.

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<sup>1</sup> The use of the word “plan” throughout this advisory is intended to address both ERISA-covered plans and IRAs.

An “eligible investment advice arrangement” may consist of (i) an arrangement that provides advice through a computer model that meets specific requirements or (ii) an arrangement that provides for fee-leveling. The “computer model” requirements, in essence, provide for a computer model certified by an appropriately trained expert that is not affiliated with the party providing advice services or any of the providers of the plan’s underlying investments. As an alternative to the computer model, Advice Providers (or their employees, registered representatives and agents) may provide advice to participants if they do not receive compensation that varies based upon participant investment decisions under the plan offering the advice arrangement and certain other requirements are met. Such an arrangement provides for “fee-leveling.”

In addition to the advice being delivered through a computer model or fee-leveling arrangement, the following requirements must be met in order to meet the statutory exemption:

1. An independent fiduciary (e.g., plan sponsor, plan investment committee) must authorize the advice program;
2. An independent auditor who has appropriate technical training or experience must represent in writing that the requirements outlined in ERISA § 408(b)(14) and the regulations are met;
3. The party providing the services must meet disclosure obligations at the time of initial investment and on an ongoing basis; and
4. Other requirements, including (i) the fiduciary adviser meets applicable securities law disclosure requirements; (ii) the sale, acquisition or holding of plan investments occurs solely at the direction of the participant or beneficiary; (iii) only reasonable compensation is received by the fiduciary adviser and its affiliates in connection with the sale, acquisition or holding of plan investments; and (iv) the terms of the sale, acquisition or holding of the security or other property, are at least as favorable to the plan as an arm’s length transaction would be.

The following comments are primarily focused on arrangements that provide for fee-leveling.

### **Changes from Previously Revoked Final Regulations**

With regard to fee-leveling arrangements, the Proposed Regulations are in large part very similar to the revoked final regulations. In revoking the final regulations, the DOL stated that it was concerned that the final regulations, as well as an accompanying class exemption, did not sufficiently mitigate against potential self-dealing on the part of Advice Providers, in violation of ERISA § 406(b) (or parallel provisions in Code § 4975), in the delivery of advice, particularly through an arrangement using fee-leveling. As such, the DOL decided to revoke the prior final regulations and class exemption, and re-issue the regulations in proposed form, so as to draft regulations that would more effectively limit or remove the potential taint of fiduciary adviser self-dealing.

The DOL is no longer proposing a class exemption that would allow broad relief with regard to certain investment advice arrangements. However, somewhat surprisingly, the Proposed Regulations are very similar to the revoked final regulations with regard to fee-leveling arrangements. In order to meet

the leveling requirement, the arrangement should include procedures by which any compensation generated by reason of a participant's investment decision under a plan offering the investment advice is offset against the total fees paid to the Advice Provider (or its employees, registered representatives and agents) for such services, or is otherwise not paid to the Advice Provider (or its employees, registered representatives and agents). In other words, fee-leveling is a device used to assure that Advice Providers do not use their positions as fiduciary investment advisers to allow the Advice Providers to increase their compensation. However, there is a key change with respect to fee-leveling arrangements pertaining to the breadth of compensation that might be considered for purposes of meeting the leveling requirements.<sup>2</sup>

With regard to fee-leveling, the revoked final regulations provided that “[a]ny fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets do not vary depending on the basis of any investment option selected by a participant or beneficiary . . . .” On the other hand, the Proposed Regulations add more specificity to the application of the leveling requirement, including the following:

1. The term “fiduciary adviser” with regard to an advice arrangement includes an “employee, agent, or registered representative” of the fiduciary adviser.
2. Leveling must occur with respect to any compensation received “from any party (including an affiliate of the fiduciary adviser), directly or indirectly . . . .”
3. “Compensation” for the purpose of the leveling requirement includes “commissions, salary, bonuses, awards, promotions, or other things of value.”
4. Compensation may not vary “based in whole or in part on a participant’s or beneficiary’s selection of an investment option . . . .”

This language in the Proposed Regulations, as pointed out by the DOL, was based upon the language and guidance it issued under Field Assistance Bulletin 2007-01 with respect to the statutory exemption. As discussed below, this increased specificity in the compensation-related language should cause Advice Providers to take a closer look at the Proposed Regulations for purposes of determining (i) if their current arrangements will meet the requirements of the exemption, (ii) if they want to create a separate “eligible investment advice arrangement” product and (iii) if their current arrangements are consistent with the DOL’s view on appropriate compensation of Advice Providers in general.

### **Prior Investment Advice Guidance Still Applies**

Importantly, the Proposed Regulations state that all prior guidance regarding investment advice still applies. Therefore, the provision of advice through computer models based upon DOL guidance in Advisory Opinion 2001-09A, better known as the “SunAmerica Opinion,” or through fee-leveling

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<sup>2</sup> Although computer-modeling arrangements are not the focus of this advisory, we note that there are some requirements in the Proposed Regulations that are stricter than those found in the revoked final regulations with regard to such arrangements.

such as that described in Advisory Opinion 97-15A, better known as the “Frost Opinion,” and other DOL guidance is still good law. As such, Advice Providers may not necessarily need to eliminate their current investment advice programs. However, in light of the Proposed Regulations, Advice Providers may want to consider adding an “eligible investment advice arrangement” to their advisory service offerings or consider whether adjustments to their current offerings are necessary.

## Issues to Consider

Based upon our review of the Proposed Regulations, we recommend that Advice Providers consider the following:

- **Generation of Fees by Certain Affiliates Without Leveling:** Unlike fee-leveling set forth in prior guidance such as the Frost Opinion and Class Exemption 77-4, under an “eligible investment advice arrangement” using fee-leveling, an affiliate of an Advice Provider can receive compensation by reason of the participant investment decisions even though the Advice Provider will also be paid a fee for providing such advice. For example, an Advice Provider may receive fees for the provision of participant investment advice while its affiliates that provide advisory services to mutual funds offered under the plan may collect advisory fees from the fund without the need for leveling. Therefore, Advice Providers and their affiliates should consider whether implementing an “eligible investment advice arrangement” using fee-leveling, in addition to or in lieu of its fee-leveling arrangement established under current law, makes business sense.
- **Potential Market Demand for Eligible Investment Advice Arrangements:** Plan sponsors and other plan fiduciaries may insist on adoption of “eligible investment advice arrangements.” Such fiduciaries may perceive that they receive added protection against breaches of the general fiduciary provisions and against violations of the prohibited transaction provisions through the implementation of these arrangements, whether using a computer model or fee-leveling. As such, Advice Providers need to decide now whether they will implement these arrangements to meet potential demand. Notably, the compliance requirements for the Proposed Regulations are more complex than the requirements for advice arrangements established under pre-PPA law. The above summary of the requirements is very much simplified.
- **Ability of Current Fee Arrangements to Meet Statutory Exemption Requirements:** In deciding whether to implement an “eligible investment advice arrangement” using fee-leveling, Advice Providers should consider how the current compensation structure among the Advice Providers and its affiliates will fit within the Proposed Regulations’ fee-leveling requirements. As discussed above, the Advice Provider providing the advice cannot receive more compensation by reason of the investment decisions made by the participants pursuant to the advice. However, the Advice Providers’ affiliates can receive more compensation under such circumstances.

In situations where a fund pays fees such as 12b-1 fees and sub-TA fees, the fee-leveling requirements would require that the Advice Providers (or their employees, registered representatives and agents) not receive any such fees except to the extent they were credited against its advisory fee. This also appears to be the case when the investment advisers, sponsors and distributors of mutual funds pay Advice Providers compensation from their corporate assets rather than fund assets, in exchange for inclusion of the mutual funds on an advice platform or otherwise in exchange for preferred access to the Advice Provider and its employees, representatives and agents. However, in other situations, the connection between Advice Provider compensation may be much more subtle. For example, if the Advice Provider is a member of a large financial services company and all employees of the company (including employees providing the advice) receive bonuses based upon business unit performance, which includes performance of proprietary mutual funds managed by affiliates, a question arises whether some type of fee credit or waiver would be necessary to meet the statutory exemption requirements. This example may pose too tenuous of a connection between the advice and the compensation; however, it is conceivable that other types of compensation arrangements would support the contention that there was a connection resulting in loss of reliance on the statutory exemption.

- **Impact of Proposed Regulations on Current Arrangements Intended to Comply with Current Law:** In reviewing the Proposed Regulations and determining how they will impact an Advice Provider's business, we believe that review of current investment advice arrangements established under pre-PPA law is warranted to assure compliance with such law has been maintained. Although the Proposed Regulations clearly state that its prior guidance on advice arrangements continues to apply, questions arise whether the DOL's view on the application of that guidance has changed or that the DOL will look at advice arrangements with increased scrutiny. We believe that some more light will be shed on what the DOL believes to be appropriate compensation practices in general, and in the context of providing investment advice in particular, when it issues regulations under ERISA § 408(b)(2) in the very near future.

## Comment Period

In the Proposed Regulations, the DOL asked the written comments be received by May 5, 2010. Specifically, the DOL requested Advice Providers to submit comments primarily related to the design of the computer model arrangement, such as (i) what investment theories are generally accepted and not accepted; (ii) whether the final regulations should include more specific language related to investment theory and the probability distribution of future returns to asset classes; (iii) the type of historical data that should be taken into account; and (iv) other information related to computer model development. Certainly, the DOL would be willing to review comments on these and other issues which Advice Providers want addressed.

*If you have any questions regarding the Proposed Regulations or the ERISA and Code issues that more generally arise in delivering investment advice to plans governed by ERISA and IRAs, please contact one of the members of Alston & Bird's Employee Benefits and Executive Compensation Group.*

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