INVESTMENT ADVICE TO DEFINED CONTRIBUTION PLAN PARTICIPANTS- UPDATE ON IMPACT OF DEPARTMENT OF LABOR ADVISORY OPINION 2001-09A AND THE PENSION PROTECTION ACT OF 2006

Under Section 3 (21) (A) (ii) of ERISA, a "fiduciary" includes a person that renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of a retirement plan, or has any authority or responsibility to do so. Section 406 of ERISA and the Internal Revenue Code created transactions (prohibited transactions) that prohibit a fiduciary from using that authority or control to cause itself, or a party in which it has an interest to receive additional fees. Fiduciaries therefore, in the absence of a statutory or regulatory exemption, were prohibited from rendering advice to participants in defined contribution plans covered by ERISA regarding investments that might result in additional investment or other fees to the fiduciary or its affiliates.

While plan sponsors and participants acknowledged the need for investment advice at the participant level, the effect of these provisions was the blockage of any advice service by the more common providers of investment products and services to defined contribution plans. Investment product providers, mutual funds, banks and insurance companies could not provide investment advice to participants since it could result in the receipt of additional fees to themselves or to their investment affiliates. While government sponsored plans, such as Section 457 plans, are not subject to the provisions of ERISA many government plans conform to its provisions and more importantly the investment providers were not about to offer any advice product to this market segment which they could not offer to their larger ERISA segment. In addition, plan sponsors were concerned about their potential liability for any advice these services might give to plan participants. The net effect of these issues was the elimination of any effective broad based investment advice service to participants in defined contribution plans be they ERISA covered or not.

In 2001, the Department of Labor (DOL) issued an opinion, Advisory Opinion 2001-09A in which it concluded that the provision of investment advice under circumstances where the advice provided by the fiduciary with respect to investment funds that pay additional fees to the fiduciary is the result of methodologies developed, maintained and overseen by an independent financial expert would not result in a violation of the prohibited transactions of ERISA. In others words, a provider of investment products to participants in defined contribution plans could offer advice services to the participants that may result in additional fees to the provider as a result of such advice if the advice was based on methodologies developed, maintained and controlled by an independent third party. Under this opinion, numerous computer based software applications were created that allowed participants in defined contribution plans to obtain various levels of advice on web based tools. The products used an independent financial expert who would develop, maintain and control the algorithms and determine the fund line ups and the portfolio mixes. Generally there was a fee for the advice service that was split between the

independent financial expert and the fiduciary that would be the product provider or an affiliate of the investment provider.

The DOL Advisory Opinion opened the door to allowing record keepers and product providers to provide advice and managed accounts to their defined contribution plan clients. Under the conditions of the Opinion, the investment provider could offer an advice service, discretionary accounts or recommendations to their plans' participants for a fee without violating the prohibited transaction provisions of ERISA. Essentially, these providers could offer an advice product to participants as long as they used an independent financial expert who would develop and control the model asset portfolios.

As a result of the DOL Opinion, many providers of services to defined contribution plans have offered web based computer models advice services to their defined contribution plans. Initially these programs offered Guidance and Advice. Guidance provided tools and generalized information on asset classes, but did not offer specific recommendations on the plans' investment options. Advice was more specific and would tell the participant which plan investment options to invest in depending on their individual situation. As these products developed it was determined that many participants wanted a service that would manage the investments for them and not require ongoing actions on their part. The programs have developed to provide three levels of advice; Guidance, Advice and Managed Accounts. Managed Accounts was developed for the participant who wanted someone else to do it for them. Past experience with just advice had shown that the number of participants that would actually use the service was small. Using demographic data from the employer or the participant, the Managed Account creates a diversified portfolio and manages it during the participant's accumulation period. The DOL Opinion allowed providers to provide this service and also charge a fee for its use. However, providers were required to partner or use the services of an independent financial expert and that expert's engine to power the advice.

In the ERISA space, however, plan sponsors continued to have concerns over their potential liability or responsibility for the selection and monitoring of the advice provider. More importantly they were concerned with their potential liability for the advice provided to participants by the advice provider. Despite pronouncements from DOL that it encouraged and supported such advice services, plan sponsors continued to be reluctant to act.

In addition, some providers wanted to offer their own advice service without the need to employ an independent financial expert i.e. develop and provide their own internal advice product. They also wanted clarification as to the plan sponsor liability to reduce the plan sponsor reluctance to provide such service. The Pension Protection Act of 2006 ("PPA") allows that approach subject to conditions explained below. The PPA in Title VI provides an exemption to the prohibited transaction provisions of ERISA allowing advisors to participant directed account plans to provide investment advice to plan participants. The investment advice provided by the fiduciary must be provided under an "eligible investment advice arrangement" and must satisfy other requirements, including appropriate disclosure of the investment advice. An eligible investment advice

arrangement is an arrangement which either: (i) provides that fees for the investment advice do not vary depending on the basis of any investment option selected; or (ii) uses a computer model under an "investment advice program" as defined in the PPA.

The PPA ushers in yet another option for plan sponsors to provide advice to their plan participants defined as "eligible investment advice arrangements" as defined above. Under the one scenario, the advisor is paid a level fee regardless of the investment and as such, the advice qualifies as an eligible investment advice arrangement. This seems to contemplate individual advisors. Under the second scenario, it assumes the compensation is not level and therefore requires a computer model for determining the advice. The computer model must satisfy a number of conditions in order to qualify as an eligible investment advice arrangement. These are:

- Be built on recognized and accepted investment theories
- Use the investment options available in the plan
- Be unbiased with regards to any investment option or group of investment options
- Be certified under the rules created by the DOL (not defined as yet)
- Be accepted and approved by plan sponsors
- Be audited by an independent investment expert on an annual basis (determination of audit scope not defined as yet)

The Act also creates a new concept of a "fiduciary advisor" and in both the level compensation and computer model scenarios, the fiduciary advisor's compensation must be reasonable. Further the fiduciary advisor must disclose the amount and sources of its compensation and that it is acting as a fiduciary. An annual audit is also required for compliance with the Act and must provide each plan sponsor that is offering the advice service an annual compliance report.

Section 408(g) (10) of PPA requires plan sponsors to use due diligence in the selection and ongoing monitoring of the investment adviser. Subparagraph (B) of Section 408 (g) (10), however, makes clear that without regard to subparagraph (A), plan fiduciaries have a duty to prudently select and periodically monitor the advisory program. Subparagraph (B) further clarifies that plan fiduciaries have no duty to monitor the specific advice given by the fiduciary advisor to any participant.

As with any new legislation the law created additional questions which will need to be resolved. In addition, the passage of PPA raised the question of the status of the existing advice programs offered under the protection of the DOL Advisory Opinion 2001-09A. Many plan sponsors seemed to think that the only way to offer individual participant advice is to comply with the provisions of PPA. In fact, the majority of current service providers comply with the DOL Advisory Opinion and not PPA. At the current time many service providers have no intent to develop their own computer based advice service.

DOL Field Assistance Bulletin # 2007-01 addresses some of these issues. In this bulletin the DOL stated:

- The new provisions of PPA do not invalidate or otherwise affect prior guidance relating to investment advice and that guidance continues to represent the views of the DOL. In other words, Advisory Opinion 2001-9A in which the DOL determined that the provision of fiduciary investment advice, under circumstances where the advice provided by the fiduciary with respect to the investment funds that pay additional fees to the fiduciary is the result of the application of methodologies developed, maintained and overseen by a independent financial expert, will not result in a prohibited transaction.
- A plan sponsor or other fiduciary will not fail to meet the requirements of the prohibited transaction provisions of ERISA solely by reason of offering an advice program to participants that is not an eligible investment advice arrangement. "Thus, it is the view of the Department that a plan sponsor or other fiduciary that prudently selects and monitors an investment advice provider will not be liable for the advice furnished by such provider to the plan's participants and beneficiaries, whether or not that advice is provided pursuant to the statutory exemption under Section 408 (b) (14)." Further "…it is the view of the Department that, like fiduciaries offering exempted advice arrangements (eligible investment advice arrangements) fiduciaries offering programs of investment advice services with respect to which exemptive relief is not required (DOL Advisory Opinion 2001-9A) have no duty to monitor the specific investment advice given by the investment advice provider to any particular recipient of the advice.". In other words plan sponsors will receive the same exemption from advice under a service provider using either approach.
- Fiduciaries may use plan assets to pay reasonable expenses for providing advice to plan participants in both exempt arrangements and those which do not require statutory exemption.

Summary

Plan sponsors now have the ability to provide participants in their defined contribution plans an advisory service which will assist participants in the selection of investments within the plan. In addition, these services can provide Managed Accounts which will create diversified investment portfolios and rebalance them over the course of the participant's life. Furthermore the uncertainty of liability for the advice of this service on the part of plan sponsors appears to have been settled in a manner that should put plan sponsors fears to rest. Plan sponsors will not be liable for the advice to participants from properly selected service providers. Plan sponsors will need to prudently select or monitor the advice service providers in the same manner as is required when they select investment options for their plans.

Investment providers now have alternatives to provide advice to participants; (1) they can use an independent financial expert who will provide the methodology i.e. the DOL Advisory Opinion or (2) they can develop their own service or in house computer model but will need to comply with the disclosure and audit provisions of PPA. Plan sponsors can select the investment advisory service which is best for their

plan participants with less confusion whether it complies with the PPA or the DOL advisory Opinion.