

StayCurrent

A Client Alert from Paul Hastings

NEW PENSION LAW RULES ON PROVIDING INVESTMENT ADVICE TO 401(K) PLAN PARTICIPANTS

by Lawrence J. Hass, J. Mark Poerio, Joshua H. Sternoff and Lynda M. Noggle

On August 3, 2006, Congress passed the long-awaited Pension Protection Act of 2006 (H.R. 4) (the "**PPA**"). Once President Bush signs the PPA into law (as he has indicated he will do), the PPA will amend the prohibited transaction provisions of ERISA and the Internal Revenue Code to create an exemption (the "**Investment Advice Exemption**") for investment advice provided to participants in 401(k) and other participant-directed pension plans pursuant to an "Eligible Investment Advice Arrangement".

This exemption serves two main purposes. First, it permits employers to arrange for investment advice to be provided to their plan participants while shielding the employers from liability for the investment advice that is actually provided. Second, it permits financial service firms who provide this investment advice to plan participants to market their own investment funds to plan participants without violating ERISA.

The Investment Advice Exemption contains many requirements in order for the protection from liability that it provides to be available for employers and investment advisers. These requirements are summarized below.

I. The Investment Advice Exemption

The Investment Advice Exemption provides that investment advisers, called "fiduciary advisers" under the PPA, will not breach their fiduciary duties by –

- providing investment-related advice to any plan, participant or beneficiary,
- buying, selling, or holding a security or other property pursuant to such advice, or
- receiving fees (directly or indirectly) in connection with the advice or in connection with the sale, acquisition, or holding of a security or other property available as an investment under the plan (a "**Transaction**").

This exemption is available only if the investment advice provided by the fiduciary adviser qualifies as an "Eligible Investment Advice Arrangement," which the PPA defines as an arrangement that meets seven statutory requirements and that either –

- provides that any fees received by the fiduciary adviser for investment advice with respect to a Transaction do not vary depending on the basis of the investment option selected, or
- uses a computer model under an "investment advice program" that meets the statutory requirements in connection with the provision of the investment advice (investment advice programs are discussed in part II below).

The seven requirements that an Eligible Investment Advice Arrangement must satisfy are:

1. **Express Authorization by Another Fiduciary.** A plan fiduciary other than the fiduciary adviser must expressly authorize the arrangement.
2. **Annual Audit.** Each year, a qualified independent auditor must determine that the arrangement satisfies all of the statutory requirements and issue a written audit report to the fiduciary who authorized the arrangement.
3. **Written Notification Requirement.** At the time of the initial provision of investment advice to a plan participant (or beneficiary), the fiduciary adviser must provide the plan participant with written notification (which may be sent electronically) that:
 - (a) describes the role of any party having a material or contractual affiliation with the fiduciary adviser in the development of the investment advice program and in the selection of investment options available under the plan;
 - (b) describes the past performance and historical rates of

return of the investment options available under the plan;

(c) describes all fees or other compensation that the fiduciary adviser will receive in connection with providing the advice or in connection with a Transaction;

(d) describes any material affiliation or contractual relationship that the fiduciary adviser or its affiliates has with respect to any security or other property involved in a Transaction;

(e) describes the manner and circumstances under which any information of a participant or beneficiary will be used or disclosed under the arrangement;

(f) describes the types of services to be provided by the fiduciary adviser in connection with the provision of investment advice;

(g) discloses that, by providing investment advice, the fiduciary adviser is acting as a fiduciary of the plan; and

(h) discloses that the plan participant may obtain advice from another adviser that has no material affiliation with and that would not receive any fees in connection with the security or other property involved in any Transaction.

In addition to the documentary necessities, the notification must be accurate and comprehensive, and must be written in a clear and conspicuous manner that is calculated to be understood by the average plan participant. The PPA directs the Secretary of Labor to develop a model form for the required disclosures of fees and other compensation.

Further, the fiduciary adviser must (i) maintain all of the information required to be disclosed in the written notice in currently accurate form; (ii) provide a revised notice to each recipient shortly after the time of any material change in the information in the notice, (iii) provide an updated accurate notice to the recipients at least annually, and (iv) provide an updated notice to each plan participant or beneficiary upon request and without charge.

4. Appropriate Disclosure Requirement. The fiduciary adviser must provide appropriate disclosure to plan participants and beneficiaries as may be required by all applicable securities laws.
5. Recipient Direction Requirement. Any Transaction must occur solely at the direction of the Recipient.
6. Reasonable Compensation Requirement. Any compensation received by the fiduciary adviser in connection with a Transaction must be reasonable.

7. Arm's Length Transaction Requirement. The terms of all Transactions must be at least as favorable to the plan as an arm's length transaction would be.

The fiduciary adviser must maintain records necessary for it to prove that it has complied with the seven requirements of the Investment Advice Exemption for five years after it provides the advice to the recipient.

II. Explanation of "Investment Advice Program"

As mentioned above, one of the two ways for an investment advice program to qualify as an "Eligible Investment Advice Arrangement" is if it is structured as an "investment advice program".¹ An investment advice program meets the statutory requirements if it complies with the following three requirements:

1. Computer Model. The investment advice is provided pursuant to a computer model that –
 - (a) applies generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
 - (b) utilizes relevant information about the participant, including age, life expectancy, retirement age, risk tolerance, other assets and sources of income and preferences as to certain types of investments;
 - (c) uses prescribed objective criteria to provide asset allocation portfolios comprised of investment options available under the plan;
 - (d) operates in a manner that is not biased in favor of investments offered by the fiduciary adviser or a person materially or contractually affiliated with the fiduciary adviser; and
 - (e) takes into account all investment options under the plan in specifying how a participant's account balance should be invested and is not inappropriately weighted with respect to any investment option.
2. Certification. An "eligible investment expert" must certify, both prior to initial use of the computer model and after any material modifications to the model, that the computer model meets the statutory requirements described above. The PPA delegates to the Secretary of Labor the task of defining the term "eligible investment expert".
3. Exclusivity of Recommendation. The sole investment advice offered under the investment advice program must be the advice generated under the computer model.

III. No Fiduciary Liability for Other Plan Fiduciaries

The Investment Advice Exemption relieves plan sponsors and other fiduciaries (other than the fiduciary adviser) of any fiduciary liability with respect to the advice provided by the fiduciary adviser if (1) the advice is provided pursuant to an arrangement between the plan sponsor or other fiduciary and the fiduciary adviser; (2) the terms of the arrangement require the fiduciary adviser to comply with the requirements of the Investment Advice Exemption; and (3) the terms of the arrangement include the fiduciary adviser's acknowledgement that it is a fiduciary with respect to the plan when it provides advice to a plan participant or beneficiary. Although the plan sponsor and other fiduciaries remain subject to the fiduciary duty to prudently select and monitor the performance of the fiduciary adviser, they are not responsible for monitoring the specific investment advice that the fiduciary adviser provides.

Plan assets may be used to pay for the reasonable expenses associated with providing investment advice pursuant to the Investment Advice Exemption.

IV. Definition of "Fiduciary Adviser"

The PPA makes the Investment Advice Exemption available only if the "fiduciary adviser" is a person who is a plan fiduciary by reason of the provision of investment advice to the plan, a participant or a beneficiary and who is (1) registered as an investment adviser under the Investment Advisers Act of 1940 or similar state law; (2) a bank or similar financial institution if the investment advice is provided by the entity's trust department; (3) an insurance company qualified to do business under the laws of any state; (4) a person registered as a broker or dealer under the Securities Exchange Act of 1934; or (5) any of their affiliates, employees, agents, or registered

representatives. In addition, the person who develops or markets the computer model used in the provision of investment advice who is a plan fiduciary by reason of the provision of investment advice to the plan, a participant or a beneficiary is treated as a fiduciary adviser, although the Secretary of Labor may issue rules under which only one fiduciary adviser may elect to be treated as a fiduciary with respect to the plan.

V. Effective Date

The Investment Advice Exemption is effective with respect to advice provided after December 31, 2006.

It is widely anticipated that financial institutions and plan sponsors will work together in developing and implementing participant advice programs consistent with this important new legislation. Such programs should be carefully structured to ensure that the protections from liability afforded by the Investment Advice Exemption are available to investment advisers and other fiduciaries alike. Our ERISA Practice Group is available to answer any questions and help with preparing to implement investment advice programs that comply with the Investment Advice Exemption.

NOTES:

¹The PPA directs the Secretaries of Labor and the Treasury to conduct a study to determine the feasibility of applying computer model investment advice programs to IRAs and Keogh plans.

If you have any questions regarding this alert, please contact any of the following members of the ERISA Practice Group:

Stephen H. Harris 213-683-6217
stephenharris@paulhastings.com

Ethan Lipsig 213-683-6304
ethanlipsig@paulhastings.com

Lawrence J. Hass 212-318-6401
larryhass@paulhastings.com

J. Mark Poerio 202-551-1780
markpoerio@paulhastings.com

Eric R. Keller 202-551-1770
erickeller@paulhastings.com

Joshua H. Sternoff 212-318-6011
joshsternoff@paulhastings.com

StayCurrent is published solely for the interests of friends and clients of Paul, Hastings, Janofsky & Walker LLP and should in no way be relied upon or construed as legal advice. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. Paul Hastings is a limited liability partnership. Copyright © 2006 Paul, Hastings, Janofsky & Walker LLP.

IRS Circular 230 Disclosure: As required by U.S. Treasury Regulations governing tax practice, you are hereby advised that any written tax advice contained herein or attached was not written or intended to be used (and cannot be used) by any taxpayer for the purpose of avoiding penalties that may be imposed under the U.S. Internal Revenue Code.