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SUMMARY OF INVESTMENT ADVICE LEGISLATIVE ISSUES

There has been considerable recent legislative interest in issues related to the provision of investment advice to plans and plan participants, triggered in large part by a bill passed by the House Education and Labor Committee (H.R. 2989). This memorandum provides background for legislators to consider with respect to the investment advice issues that have been raised. Specifically, this memorandum summarizes:

- The investment advice rules in effect prior to the Pension Protection Act of 2006 (the "PPA"), including the "SunAmerica" computer model and the pre-PPA level-fee rule.
- The PPA level-fee rule.
- The level-fee rule contained in the class exemption issued by the Department of Labor ("DOL") that is not yet effective ("2009 class exemption").
- The PPA computer model rule.
- The special computer model rule contained in the 2009 class exemption.
- The investment advice bill passed by the House Education and Labor Committee.
- The public policy issues and alternatives.

This memorandum applauds the important objectives of the House Education and Labor Committee: to improve the quality of investment advice and to eliminate harmful conflicts of interest. However, as discussed below, the bill passed by the Committee seems to go further than that, invalidating many existing non-conflicted advice arrangements as well. The purpose of this memorandum is to facilitate a public policy discussion that can lead to refinements of the bill to conform to the important objectives of the Committee.

In brief, the Committee's focus was on the PPA investment advice provision and the 2009 class exemption. It is these rules that some have characterized as permitting conflicted advice. Accordingly, the public policy debate should focus on whether those rules should be maintained or repealed. But non-conflicted existing arrangements that were permitted under pre-PPA law should not be invalidated.

Prior to the Pension Protection Act

Prior to the PPA, the prohibited transaction rules generally prohibited any provision of investment advice where the advisor could benefit based on the advice given. The only exception to this rule was for class and individual exemptions granted by the DOL, where the DOL had specifically determined that an advice arrangement had enough safeguards in place to remove or substantially diminish any real or potential conflict, so that the use of such arrangement was in the best interests of the participants.

Prior to the PPA, it was clear that certain advice arrangements did not involve any conflict of interest and thus did not violate the prohibited transaction rules. For example, many advice arrangements relied on a DOL Advisory Opinion generally referred to as “SunAmerica”. Under SunAmerica, generally a plan advisor, which may be a financial institution, arranges for advice to be given to participants based solely on a computer model designed and exclusively controlled by an independent third party. The advisory opinion articulates a very specific and objective rule for determining whether the third party is truly independent. Because all advice is provided pursuant to an independently designed computer model, and because that advice cannot be modified by the plan advisor, the advice is not conflicted.

Another example of non-conflicted advice is advice given by an advisor that receives the same compensation regardless of which investment option is chosen (the “pre-PPA level fee rule”). This rule was very strictly applied before the PPA. So, for example, if advice is given by an employee of a financial institution, the investment option chosen cannot affect the compensation received by the employee, the financial institution, *or any affiliate of the financial institution*.

Both of these examples—SunAmerica and pre-PPA level-fee arrangements—reflect conscious efforts to design a non-conflicted advisory platform. In addition, both types of arrangements can permit the offering of both traditional advice (whereby a participant decides whether to implement each piece of advice) and managed accounts (whereby the advice is automatically implemented pursuant to prior authorization by the participant). With respect to SunAmerica, managed accounts represent a significant portion of the advice provided in the marketplace.

The PPA Level-Fee Rule and the Class Exemption Level-Fee Rule

The PPA created two exceptions to the prohibited transaction rules described above, solely for use with traditional advice (i.e., they are not available for managed accounts). Under the first exception, the PPA created a new version of the level-fee rule. Under the “PPA level-fee rule”, investment advice to a participant is permitted as long as the investment options chosen cannot affect the compensation of (1) the advisor giving the advice or (2) the entity employing the advisor. However, unlike the pre-PPA

level-fee rule, the PPA level-fee rule permits variation in the compensation of an affiliate of that entity. So, for example, if an entity provides investment advice to plan participants, it would be permissible for a recordkeeping affiliate of the entity to receive different levels of revenue sharing based on which investment option is chosen. The rationale for the PPA level-fee rule was that if the actual providers of the advice are not operating under a conflict of interest, the advice rendered will not be biased. In addition, as a condition of the PPA level-fee rule, the PPA requires annual audits and extensive disclosures to the participants regarding the benefits potentially received by the affiliate.

The DOL took an additional step in the 2009 class exemption (issued in January of 2009), the effective date of which has been delayed. Under the “class exemption level-fee rule”, investment advice to a participant is permitted as long as the investment options chosen cannot affect the compensation of the advisor giving the advice. The compensation of the advisor’s employer or such employer’s affiliate may, however, vary based on the investment option chosen. The rationale for the 2009 class exemption is as follows: if the compensation of the advisor who is actually providing the advice is unaffected by which investment option is chosen, the advice will be impartial. Also, as under the PPA level-fee rule, annual audits and extensive disclosures would be required regarding the extent to which the advisor’s employer or its affiliates benefit from the selection of different investment options.

The PPA Computer Model Rule and the Class Exemption Off-Model Rule

Under the second rule enacted in the PPA, a financial institution may design its own computer model to provide investment advice to participants even if such financial institution may benefit based on the investment options chosen. This is different from SunAmerica where the computer model must be developed by an independent third party. However, under the PPA computer model, an independent third-party expert must certify that the financial institution’s computer model is valid and unbiased. The PPA computer model also includes a number of requirements not applicable to SunAmerica, such as (1) an annual audit by an independent expert (in lieu of control of the model by such an independent expert), (2) a requirement that the computer model take into account all investment options under the plan, and (3) a rule limiting its application to non-managed accounts. The PPA computer model is also subject to the extensive disclosure requirements referenced above, so that participants understand the benefits derived by the developer of the computer model.

The 2009 class exemption takes the computer model rules a step further. Under the 2009 class exemption, the financial institution that developed the computer model may also provide advice separate from the computer model, as long as the basis for that advice is explained to the participant and the extensive disclosures referenced above are provided. The rationale for the “class exemption off-model rule” is as follows. If a participant receives (1) the computer model recommendations as a reference point, (2)

an explanation of the basis for the different advice, and (3) disclosures explaining how the advisor may benefit from the different advice, the participant has the tools to evaluate the merits of the different advice. This class exemption would also generally permit off-model advice with respect to SunAmerica.

To our knowledge, there has been very little use of the PPA computer model rule (and, of course, no use of the 2009 class exemption since it is not yet effective). The PPA computer model, with its extensive requirements, including annual audits, is much more expensive to administer than SunAmerica.

House Education and Labor Committee Bill

The House Education and Labor Committee has recently passed a bill that is structured as follows. First, the bill repeals the PPA investment advice provision with respect to ERISA plans (but not with respect to IRAs or non-ERISA plans). But the bill then goes further. The bill provides new rules under which there are only two permitted methods of providing investment advice to participants or to a plan. (As discussed further below, advice to a plan was not addressed by the PPA provisions or by SunAmerica.) One method is very similar to the PPA computer model method, except that it adds additional requirements as a condition of using such approach (“bill computer model rule”).

The second method is more complicated. Generally, under the second method, the advice provider (1) must be registered as an investment adviser under the Investment Advisers Act of 1940, (2) must not be the “plan investment provider”, (3) must satisfy the pre-PPA level fee rule, (4) must be a fiduciary with respect to the plan, and (5) must satisfy other requirements, including disclosure of potential indirect benefits related to the advice (“bill level-fee plus rule”). The definition of a “plan investment provider” is not clear. The definition can be read to include any financial institution that creates or manages any investment product in which any defined contribution plan invests, which would generally preclude use of this method by the vast majority of financial institutions. The definition can also be read to only include a financial institution that creates or manages any investment product in which the defined contribution plan receiving the advice invests. Even this narrower reading would invalidate many non-conflicted arrangements satisfying the pre-PPA level-fee rule.

The bill would have some unfortunate effects, as discussed below. The purpose of the discussion below is not to criticize the bill or the Committee. The Committee set out with important goals: to improve the quality of investment advice and to eliminate conflicted advice that is harmful. However, in doing so, it appears that the Committee bill may have gone further than necessary to achieve its original intended objective. The purpose of this memorandum is to lay out the legal and policy issues so as to

facilitate ongoing dialogue and refinement of the bill as the legislative process moves forward.

Repeal of the PPA rule: With respect to ERISA plans, the bill would repeal the PPA investment advice provision (i.e., both the PPA level-fee rule and the PPA computer model rule). Even though technically the bill only repeals the ERISA part of the PPA provision, the effect is generally the same as full repeal. Although the PPA provision would remain in the Internal Revenue Code, an ERISA plan must satisfy both the Code and ERISA, so the absence of an ERISA exemption renders the Code exemption ineffective for ERISA plans.

Elimination of most SunAmerica arrangements: SunAmerica arrangements generally do not satisfy the PPA computer model rules, which were designed to address advice developed by entities also offering investment products in the plan. For example, SunAmerica arrangements do not have annual audits, do not need to be certified by an independent expert (since the advice is developed by an independent expert), sometimes only take into account a subset of plan options, and do not need to satisfy several of the other extensive PPA computer model rules. To comply with the PPA computer model rules would be quite expensive, an expense that plan sponsors have informally indicated that they would be unlikely to incur. More importantly, since SunAmerica provides non-conflicted advice developed by an independent third party, the extra expense is not justified by any corresponding benefit to employees.

Some SunAmerica arrangements can use the bill level-fee plus rule. In some SunAmerica arrangements, the developer of the computer model contracts directly with the plan and accepts fiduciary status. Those arrangements can satisfy the bill level-fee plus rule. However, it is our understanding that in most cases, the developer of the computer model will not accept fiduciary status without significant additional compensation; also, in some cases, the developer may simply not be structured to take on fiduciary duties and liabilities. So the financial institution offering plan investment options is the fiduciary, and as such, contracts with the developer of the computer model. Those arrangements, which were clearly permissible under pre-PPA law and do not involve conflicted advice, would not satisfy either the bill level-fee plus rule or the bill computer model rule and thus would be invalidated by the bill.

Elimination of most managed accounts: Many in the advice industry believe that the most effective means of providing advice is through managed accounts, whereby advice is automatically implemented pursuant to a participant's prior authorization. Where it is up to the participant to obtain advice and to implement the advice that is provided, both the utilization rates generally, and the implementation rates for those who actually utilize the advisory service, are often quite low.

Most managed accounts are based on SunAmerica. Although there is some technical lack of clarity, it appears that the bill would prohibit all managed accounts

unless the developer of the computer model satisfies the bill level-fee plus rule by accepting fiduciary status (and not providing investment products). This is true since the bill computer model rule explicitly prohibits managed accounts.

Elimination of many pre-PPA level-fee arrangements: The bill would invalidate many arrangements where the advice satisfies the pre-PPA level-fee rule. In other words, the bill would invalidate many arrangements under which the investment options chosen cannot affect the compensation of the advisor, the advisor's employer, or any affiliate of that employer. How many such arrangements would be invalidated would depend on how the definition of plan investment adviser is interpreted. But in any case, many such arrangements would be invalidated.

Elimination of all (or substantially all) class and individual exemptions: All (or substantially all) existing DOL class and individual exemptions with respect to investment advice would be repealed since they would not fit within the bill's two rules. Moreover, the DOL's authority to grant any future class or individual exemptions with respect to investment advice would appear to be effectively repealed.

Elimination of most plan-level advice: The PPA provision was limited to advice provided to participants. However, the bill goes further and very significantly limits advice that may be given to a plan. For example, in certain situations, an advisor may be asked to provide advice to a plan sponsor (especially small businesses) regarding which of a plan provider's large menu of investment options should be offered to participants.

Guidance regarding which investment options should be offered to participants cannot be given through a computer program, so under the bill, investment advice to a plan can only be given under the bill level-fee plus rule. If the plan investment provider definition is read expansively to preclude the use of the bill level-fee plus rule by a financial institution providing financial products to any plan in the country, virtually all financial institutions would be precluded from providing advice to a plan, regardless of whether such advice is conflicted.

The area of advice to plans is not one that has been the subject of almost any public policy debate, and certainly has not been the subject of any hearings, either during consideration of the PPA or now. In the absence of any discussion, the bill's very significant restrictions on non-conflicted advice to plans are of concern.

Elimination of many sources of non-conflicted advice: The bill would prohibit many regulated entities, such as banks, from providing non-conflicted, non-computer model advice, even if the entity would otherwise satisfy the pre-PPA level fee rule and the bill level-fee plus rule. This prohibition would apply because the entity is not registered as an investment adviser under Investment Advisers Act of 1940, but is regulated under a different set of rules.

Public Policy

The Committee clearly did not set out to invalidate the majority of existing advice arrangements regardless of whether such arrangements involve harmful conflicts of interest. However, that is what the Committee bill would do. This would have a huge effect on participants. Employers are not required to offer investment advice programs and, in this economic climate, there are few employers able to absorb new costs and burdens attributable to a purely voluntary program that is currently working well to provide helpful, non-conflicted advice. Accordingly, informal indications from plan sponsors are that the imposition of new costs and burdens would result in the termination of these helpful, non-conflicted advice arrangements, not expensive redesigns. At the same time, employees need advice with appropriate safeguards now more than ever; we should be encouraging not discouraging such programs.

The impetus for the Committee's actions appears to have been the PPA investment advice provision and the 2009 class exemption. These are the rules that have been described by some as permitting conflicted advice. In this context, the public policy debate should be focused on whether to retain the PPA provision and the 2009 class exemption. The intent of the PPA investment advice provision was worthy: to broaden the availability of investment advice to participants very much in need of advice. However, if a decision is made that the PPA provisions and the class exemption provide insufficient protection against conflicts of interest, an appropriate response would be to repeal the PPA provisions and to direct DOL to withdraw the class exemption. But there is no reason to do more than that.

To summarize, the following should be preserved, not prohibited:

- SunAmerica advice, which is based on a computer model developed by an independent third party and thus is clearly not conflicted.
- Advice satisfying the pre-PPA level-fee rule, which is by definition non-conflicted.
- Non-conflicted managed accounts, which should be promoted as an effective means of providing advice.
- DOL class and individual exemptions. If DOL would like to reexamine any class or individual exemption, it has the power to do so. Invalidation of all such exemptions without careful review is not appropriate.
- Non-conflicted advice to a plan, which was not addressed by the PPA or the 2009 class exemption, and should not be limited today.

In short, we believe that a vibrant public policy discussion will result in legislation that addresses the very important objectives of the Committee without invalidating most existing advice arrangements where no concerns about conflicts apply.