

The Pension Protection Act of 2006: Investment Advice Provisions

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This bulletin analyzes the investment advice provisions of the Pension Protection Act of 2006 (PPA), both the good and the bad. Until the PPA, the prohibited transaction rules of ERISA (and the Internal Revenue Code) have limited the provision of investment advice to participants; it is this legal issue that the PPA seeks to resolve. Before analyzing the details, we'll look at the background to the new law. Then we'll briefly describe what the PPA provides and finally discuss the observations, concerns and questions we have about the new exemption.

BACKGROUND

Study after study has shown that, left to their own devices, many—perhaps most—participants in participant-directed plans, such as 401(k) and 403(b) plans, don't invest their accounts very well. The penalty for those participants is that they will not accumulate adequate retirement savings. Congress has been concerned about this issue, and after wrestling with it for several years, in the PPA, Congress has finally acted. The PPA encourages investment advice for participants by creating an exemption from the prohibited transaction provisions of ERISA and the Internal Revenue Code that have been perceived as an impediment to providing such advice.

To be clear, we should point out that, while the original legislative proposals would have offered some relief both for plan level advice (concerning the selection and monitoring of the investment options) and for participant-level advice, the new law addresses only advice to participants.

Before these changes in the law, the marketplace has addressed the problem of participant investing in various ways. One approach has been to encourage participants to use professionally designed or managed portfolios, such as managed accounts, risk-based lifestyle funds and age-based lifecycle funds. Another alternative has been to offer investment advice to participants, though up to now, both plan sponsors and advisers have perceived legal impediments to providing participant-level advice. Whether the PPA will have a significant impact on this remains to be seen.

In order to understand what the PPA does, it is important to understand the legal issues it seeks to address.

PRE-PPA LAW

The legal issue addressed by the new provisions arises under the prohibited transaction rules. These rules prohibit fiduciaries from engaging in conflicts of interest, such as where a fiduciary uses its authority or influence to profit from the use of plan assets, e.g., to increase its compensation. This conflict can exist at the provider level and at the adviser level.

For example, if a broker, broker/dealer or RIA (which we refer to generically as "financial advisers") gives investment advice to participants about the allocation of their accounts, they are considered fiduciaries under ERISA. (Investment advice for this purpose exists where the advice relates to the purchase, holding or sale of investments, forms the primary basis for making investment decisions and is individualized and based on the particular needs of the participant.)

A prohibited transaction would occur, for example, if a financial adviser in this situation, who is receiving commissions or 12b-1 fees, were to give fiduciary investment advice to a participant to sell one mutual fund, on which the broker receives 25 basis points, and purchase another fund, on which he receives 30 basis points. Effectively, the financial adviser causes himself to receive greater compensation because of the advice he gives – and this is prohibited.

Similarly, the problem exists if an investment provider — say, a mutual fund complex — gives fiduciary investment advice. The management fees in its funds will almost certainly vary (as will the revenue sharing it receives from unrelated mutual funds), so a prohibited transaction would occur because its advice can impact the money it makes.

So what is the "solution" offered by PPA?

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THE PPA ADVICE PROVISIONS

To summarize (the rules are more extensive than we have room to outline here):

- Under the new law, there are two situations in which a fiduciary adviser will not engage in a prohibited transaction if it gives investment advice to participants:
 1. the adviser's compensation is "level" – that is, the amount the adviser receives for giving the advice remains the same no matter what advice is given and how the participant invests his account; or *alternatively*
 2. the advice is given through a computer model, in which case, the compensation does not have to be level.
 - To qualify for either of those exemptions, the adviser must satisfy a number of requirements.
 - The PPA also creates a new concept of a "fiduciary adviser," which includes registered investment advisors, banks, insurance companies, broker/dealers, registered representatives of a broker/dealer, employees and affiliates of any of these entities.
 - For the *computer model* case, the following conditions apply:
 - The model must:
 - apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
 - utilize relevant information about the participant, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income and preferences as to certain types of investments;
 - utilize prescribed objective criteria to provide asset allocation portfolios comprised of investment options available under the plan;
 - operate in a manner that is not biased in favor of investments offered by the fiduciary adviser or a person with a "material affiliation or contractual relationship with the fiduciary adviser;" and
 - take into account all investment options under the plan and specifying how a participant's account balance should be invested and is not inappropriately weighted with respect to any investment option.
 - The model must be certified as satisfying those rules (as well as others, that may be imposed by the Department of Labor) by an investment expert who is independent of the entity that is using the model to offer the advice.
 - The advice must be given exclusively through the model. By "exclusively," the PPA means that all advice delivered to a participant, whether, *e.g.*, delivered over the telephone or in a face-to-face meeting, must be based only on the results produced by the model, unless the participant requests other advice and it can be shown that this request was unsolicited by the adviser. More on this issue later.
- Note that the entity that develops the computer model or markets an investment advice program or computer model is also considered a fiduciary.
- In *both* cases – i.e., in both the level compensation and the computer model scenarios – there are additional conditions that apply. The most important of those provisions are:
 - The compensation received by the fiduciary adviser and its affiliates must be reasonable, whether level or variable.
 - The provision of advice to participants must be approved by a plan fiduciary other than the fiduciary adviser or one of its affiliates (presumably, this would typically be the plan sponsor).
 - The adviser must make certain disclosures to the participants, including the amount and sources of its (and any affiliate's) compensation and the fact that it is acting as a fiduciary.
 - The adviser must be "audited" annually for compliance with the PPA requirements and must annually provide a compliance report to each plan sponsor that is offering the advisory services to its participants.
 - The actual implementation of investment decisions based on the advice (buying, selling or holding securities) must be solely at the direction of the participant. *Comment:* In light of this requirement, the PPA does not cover investment management (that is, where the adviser has discretion to implement its investment decisions).
 - The plan sponsor or another independent fiduciary must prudently select and monitor the fiduciary adviser, but so long as all the conditions of the exemption are satisfied (and the terms of the arrangement require compliance with the exemption, including acknowledgment of fiduciary status), it has no duty to monitor the advice given to the participants. In other words, the plan sponsor has no responsibility or liability under ERISA for the advice given. *Comment:* It is not entirely clear that this "exemption" (the term used in the PPA) was necessary. Some lawyers believe that, even under the prior law, the plan sponsor was not responsible for the advice given to participants so long as it prudently selected and monitored the adviser. Others reached the opposite conclusion, but the PPA now provides a definitive answer.

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OBSERVATIONS, CONCERNS AND QUESTIONS

We have a number of concerns and observations about the new law:

The Need to Comply. The most obvious observation is that the law creates an exemption for a situation that does not appear to be a prohibited transaction. As described above, ERISA says that a fiduciary cannot use its authority to influence the amount of its compensation. But if its compensation is already level, that is, the same regardless of the advice given, there is no prohibited transaction. So if a fiduciary adviser's compensation is already level (for example, in the typical RIA scenario), why do we need a somewhat elaborate set of rules – including an expensive audit requirement that may increase the cost of participant advice – for obtaining an exemption for a non-prohibited transaction?

The receipt of level compensation by an investment adviser does not violate the ERISA conflict-of-interest prohibition. Since there is no prohibited transaction, no exemption is needed. (This rationale would not apply in the computer model situation – unless the fiduciary adviser's compensation were level.) Thus, presumably, an adviser that is already receiving level compensation could continue to act without satisfying the new requirements.

Well, maybe not. First, there appear to be greater protections for the plan sponsor if the adviser complies with the new rules. That is, under the PPA, it is now clear, in a complying arrangement, that the plan sponsor is not responsible for the advice given by a fiduciary adviser to the participants. The PPA also states that the plan sponsor will not be considered to have breached a duty under ERISA by offering participant-level investment advice. In both cases, these protections are conditioned on compliance with the new requirements. As a result, we may see plan sponsors demanding this “safe harbor” relief, which could effectively force advisers to comply with new requirements, even if their compensation is level.

And whether or not plan sponsors demand it, fiduciary advisers wishing to provide the greatest protection for their clients will take steps to comply. Finally, it also seems likely that the requirements of the exemption will become the industry “norm.” So for competitive reasons, advisers may need to comply even though no prohibited transactions exist.

We believe that most level fee advisers will opt to comply. Indeed, several level fee advisory firms have already contacted us about developing their agreements and procedures for compliance.

Note: ERISA already provides protections comparable or superior to those provided under the new PPA provisions for investment management. Under ERISA Section 3(38), an investment manager is defined as an RIA, bank or insurance company that is given discretion over plan asset

investment decisions and agrees in writing that it is a fiduciary. If the plan appoints an investment manager – at either the plan or participant level – the plan sponsor is not responsible for the manager's investment decisions, though it is required to prudently select and monitor the investment manager. These requirements look a lot like the PPA requirements for participant level investment advice with a major difference. Where the manager's compensation is level, there is no prohibited transaction under ERISA, so there is no need for compliance with the PPA requirements. And, as noted, the plan sponsor receives at least the same level of protection as provided under the new law.

Compliance Burdens. Why would an adviser object to complying? There are a number of reasons:

- The requirement that the adviser acknowledge in writing that it is a fiduciary could prevent some financial advisers in the computer model situation from taking advantage of the exemption because their broker-dealer firms will not permit them to make this acknowledgment. However, we understand that some broker-dealers permit their registered representatives to give this acknowledgment, where level fee arrangements (such as wrap accounts) can be structured. We also understand that some broker-dealers are considering the computer model approach, as are some of the mutual fund complexes. It remains to be seen if the wirehouses will do so.
- The PPA provides an exemption for: (i) the provision of investment advice to participants; (ii) the purchase, sale or holding of securities based on that advice; and (iii) the receipt of compensation by the fiduciary adviser or any affiliate of the adviser. However, in the level compensation situation, the PPA only requires that the compensation received by the fiduciary adviser, and not that received by his affiliates, be level (though the disclosure requirements do include the compensation of both the adviser and its affiliates). But this is one of the areas where the PPA is poorly drafted. That is, it is not entirely clear whether this is a distinction that Congress meant, *i.e.*, whether the compensation of the affiliates must be disclosed but only the compensation of the fiduciary adviser must be level. Our reading of the statute indicates that this is the case, but others have expressed concern about a possible ambiguity in the law.

Assuming this distinction is intended, the issue of who the fiduciary adviser in this context is extremely important, but it is not entirely clear. Is it the individual who gives the advice or his firm? Presumably, if the individual is an employee of a firm, the firm is the adviser, so its compensation related to the advice must be level.

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However, that is not clearly stated in the law. And, if the firm “controls” the individual on what advice to give, the fiduciary adviser would also seem to be the firm. Again, it is not clear. As a result, deciding exactly who the fiduciary adviser is – and therefore whose compensation must be level – could be problematic.

- The computer model approach may be viewed as too restrictive because of the exclusivity requirement. That is, if a financial adviser is meeting with a participant who wants advice, the adviser will be limited to providing the advice generated by the computer model and the adviser would not be able to offer individualized advice outside the model. However, there is an exception if the participant asks for additional advice and it can be shown that he was not solicited to do so. Even here, there could be a problem in showing that the request wasn’t solicited. For example, where only one out of a hundred participants requests other advice, it suggests that the adviser was not soliciting the participants for non-computer model advice. But if a substantial number of participants request additional advice, it could support a conclusion that the participants were being solicited. Of course, all of this begs the question . . . what does solicitation mean in this context? Hopefully, DOL guidance will clear up the picture. Further, while we read the law to say that the additional advice is not required to be based on the model and that the consultant can deviate from the model, we hope that the DOL will also make that clear.
- Perhaps the biggest impediment in both the level compensation and computer model situations is the burden and expense of an annual audit by an independent, qualified third party. While the law is reasonably clear on what has to be audited, it is not entirely clear on how the audit is to be conducted. The PPA says that the auditor

must verify whether the adviser has complied with the conditions of the exemption, which would cover such things as whether: the fiduciary adviser is one of the approved types of entities; the arrangement has been approved by an independent fiduciary; the proper disclosures are being given to the participants; the adviser’s fees are level (where the adviser is operating under that exemption); or whether the advice is given exclusively by the computer model and, if not, whether the participants were solicited to ask for additional advice.

But is the term “audit” to have the same meaning as an accounting audit? Can the “auditor” reach conclusions as an accountant does through statistical sampling...or is something more extensive required? And does the audit relate to the conduct of the adviser generally or must it be done on a client by client basis – *i.e.*, must the report given to the individual plan sponsor relate to how well the adviser met the requirements with respect to that plan or does it look only at his overall compliance? We assume the DOL will issue guidance on this subject to reduce the confusion. In any case, this requirement will add a level of expense that will either be passed on to the participants or will be absorbed by the advisers with deeper pockets.

CONCLUSION

The investment advice provisions of PPA address a real need, but there are some significant holes in the law and some conditions that at this stage are unclear or may be unduly burdensome for advisers (other than larger level-fee advisory firms that focus on participant-level advice) and providers (other, perhaps, than the larger providers with affiliated mutual funds). We hope that DOL guidance will be forthcoming in the near future to clarify some of the key issues in the new law.

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