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# Department of Labor Proposes New Rules on 401(k) Plan Investment Advice

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*On February 26, 2010, the Department of Labor (DOL) released new proposed regulations under the Employee Retirement Income Security Act (ERISA) relating to the provision of investment advice to participants and beneficiaries of participant-directed individual account plans such as 401(k) plans and IRAs. The new proposed regulations replace the final regulations that were issued in January, 2009, but then deferred and finally withdrawn in November in response to commenters' concerns that the administrative class exemption in the regulations might not adequately mitigate potential self-dealing by investment advisors. The DOL has addressed these concerns by excluding the class exemption from the new proposed regulations.*

Aside from the removal of the class exemption, some clarifications on the "level-fee" requirements described below, and a new condition relating to computer models, the new proposed regulations are substantially the same as the withdrawn final regulations. When finalized, the proposed regulations will implement the prohibited-transaction exemption for the provision of investment advice in ERISA sections 408(b)(14) and 408(g) that was enacted under the Pension Protection Act of 2006 (PPA).[1]

## Background

Absent an exemption, ERISA's and the Code's prohibited-transaction rules bar a fiduciary from rendering investment advice to plan participants on investments that result in additional fees to plan fiduciaries or their affiliates. The PPA added a new statutory exemption from the prohibited-transaction rules covering the provision of investment advice. Subject to certain safeguards and conditions, the new exemption was

[1] The PPA also added parallel provisions to sections 4975(d)(17) and 4975(f)(8) of the Internal Revenue Code of 1986, as amended (Code). Any references contained herein to sections 408(b)(14) and 408(g) of ERISA include corresponding references to sections 4975(d)(17) and 4975(f)(8) of the Code.

intended to expand the availability of investment advice to participants in 401(k) plans, IRAs and similar individual account plans that permit participants to direct the investment of their plan accounts.

On January 21, 2009, the DOL published final regulations implementing the statutory exemption for investment advice added by the PPA. The final regulations also contained an administrative class exemption expanding the prohibited-transaction relief to certain circumstances not covered by the statutory exemption. For example, the class exemption would have permitted individualized follow-up advice to participants who previously received generalized computer-generated advice or IRA participants who received investment education materials ("off-model advice"). More important to institutional advisers, the class exemption would have provided relief at the fiduciary-advisor-entity level, so long as the individual employee, agent, or registered representative providing the advice met the level fee requirements, even if the entity would receive varying fees based on participants' investment elections ("modified fee leveling").

The effective date of the 2009 final regulations was originally March 23, 2009, but, at the request of new administration, the DOL delayed the effective date of the regulation and reopened the notice and comment period. The DOL determined that the issues raised by the commenters, particularly with respect to the modified fee leveling, were indeed sufficient to cast doubt on the whether the class exemption's conditions were adequate to mitigate the potential for investment advisor self-dealing. Based on such determination, the DOL withdrew the 2009 final regulations on November 20, 2009.

## The New Proposed Regulations

The new proposed regulations replace the guidance contained in the 2009 final regulations, but are limited in scope to the implementation of the PPA statutory exemption for investment advice. The administrative class exemption that was included in the 2009 final regulation has been eliminated.[2]

The proposed regulation confirms that the PPA's addition of a statutory exemption for the provision of investment advice does not in any way impose an obligation on any plan fiduciary or other party to offer, provide or otherwise make investment advice available to any participant or beneficiary. For plan fiduciaries that want to provide such advice, however, the proposed regulation allows "eligible investment advice" to be provided under the ERISA statutory exemption in either of two ways: (1) through an advisor who is compensated on a "level fee" basis or (2) through the use of a computer model that is certified as unbiased.

### Level Fees

Under the "level fee" alternative, the fees or other compensation received by a fiduciary adviser (including any employee, agent or registered representative of the adviser) from another party (including an affiliate of the advisor) cannot vary based in whole or in part on a participant's selection of a particular investment option.[3] In addition, the investment advice provided must be based on generally accepted investment theories that, at a minimum, take into account each of the following factors:

2 In the preamble to the new proposed regulations, the DOL noted the statutory exemption does not provide prohibited-transaction relief for individualized "off-model" advice rendered to individuals who would have been covered by the withdrawn class exemption unless such advice on its own meets the requirements of the statutory exemption.

3 Both the 2009 final regulation and the new proposed regulations permit receipt of varying fees by an affiliate of a fiduciary adviser. However, in response to concerns raised by commenters that the 2009 final regulations created an economic incentive for the adviser to recommend investments that pay varying fees to its affiliates, the DOL clarified in the new proposed regulations that the fee-leveling requirements do not permit any compensation received by affiliates in connection with the adviser's recommendation to flow through to the adviser. See, also, DOL FAB 2007-1

- The historic risks and returns of different asset classes over defined periods of time;
- Investment management and other fees and expenses relating to the recommended investments;
- To the extent such information is furnished to the adviser, information relating to the participant's age, life expectancy, retirement age, risk tolerance, current investments, investment preferences and other sources of income.[4]

**Computer Models**

Under the "computer model" alternative, the investment advice must be generated by a computer model that meets the following requirements:

- The computer model must be designed and operated to—
  - Apply generally accepted investment theories that, at a minimum, take into account each of the three factors described above with respect to the level-fee alternative;
  - Use objective criteria to provide asset allocation portfolios of plan investment options;
  - Avoid investment recommendations that inappropriately (i) favor investment options offered by the adviser (or a person with a material affiliation or contractual relationship with the adviser) over other options available under the plan, (ii) favor investment options that may generate greater income to the adviser (or a person with a material affiliation or contractual relationship with the advisor) or (iii) distinguish among investment options in a single asset class based on a factor that cannot confidently be expected to last into the future;
    - The requirement to avoid investment recommendations based on factors that can't confidently be expected to last into the future is a new limitation that is intended to exclude consideration of historic rates of return of investments within the same asset class. Thus, while historic rates of return are required to be considered for purposes of allocating assets among the various asset classes, they cannot be considered for purposes of recommending particular investments within an asset class.
  - Take into account all available investment options under the plan without giving inappropriate weight to any option, although the model need not make recommendations regarding qualifying employer securities, target funds, guaranteed annuity options or self-directed brokerage accounts.
- Prior to the use of the model, the advisor must obtain a written certification from an "eligible investment expert" that the model meets the requirements of the regulation. For this purpose, an "eligible investment expert" is a person (other than a person with a material affiliation or contractual relationship with the adviser) who, through employees or otherwise, has the appropriate technical training or experience and proficiency to analyze, determine and certify whether the model meets the requirements.

[4] Although the new proposed regulations require the fiduciary adviser to request such information, the adviser must consider such information only to the extent that the plan, participant or beneficiary actually provides it. Also, the new proposed regulations permit the adviser to request and consider any additional information that it considers appropriate.

**Additional Requirements**

To qualify for exemption under either the level-fee or computer model alternatives, each of the following additional requirements must be satisfied:

- **Fiduciary Authorization.** The investment advice arrangement must be authorized by a plan fiduciary (or in the case of an IRA, the IRA beneficiary), other that the person offering the arrangement, a person providing any of the investment options offered under the plan, or an affiliate of either. For plans sponsored by the person offering the arrangement (or an affiliate of such person), the arrangement may be authorized by the plan sponsor, so long as the same arrangement is offered to unaffiliated plans in the ordinary course of its business.

- **Annual Audit.** At least annually, the fiduciary adviser must engage an independent auditor to conduct an audit of the arrangement's compliance with the requirements of the regulation and provide a written report to the fiduciary adviser and authorizing fiduciary within 60 days following completion of the audit. If the auditor's report identifies noncompliance with the regulations, the fiduciary adviser must submit a copy of the report to the DOL within 30 days after it receives the report.

- **Fiduciary Adviser Disclosures.** Before the initial provision of investment advice, the fiduciary adviser must provide to the participant or beneficiary, without charge, written notification of the following—

  - The role of any party that has a material affiliation or material contractual relationship with the fiduciary adviser in the development of the investment advice program, and in the selection of the options available under the plan;

  - The past performance and historical rates of return of the designated investment options under the plan if such information is not provided elsewhere;

  - All fees or other compensation the adviser or any of its affiliates will receive in connection with the provision of the advice or the participant acting on the advice;

  - Any material affiliation or material contractual relationship of the fiduciary adviser or its affiliates in the recommended securities;

  - The manner, and under what circumstances, participant information provided under the arrangement will be used or disclosed;

  - The types of services provided by the fiduciary adviser in connection with the provision of investment advice;

  - That the adviser is acting as a fiduciary of the plan in connection with the provision of the advice; and

  - That the recipient of the advice may separately arrange for the provision of advice by another adviser that has no material affiliation with and receives no fees or other compensation in connection with the security or other property.

The notice must be written in a clear and conspicuous manner, calculated to be understood by the average plan participant. The proposed regulation includes an optional model disclosure notice that fiduciary advisers can use to satisfy the notice requirement.

- **Other Conditions for Exemption.** The fiduciary adviser must also comply with all applicable disclosure requirements under the federal securities laws in connection with the sale, acquisition or holding of the security or other property, and any such sale, acquisition or holding of the security or other property must occur solely at the direction of the recipient of the advice. In addition, any compensation received by the fiduciary adviser and its affiliates in connection with the sale, acquisition or holding of the security or other property must be reasonable and the terms of the transaction must be at least as favorable to the plan as the plan would have obtained under an arm's length transaction.

- **Record Retention.** The fiduciary adviser must maintain records needed to determine compliance with the requirements for exemption for at least six years after the advice is provided.

## Effect on Other Guidance

Like its predecessor, the new proposed regulations keep intact all prior regulations (other than the withdrawn 2009 final regulations), exemptions, interpretive or other guidance issued by the DOL pertaining to the provision of investment advice and the circumstances under which such advice may or may not constitute a prohibited transaction under section 406 of ERISA or section 4975 of the Code. Thus, for example, an investment advice arrangement that fails to meet either the level-fee or computer model requirements of the new proposed regulations might still pass muster under prior DOL guidance, such as the DOL's SunAmerica letter.[5]

## What's Next?

Comments on the new proposed regulations are due on May 5, 2010. The DOL has specifically requested comments on the conditions applicable to investment advice provided under the computer model alternative, including without limitation responses to questions relating to—

- The identification and application of generally accepted investment theories and the investment practices associated with such theories;

- The historic data that should be taken into account in determining expectations for future performance, and the minimum standards for such data; and

- The appropriate criteria for asset allocation; and

- Whether and to what extent investment management style (i.e., active vs. passive management, should be taken into account.

The new proposed regulations will become effective 60 days after publication of the final regulations in the Federal Register.

[5] DOL Advisory Opinion 2001-09A, Dec. 14, 2001. (Providing, generally, that a plan fiduciary who provides investment advice under a computer model that is generated, maintained and overseen by an independent third party under the facts and representations contained in the submission does not engage in a prohibited transaction under section 406 of ERISA because the investment decisions or recommendations provided are not the result of the fiduciary's exercise of its authority, control or responsibility as a fiduciary).

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work or any of the members of the Executive Compensation & Benefits group.

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