

## Investment Advice to Participants: What the “Final” DOL Regulation Means

By Fred Reish, Bruce Ashton and Jason Roberts

On January 21, 2009, the Department of Labor (DOL) issued a regulation under ERISA Section 408(g). The regulation is designed to provide guidance on the statutory exemption (the “statutory exemption”) enacted in the Pension Protection Act of 2006 (PPA) for investment advice to participants in participant-directed individual account plans and in individual retirement accounts (IRAs). The regulation also contains a class exemption (the “class exemption”) providing additional relief.

This bulletin examines the effect of the regulation on broker-dealers and registered investment advisers that provide investment advice to 401(k) plan participants and IRA beneficiaries (referred to collectively as “participants”). We first discuss the regulation and then suggest steps that firms should begin taking now to come into compliance with the new rules, whether or not they are effective in their current form.

### Current Status

The regulation was scheduled to go into effect on March 23, 2009, but on February 3, 2009, the DOL released a notice proposing to extend the effective date by 60 days (to May 22, 2009). Additionally, the DOL notice requested comments, which are due by March 6, 2009, to help in its review of the rules as requested by the Obama administration. When and in what form the regulation will be finalized is unclear in light of strong Congressional opposition that is primarily aimed at the class exemption. Critics argue that the proposed safeguards for the class exemption do not go far enough in ensuring that the advice will be unbiased and free of conflicts of interest. Indeed, a statement issued by Congressman George Miller (D-California), Chairman of the House Education and Labor Committee, and Congressman Rob Andrews (D-New Jersey), immediately preceding publication of the final rule, stated that they would “use every tool at [their] disposal to block the implementation [of the regulation].”

Notwithstanding the delay and the opposition, we believe that the DOL and/or Congress will seek to implement the less controversial provisions of the regulation. To the extent all or part of the regulation becomes effective in May 2009, firms should begin preparing to respond to the associated operational, logistical and compliance-related challenges.

### Background

Anyone who gives individualized investment advice to plan participants for a fee is a fiduciary under ERISA and the Internal Revenue Code (but is a fiduciary only under the Code if he provides advice in certain non-ERISA situations, e.g., to

### Pre-Conference Session at 401(k) Summit

*Fred Reish, Bruce Ashton and Jason Roberts will present a pre-conference session, entitled “Disclosure Obligations in Times of Uncertainty,” at the upcoming 401(k) Summit. The session will be aimed at financial services professionals and will address current legal requirements—the fiduciary rules, proposed 408(b)(2) regulation, the recently introduced Defined Contribution Fee Disclosure Act and any other major proposals between now and then—plus strategies for managing risk and “best practices.” The session will be held at 8:00am on Sunday, March 22, in the Madeleine room, sections C and D. It is open to all registrants at the Summit.*

an IRA beneficiary or to a one-person plan). It is a prohibited transaction under Section 406(b) of ERISA and section 4975 of the Code for a fiduciary to use his position to increase his compensation. Absent an exemption, if an adviser (or its affiliates or other persons in which the adviser has an interest) receive additional fees from the recommendation of investments, the adviser would be engaging in a prohibited transaction. Prior to the enactment of the PPA, the adviser could avoid engaging in a prohibited transaction if its fees (and any compensation received by affiliates or other parties in which the adviser has an interest) did not vary based on the advice given (for example, through a purely level fee—for itself, affiliates and interest persons—or by offsetting such revenues against a stated fee). Those “pure” level fee arrangements continue to be acceptable after the PPA and, in fact, the providers of that advice do not need to comply with the conditions discussed in this bulletin. (We will be publishing a separate bulletin on that subject within a week or two.)

Because of the prohibited transaction rules and the concern of many plan sponsors that they would be responsible for the advice given to their participants, investment advice to participants was not as widespread as it could have been. In 2006, the PPA added a new prohibited transaction exemption to ERISA and the Code in an effort to increase the availability of participant-level investment advice.

### The Statutory Exemption

The PPA amended ERISA and the Code to provide exemptive relief for certain transactions in connection with the provision

of investment advice to participants. To qualify for relief, each fiduciary adviser (identified as, among others, an RIA or broker-dealer, and their representatives) must either:

1. ensure that any fees received (by the individual adviser and the adviser's firm) in connection with the provision of investment advice will not vary based on any investment options recommended by the adviser and selected by the participant; or
2. utilize an objective computer model that is independently certified not to inappropriately favor investment options offered by the fiduciary adviser or those that generate greater income for the fiduciary adviser or its affiliates.

We refer to the first of these as the "limited level fee" exemption because the requirement of level compensation applies only to the individual adviser and the firm of which he is a representative. The level fee requirement in the regulation does not extend to affiliates of the adviser. If the compensation of the adviser, his firm and all affiliates did not vary, this would be a "pure level fee" arrangement, which would not constitute a prohibited transaction and would not require an exemption.

Under the second exemption, the computer-model exemption, the compensation need not be level for the adviser, his firm and their affiliates. In other words, the compensation may vary based on the investment options recommended to and selected by the participant.

In either case, the fiduciary adviser must acknowledge that it is acting as a fiduciary and provide details of its fees and compensation, affiliations (and their related compensation) and services to be rendered. Each fiduciary adviser must submit to an annual audit that evaluates the adviser's compliance with the conditions for the exemption, as well as the adequacy of its policies and procedures.

The final regulation and the preamble provide guidance on the requirements for the annual audit and certification of the computer model. It also has an acknowledgment by the DOL that, if a fiduciary adviser provides advice under a "pure" level fee arrangement (for itself and all affiliates), no prohibited transaction exists and, therefore, compliance with the conditions for the exemption is not required.

### ***Class Exemption***

The regulation also includes a class exemption that the DOL considered "necessary to provide comprehensive relief for fiduciary investment advice and to address certain aspects of the statutory exemption that were unclear or that did not extend relief to certain arrangements."

Under the class exemption, there are two separate methods of avoiding prohibited transactions while giving participant advice. The first is an expansion of the computer model exemption, and the second is a relaxation of the level fee exemption. The computer model class exemption covers cases where computer model advice has been given or where the plan or IRA offers so many options

that computer model advice is not feasible. We refer to that as the "class model" exemption. The expanded level fee advice class exemption is referred to as the "class level fee" exemption.

Under the class model exemption, participants must first be provided with investment advice generated by a computer model that either (1) meets the requirements of the statutory exemption (including the certification requirement) or (2) meets the requirements with respect to content and absence of bias (but that does not need to meet the certification requirement so long as it is designed and maintained by a person independent of the fiduciary adviser). If class model advice is given, there is no requirement that the compensation of the adviser, his firm or affiliates be level (which is the same as the statutory exemption).

In the case of a plan that offers self-directed brokerage accounts, brokerage windows and the like and in the case of IRAs, where the types or number of investments effectively precludes the use of computer model advice (for example, a brokerage account or mutual fund window), the participant must be given investment education materials related to investment concepts generally.<sup>1</sup> However, a plan or IRA that offers designated investment options in addition to the self-directed brokerage account or window, must also provide the participant with class model advice related to the designated options.

The class level fee exemption permits individualized advice under a level fee approach. The class exemption creates a third category, or definition, of level fee advice. (The first two are: (1) the pure level fee arrangement, where the fees of the individual adviser, his firm, and any affiliates do not vary, and (2) the limited level fee arrangement, where the fees of the individual adviser and the fiduciary adviser—that is, the entity—do not vary, but the fees of affiliates may vary based on the options selected.) The class fee leveling requirement applies solely to the compensation received by the individual providing the advice on behalf of the supervisory entity (*e.g.*, the broker-dealer or the RIA) and not to the compensation of that entity, or other employees of that entity (*e.g.*, the individual's manager), or affiliates of that entity.

In an attempt to mitigate potential conflicts of interest, the class exemption requires the fiduciary adviser to make a determination that the advice is prudent and in the best interest of the participant and to explain the basis for that determination. The fiduciary adviser must explain why and how the advice deviates from the computer model recommendations (or investment education materials) and, to the extent applicable, why the advice includes an option with higher fees than other options in the same asset class available under the plan. The exemption further requires the fiduciary adviser to document the explanation within 30 days of the delivery of such advice. This documentation must be maintained by the adviser's firm for a period of not less than six years after the provision of the investment advice.

Finally, the class exemption requires the fiduciary adviser to adopt and follow written procedures designed to assure compliance with the conditions of the exemption. As with the statutory exemption, fiduciary advisers providing advice to participants under the class exemption must have an annual audit of:

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<sup>1</sup> To the extent it is determined that the number of investment choices would reasonably preclude the use of a computer model to generate investment recommendations, paragraph (d)(3)(ii)(B) of the final rule requires that participants and beneficiaries be furnished with material, such as graphs, pie charts, case studies, worksheets, or interactive software or similar programs that reflect or produce asset allocation models taking into account the age (or time horizon) and risk profile of the beneficiary, to the extent known.

- their compliance with the conditions for the exemption; and
- their compliance with the required internal policies and procedures.

The model and class level fee exemption contained in the class exemption are not included in the statutory exemption and thus will go into effect only if the class exemption becomes final.

### General Requirements

The requirements for both the class exemption and the statutory exemption also contain provisions relating to noncompliance. It may seem obvious that the exemptions will not protect against any prohibited transaction where the conditions have not been satisfied. However, there is an additional requirement: in a case of a pattern or practice of noncompliance with any of the conditions of the regulation, the exemption(s) would not apply to any advice by the fiduciary adviser during the period over which the pattern or practice extended. If a prohibited transaction occurs, the disqualified person (and/or firm) may be personally liable for disbursement of revenues received and be subject to significant excise taxes.

While the DOL believes that these safeguards will help to ensure compliance with the class exemption and eliminate the potential for conflicts of interest, the issue was hotly debated during the comment period and remains a source of controversy.

The regulation contains a model disclosure form, which appears in an Appendix, that may be used for purposes of satisfying the fiduciary adviser's disclosure obligations under both the statutory and class exemptions. This optional model disclosure form appears to be exhaustive, and the regulation states that the use of an appropriately completed model disclosure will be deemed to satisfy the requirement that such information be written in a clear and conspicuous manner calculated to be understood by the average participant.

### Discussion

While the status of the final rule is pending, broker-dealers and RIAs that wish to provide advice to participants should begin the process of evaluating the risks and benefits of adopting a fiduciary adviser program. Regardless of whether these rules are ultimately adopted, in whole or in part, there are a number of compliance and operational challenges that must be addressed. The following are some examples:

- Regardless of whether the advice is delivered through a level fee or computer model arrangement, fiduciary advisers are required to acknowledge their fiduciary status to the participant. Broker-dealers that have been reluctant to do so in the past must decide whether to accept fiduciary responsibility, move their plans and IRAs to an advisory platform or refrain from providing advice

so as to avoid engaging in a prohibited transaction. In practice, avoiding giving advice may be difficult.

- Affected firms should begin by undertaking a review of their errors and omissions policies to ensure that the proffered method of advice delivery is covered and to determine whether there are any exclusions to providing advice as fiduciaries.
- We recommend implementing fiduciary-based training, which is specific to providing advice as fiduciary advisers. This should be aimed at both the producer and those conducting supervisory reviews of the advice arrangements.
- These firms should also begin to develop written agreements and create procedures to address the requirements of the exemption(s). In our experience, this will be more of a challenge for broker-dealers than RIA firms.
- RIAs should update their Form ADVs (or disclosure brochures) to explain how advice will be delivered to participants and to include the required disclosures.
- Because there is no equivalent document to the Form ADV Part II for broker-dealers, most firms will need to create the fiduciary adviser disclosure document from scratch. In our experience, we have found that creating these documents takes considerable time and effort to account for the receipt of indirect payments and revenue sharing arrangements and to develop policies and procedures to avoid the potential for conflicts of interest.
- With respect to the provision of advice under the statutory exemption, the final rules contain numerous requirements relating to information required to be elicited from participants and evaluated prior to rendering advice. It is important to note that these requirements differ from those set forth in the PPA as well as those contained in the proposed rules released in August 2008. Consequently, even those firms that have previously developed fiduciary adviser programs must now reconcile their agreements and disclosures to ensure that they are meeting the requirements of the final rules.

### Conclusion

We may or may not see the implementation of a final regulation exempting the provision of investment advice to participants in the immediate future. Even if a regulation is issued, it may take a form different from the final rules released in January. Nevertheless, in our view, the information contained in the final rules is valuable for risk management purposes to avoid legal problems that may arise from engaging in prohibited transactions. It is important to evaluate the extent to which your firm may be engaging in such activities and to take appropriate steps to mitigate these risks immediately. At a minimum, many of the requirements of the final rules establish a standard for best practices and should serve as a guide for complying with future regulatory action.

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