Employee Benefits and Executive Compensation Advisory: 401(k) Plan Investments – New Proposed Regulations Relax Restrictions on Investment Advice to Participants

3/30/2010

On March 2, 2010, the Department of Labor published proposed regulations on the provision of investment advice to 401(k) plan participants. These regulations offer guidance and relief to plan sponsors who wish to assist plan participants with plan investment choices without triggering a prohibited transaction between the plan and the investment advice provider.

Background

Under the Employee Retirement Income Security Act of 1974 (ERISA), any person who delivers investment advice to a retirement plan for a fee is considered a fiduciary to that plan. Payments between a plan and a fiduciary are generally considered to be prohibited transactions under Section 406(a) of ERISA and Section 4975(c) of the Internal Revenue Code, unless an exemption is available. Historically, a lack of exemptive relief has limited the types of investment advice arrangements available to participants in 401(k) plans and Individual Retirement Accounts (IRAs).[1]

The Pension Protection Act of 2006 amended ERISA to expand the availability of investment advice to participants in 401(k) plans, subject to safeguards and conditions, by creating a new exemption from the prohibited transaction rules.

The Department of Labor first proposed regulations implementing the exemption in August 2008. A final rule and related class exemption were published in January 2009, but then withdrawn in November 2009 amid questions of conflicts of interest raised by the class exemption. The new proposed regulations withdraw the class exemption, and make certain changes to the statutory exemption to reflect comments of interested parties submitted during the regulatory process.

The regulations exempt two types of "eligible investment advice arrangements" provided by a "fiduciary adviser" from the prohibited transaction rules: arrangements that use fee-leveling, and arrangements that use computer modeling. A "fiduciary adviser" is defined as a person who provides investment advice to a plan for a fee, including:

- A person registered as an investment adviser
- A bank or similar financial institution or savings association subject to review by federal or state banking authorities
- An insurance company qualified to do business under the laws of a state
- A person registered as a broker or dealer
- An employee, agent, or registered representative of the above.

The definition of a fiduciary adviser also generally includes any person who develops a computer model or markets a computer model or investment advice program.

Fee-Leveling Arrangements

"Fee-leveling" arrangements are those in which the compensation to the investment adviser does not vary based on the investments selected by the participant. The regulations set forth the following requirements with respect to these arrangements:

- Investment advice must be based on generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time.
- The investment advice must take into account investment management and other fees attached to the recommended investments.
- A fiduciary adviser must request (and if furnished, take into account) participant information relating to age, "time horizons" (*e.g.*, life expectancy, retirement age), risk tolerance, current investments, other assets and income sources, and investment preferences. A fiduciary adviser may request and take into account additional information.
- No fiduciary adviser (including any employee, agent, or registered representative) that provides investment advice may receive from any party (including from an affiliate of the fiduciary adviser) any fee or other compensation based in whole or in part on the participant's selection of an investment option.

Computer Modeling Arrangements

A computer model will also be an "eligible investment advice arrangement" if the model:

- Is based on generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time.
- Takes into account investment management and other fees attached to the recommended investments.
- Requests (and if furnished, takes into account) participant information relating to age, "time horizons" (*e.g.,* life expectancy, retirement age), risk tolerance, current investments, other assets and income sources, and investment preferences. The model may also request and take into account additional information.
- Utilizes appropriate objective criteria to provide asset allocation portfolios comprised of investment options under the plan.

- Avoids recommendations that inappropriately favor investment options offered by a fiduciary adviser or affiliate, or that may inappropriately generate greater income for the fiduciary adviser or affiliate, or that inappropriately 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.
- Takes into account all investment options (other than brokerage or similar arrangements) available to participant directed accounts under the plan.
- Obtains a written, signed certification from an unaffiliated eligible investment expert that the computer model meets the above requirements. The certification must identify the methodology used by the expert to analyze the computer model, as well as any limitations to the methodology.

Additional Requirements

The proposed regulation sets forth certain additional requirements that apply to both types of arrangements, including:

- **Fiduciary Authorization.** The arrangement must be authorized by a plan fiduciary other than the person offering the arrangement, any person providing investment options (other than brokerage or similar arrangements) available to participant-directed accounts under the plan, or an affiliate of either. If the plan sponsor is also a fiduciary adviser, the arrangement may be offered to the plan's participants only if the same arrangement is offered to participants of unaffiliated plans in the ordinary course of business.
- **Annual Audit.** The fiduciary adviser must annually engage an independent auditor to review the arrangements and opine as to whether they comply with the regulations.
- **Disclosure.** The fiduciary adviser must provide certain specified information to plan participants, including the roles of any party that has a material affiliation with the fiduciary adviser in the development of the arrangement and selection of investment options; historical performance of the plan's investment options; all fees and compensation the fiduciary adviser is to receive in connection with the arrangement; affiliations of the fiduciary adviser in any security or other property; the manner in which any participant information will be used or disclosed; the types of services provided by the adviser under the arrangement; the fiduciary adviser's fiduciary role; and the participant's right to seek another investment advice arrangement. The disclosure must be provided prior to the advice, annually, at the time of any material changes, and upon request, and must in all cases be provided free of charge. The proposed regulation includes a model disclosure, the use of which is not mandatory.

Discussion

Stakeholders such as brokers and mutual fund companies have, over the course of this regulatory process, raised concerns about these new rules.

- *Broker compensation fallout*. The regulations make clear that brokers may not receive any fee or other compensation from any party based in whole or in part on the participant's selection of an investment option. However, an affiliate of a fiduciary

adviser may receive fees that vary by investment. This rule effectively kills any bonus-based compensation that may have been provided to a broker for his promotion and sale of investments, including cash, as well as trips and other rewards.
- *What are "generally accepted investment theories"*? Presumably, this term will be further defined in future regulation, but how will it be defined, and do regulators in the United States have sufficient financial expertise to determine which theories are "generally accepted?"
- *Performance data.* While computer models are required to take fees into account, they may not "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." In other words, investment advice will be focused on lower fees rather than past performance, skewing investors towards passively managed funds which may not necessarily be the best choices for a particular investor.

It is anticipated that these questions will be raised by commentators and addressed in the final regulations.

Request for Comments

The Department of Labor will accept comments to the proposed regulations on or before May 5, 2010.

Endnotes

[1] Note that the term "401(k)" plan is used broadly in this alert; these rules also apply to plans similar to 401(k) plans as well as to Individual Retirement Accounts.

For assistance in this area please contact one of the attorneys listed below or any member of your Mintz Levin client service team.

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