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LEGAL ALERT

March 1, 2010

Department of Labor Reproposes PPA Participant Investment Advice Regulation

On February 26, 2010, the U.S. Department of Labor (DOL) released its reproposed regulation implementing the ERISA exemptions for participant investment advice enacted in the Pension Protection Act of 2006 (PPA).

By way of background, the ERISA prohibited transaction rules generally bar investment advisers from providing advice to retirement plans and their participants, including IRAs, on investments that generate additional income for the adviser or its affiliates. This prohibition most particularly affects advisers affiliated with:

- Product manufacturers such as insurance companies and mutual fund complexes,
- Broker-dealers, and
- Retirement platform providers that receive indirect compensation from investment products.

That is to say, advisers affiliated with core product and service providers to retirement plans often have been prohibited by statute from providing investment advice to those plans.

As the trend toward self-directed accounts emerged, DOL issued guidance elucidating circumstances in which investment support for participants would not raise a prohibited transaction concern.

- Investment "education" is not, in DOL's judgment, investment "advice" and thus can be provided to participants without committing a prohibited transaction.[1]
- If properly structured, the investment advice function can be outsourced to an independent financial expert, as a means to avoid the prohibited transaction concern – generally referred to as the SunAmerica approach.[2]
- Similarly, reducing the amount due to the adviser for its services by the fees or other economic benefits accruing to the adviser or its affiliate by reason of the investment choices made under the plan — that is, enterprise-wide fee leveling — avoids the prohibited transaction concern.[3]

Also, certain class exemptions issued by DOL to provide relief for specific investment transactions at least arguably include relief for any investment advice leading to those transactions, including with respect to:

- Nonproprietary mutual funds (PTE 75-1),
- Proprietary insurance products and mutual funds (PTE 77-4 and PTE 84-24), and
- Transactions through broker-dealers (PTE 86-128).

Where prohibited transaction concerns were present, however, prior to the PPA there was no comprehensive ERISA solution for providing investment advice to participants. That regulatory gap (coupled with the incremental cost of investment advice) meant that no more than 10% of participants and IRA beneficiaries were making investment choices with the benefit of professional assistance.

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[1] Interpretive Bulletin 96-1, 29 CFR § 2509.96-1.
[2] Advisory Opinion 2001-09A (Dec. 14, 2001).
[3] Advisory Opinion 2005-10A (May 11, 2005); Advisory Opinion 97-15A (May 22, 1997).

Recognizing the importance to national retirement security of improving the quality of the investment choices made by plan participants and IRA beneficiaries, Congress undertook in the PPA to provide a comprehensive legal solution. Both the House and Senate versions of the bill contained an investment advice exemption that would allow advisers affiliated with core product and service providers, among others, to offer investment "advice" without enterprise-wide fee leveling; a more conditional exemption was included in the House bill, and a somewhat less conditional version in the Senate bill. The conference committee agreement generally favored the House version, which was enacted as § 601 of the PPA, and provides relief for advice provided:

- On a level-fee basis, or
- By a computer model driven by the adviser (rather than by an outside third party, as under the SunAmerica approach) and certified to be free of bias.

Those exemptions are subject to conditions and safeguards at least as stringent as any other exemption granted under ERISA.

In January 2009, during the final days of the Bush Administration, DOL finalized regulations both implementing those statutory exemptions and completing their logic by extending relief to:

- Advisers who, typically to comply with other regulatory requirements, are directly employed by (as distinguished from affiliated with) a product manufacturer or platform provider, under a modified level-fee exemption; and
- "Off model" advice, which allowed the adviser to continue to be responsive to the participant after the computer model-generated advice was delivered.

Early in the Obama Administration, DOL deferred, and ultimately on November 20, 2009, withdrew those regulations, with the announced intention of reproposing more limited relief.

Reproposed Regulation

The new proposed regulation, which was accompanied by a fact sheet and is to be published in the Federal Register on March 2, differs from the January 2009 regulation in at least the following respects:

1. As expected, DOL did not retain the modified level-fee and off-model advice exemptions. For better or worse, advisers will be required to find relief in the pre-PPA guidance or refrain from advising participants in the circumstances within the scope of that withdrawn relief.

2. The reproposal does not, however, back away from the position, embodied in both FAB 2007-1 and the January 2009 regulations, that the level-fee exemption permits affiliates of the adviser to receive income varying with the participant's investment choices, but not the individual adviser or the entity directly employing that adviser. The January 2009 regulations made it clear that incentive compensation or bonuses for the individual adviser reflecting the overall success of the employing entity, as opposed to the selection of particular investment options, may be permissible, depending on the details. In the new proposal, DOL added more language intended to emphasize that an affiliate may not provide any form of incentive (including commissions, salary, bonuses, awards, or promotions) to the adviser that turns on the participant's investment choices.

3. In describing the advice to be provided under either the level-fee or computer model exemption, DOL specified that the advice should take account of the historic risks of different asset classes as well as their returns – a clarification of a point at least implicit in and certainly understood under the January 2009 regulations.

4. In enumerating the details of the computer model advice program, DOL added in the proposal that the model may not "[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." That limitation is intended specifically to exclude consideration of historic rates of return of particular investment products. The preamble to the proposal invites commentary on the utility of historic rates of return, and raises a number of other provocative questions about "generally accepted investment theory" and practices.

> *Comment*: In this respect, DOL appears to be at least entertaining a departure from its historic approach to regulation under ERISA. In enacting ERISA in 1974, Congress did not take a "legal list" or other prescriptive approach to the regulation of plan investments; instead, it enunciated broad principles and relied on the standards of sound fiduciary and investment practice, as they evolved over time, to safeguard the interests of participants. For more than 30 years, DOL followed the lead of Congress in administering the statute, adopting for various regulatory purposes the broad principles of modern portfolio theory or "generally accepted investment theory" but avoiding any more granular direction of plan investments. DOL's first important departure from this approach was in its qualified default investment alternative (QDIA) regulations adopted in October 2007, in which it endorsed target date and balanced approaches as QDIAs and rejected stable value alternatives. Again for better or worse, a more directed regulation of plan investments has the consequences of (i) enshrining policy judgments deemed wise at a particular moment in time, and curtailing flexibility to adjust for evolving thinking and circumstances over time, and (ii) dictating winners and losers – under the participant advice proposal, perhaps index funds over actively managed funds – on a one-size-fits-all basis.

The reproposal does not disturb:

- Any guidance issued prior to the PPA, including SunAmerica; or
- The availability of the computer model exemption for IRAs.

The effective date of a final regulation is to be 60 days after publication in the Federal Register. Comments on the reproposed regulations are due May 5, 2010.

Middle Class Task Force Report

It may be instructive that the reproposed regulation was released in conjunction with the first annual report of the White House Task Force on the Middle Class. As previewed in January, the report gives significant attention to retirement security issues, including the Administration's budget proposals and regulatory agenda. It also speaks of a desire to provide low- and middle-income Americans with "access to well-diversified low-cost investment options" for their retirement savings, ideally in the form of options that are "free of inflation and market risk" and might even "guarantee a specified real return above the rate of inflation."

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If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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