



# AMERICAN BENEFITS COUNCIL

March 1, 2010

## SUMMARY OF INVESTMENT ADVICE REGULATIONS COURTESY OF DAVIS & HARMAN, LLP

On February 26, the Department of Labor released proposed regulations on the provision of investment advice to participants in individual account plans, such as 401(k) plans, and to owners of IRAs. The regulations interpret the statutory prohibited transaction exemptions in ERISA and the Internal Revenue Code that were enacted as part of the Pension Protection Act of 2006 (the “PPA”). The proposed regulations were announced as part of the White House Middle Class Task Force’s year-end report.

### **Background**

The prohibited transaction provisions of ERISA and the Internal Revenue Code generally prohibit an investment adviser from recommending an investment that may cause the adviser, or any person in which it has a material interest, to receive additional compensation. The prohibited transaction rules apply to investment advice provided to participants in ERISA-covered individual account plans as well as advice provided to IRA owners.

There are a number of different administrative prohibited transaction exemptions that potentially permit an investment adviser (or a party in which it has an interest) to receive variable compensation. There are also investment advice programs that are designed to satisfy the prohibited transaction rules. The most prominent of these programs is often referred to as a “SunAmerica Program,” after DOL Advisory Opinion 2001-09A issued to SunAmerica, which involves the use of a computer model developed by an independent third-party to provide investment advice.

The PPA amended both ERISA and the Code to add a statutory exemption relating to the provision of investment advice through an “eligible investment advice arrangement.” An eligible investment advice arrangement is an arrangement that either provides that any fees received by the adviser do not vary based on any

investment selected (the “fee-leveling exemption”) or uses a computer model certified by an independent third-party as unbiased (the “computer model exemption”). The computer model exemption differs from a SunAmerica program in that the model may be developed by the adviser, rather than an independent third-party. There are a number of requirements that apply to both exemptions, including disclosure requirements intended to highlight potential conflicts of interest and a requirement that a plan fiduciary or IRA owner expressly authorize the advice.

The Bush Administration finalized regulations interpreting the PPA’s investment advice exemptions and issued an additional class exemption in January 2009. The Department of Labor under the Obama Administration delayed the effective date of, and ultimately withdrew, the regulations and the class exemption. Today’s proposed regulations replace the withdrawn final regulations and exemption.

### **Existing Exemptions and Programs**

The regulations confirm that the statutory PPA investment advice exemptions do not disturb either the existing administrative exemptions covering investment advice or current programs that comply with the prohibited transaction rules, such as SunAmerica programs.

### **Fee-Leveling Exemption**

The proposed regulations would define fee-leveling to provide that the adviser, including any employee, agent, or registered representative of the adviser, cannot receive, directly or indirectly, any fee or other compensation that varies based in whole or in part on a participant’s selection of an investment. Thus, the primary relief provided by the proposed regulations would be to permit an affiliate of the adviser, or other person in which the fiduciary adviser has a material interest, to receive compensation that varies as a result of the adviser’s advice.

The interpretation in the proposed regulations is narrower than the approach taken in the Bush Administration class exemption, which would have permitted the adviser to receive variable compensation so long as the individual who provides the advice did not receive variable compensation (sometimes described as fee-leveling at the individual level). The regulations emphasize that the adviser (including its employees, agents or registered representatives) cannot receive any compensation or fees from an affiliate that benefits from the advice as a result of the adviser’s recommendations.

## **Computer Model Exemption**

The regulations also reject the approach taken in the Bush Administration class exemption to so-called "off-model advice," which would have allowed an adviser to provide individualized advice if a person asked for more advice after receiving the computer model advice or, in the IRA context, investment education material. The off-model advice rule was significant to IRAs in particular because the computer model exemption is very difficult to use in the IRA context since the exemption generally requires that all available investment options be taken into account by the model. The Obama Department of Labor, however, concluded that the potential conflicts of interest were too great. As a result, the proposed regulations would permit off-model advice only to the extent the advice separately satisfies the prohibited transaction rules.

## **New Computer Model Rule**

The proposed regulations include a new limitation on the computer model exemption by providing that a model must avoid investment recommendations within an asset class on the basis of a factor that cannot confidently be expected to persist in the future. The preamble suggests that this limitation is intended to draw attention to the fact that certain fund attributes, like lower fees, can be expected to persist in the future, while other attributes, such as historical performance, are "less likely to persist and therefore less likely to constitute appropriate criteria for asset allocation."

This proposed rule can be expected to raise significant discussion and concerns. For example, if a computer model does not systematically favor passive investments with lower fees, that will have to be justified based on "confidence" that historically good performance from actively managed funds will persist. Such confidence may be difficult to attain. Accordingly, the regulations appear to tilt the playing field to some extent toward passive investing.

## **Generally Accepted Investment Theories**

Advice under either exemption must be based on generally accepted investment theories. To date, such theories have not been defined. But the preamble devotes considerable attention to this issue, raising numerous questions about whether the regulations should provide rules regarding what constitutes generally accepted investment theories. If DOL goes down this path, the results could have dramatic effects. This bears close scrutiny.

## **Effects on SunAmerica**

Neither the proposed regulations nor the preamble address how the prior two discussions might affect SunAmerica programs. If PPA computer models are required to favor passive investments to some extent, will SunAmerica computer models become subject to a similar requirement? If generally accepted investment theories are defined in the context of the PPA exemptions, will that affect SunAmerica computer models?

## **Other Issues**

The proposed regulations, like the Bush Administration regulations, provide that the investment advice must be implemented “solely at the direction of the recipient of the advice.” Thus, as expected, this guidance appears to be inapplicable to managed account programs, whereby a participant’s account is automatically invested pursuant to the computer model.

In general, all designated investment options available under a plan must be taken into account in applying the model under the computer model exemption, subject to exceptions for employer securities, target date funds (and similar investments), and annuity investment options. Also, as in the prior regulations, investments available through a brokerage window are not treated as designated investment options and thus need not be taken into account.

As mentioned above, both exemptions are conditioned upon satisfaction of certain disclosure requirements. The proposed regulations include a model disclosure form that may be used.

Comments on the proposed regulations are due by May 5. The regulations are proposed to be effective 60 days after publication of the final rule.