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March 2010

DOL Proposes New Rules on Providing Investment Advice to Plan Participants and Beneficiaries

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On February 26, 2010, the Department of Labor (the "DOL") announced a new proposed regulation (the "Proposed Rule") designed to clarify the statutory prohibited transaction exemption in the Employee Retirement Income Security Act of 1974 ("ERISA") that permits fiduciary advisers[1] to provide investment advice to participants and beneficiaries of 401(k) and other participant-directed pension plans that results in the purchase of investment products offered by investment management affiliates of a fiduciary adviser. The statutory exemption (Sections 408(b)(14) and 408(g) of ERISA) was enacted as part of the Pension Protection Act of 2006 (the "PPA") to remove a prohibited transaction obstacle from the offering of professional investment advice to plan participants and beneficiaries to assist them in making prudent decisions regarding their individual plan accounts.

The Proposed Rule mirrors the DOL's previously published final rule issued in the last days of the Bush Administration (the "Withdrawn Rule"),[2] except for two significant differences. First, the Proposed Rule does not include an additional class exemption that would have allowed fiduciary adviser entities to receive different fees or compensation for different investment products selected by a plan participant as long as the compensation received by employees, agents or registered representatives of the fiduciary adviser did not vary. Thus, fiduciary advisers will now also be subject to the "fee-levelling" requirement described below. Second, the Proposed Rule requires that if computer models are used to provide advice to participants and beneficiaries, the models will be prohibited from using factors that are not expected to persist in the future, such as historical performance, to distinguish among investment options within a single asset class.

As in the Withdrawn Rule, the Proposed Rule would clarify and provide greater detail concerning the requirements of the statutory exemption, including the features that "eligible investment advice arrangements" must have in order to be covered by the exemption. These requirements are summarized below.

Fee-Levelling Requirement

Under the Proposed Rule, both a fiduciary adviser and its employees, agents and registered representatives would not be permitted to receive, directly or indirectly, any fee or other form of compensation that varies based on the selection of an investment option by a participant or beneficiary. Thus, a fiduciary adviser would be prohibited from receiving economic incentives from its affiliates or any other party to favor or promote certain investments – *e.g.*, investment products offered by an affiliate. The DOL noted that extending the fee-levelling requirement to fiduciary advisers was necessary in order to eliminate economic incentives for the fiduciary adviser that would create a conflict of interest that is not easily mitigated.

Fiduciary Advice Substantive Requirements

In addition to receiving level fees, the Proposed Rule would require that any investment advice rendered by a fiduciary adviser must (i) be based on generally accepted investment theories that take into account the historic risks and returns of different assets classes over periods of time, (ii) take into account management fees and expenses attendant to the recommended investments, and (iii) to the extent furnished after a request by the fiduciary adviser, take into account participant information such as age, time horizons, risk tolerance and investment preferences.

Computer Model Arrangement Requirements

The requirements to satisfy the computer model arrangement alternative under the Proposed Rule are identical to the Withdrawn Rule, except that the computer model would now be prohibited from using factors that are not expected to persist in the future to distinguish among multiple investment options within a single asset class. The DOL noted that certain differences, such as fees, expenses and management style, will likely persist into the future, while a factor such as historical performance is less predictable and therefore would typically not constitute appropriate criteria for asset allocation within the same asset class. The DOL seemed to acknowledge that this new requirement may be controversial by specifically requesting comments concerning the types of historical data that a computer model should take into account when factoring in expected future performance.

In contrast to the Withdrawn Rule, the Proposed Rule would no longer permit fiduciary advisers to provide investment advice to a participant or beneficiary following the furnishing of recommendations generated by a computer model or, in instances where a computer model is not feasible, investment education material, unless such additional investment advice complies with the fee-level arrangement or is generated by a computer model in compliance with the computer model arrangement. The DOL noted that otherwise permitting the fiduciary adviser to freely render investment advice would raise significant conflict of interest concerns and that the prior conditions were inadequate to mitigate such conflicts.

Except for the two differences described above, the computer model arrangement requirements under the Proposed Rule are identical to the Withdrawn Rule and would require a fiduciary adviser relying on the computer model arrangement alternative to:

1. apply generally accepted investment theories that take into account historic risks and returns;

2. consider management fees and expenses attendant to the recommended investments;

3. request specific information from participants and beneficiaries and, to the extent furnished, utilize the provided information;

4. utilize objective data to provide asset allocation portfolios comprised of investment options available under the plan;

5. avoid inappropriately favoring investment options either offered by the fiduciary adviser or that may generate greater income for the fiduciary adviser; and

6. consider and give proper weight to all investment options designated by the plan.[3]

In addition, the Proposed Rule would require, prior to using a computer model, an "eligible investment expert"[4] to provide written certification that the computer model satisfies each of the above requirements and explain the methodologies used to reach this conclusion.

Additional Requirements

In addition to the above requirements, which specifically relate to the fee-levelling arrangement and the computer-model arrangement alternatives, the Proposed Rule would require a fiduciary adviser to satisfy the following four conditions.

Authorization by a Plan Fiduciary. A plan fiduciary other than the fiduciary adviser must expressly authorize the investment advice arrangement.

Annual Audit. On an annual basis, a qualified independent auditor must determine that the investment advice arrangement complies with the statutory requirements and issue a written report detailing his specific findings to the fiduciary who authorized the investment advice arrangement.

Fiduciary Adviser Disclosures. Prior to rendering investment advice, the fiduciary adviser must provide a participant or beneficiary with a written disclosure that includes the following:

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

2. the past performance and historical rates of return of the designated investment options available under the plan, to the extent that information is not otherwise provided;

3. all fees and compensation that the fiduciary adviser or its affiliates will receive in connection with the advice or services relating to the advice;

4. the manner, and circumstances in which, any participant or beneficiary information will be used or disclosed;

5. the types of services provided by the fiduciary adviser in connection with providing investment advice, including any limitations or abilities of a computer model to take into account an investment primarily in qualifying employer securities; and

6. a statement that the fiduciary adviser is acting as a fiduciary of the plan in connection with providing advice.

Retention of Records. The fiduciary adviser must maintain, for at least six years after the provision of investment advice under the Proposed Rule, any records necessary for determining whether the applicable requirements of the Proposed Rule have been satisfied.

Effective Date

The DOL is seeking public comments on the proposed rule until May 5, 2010.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] The PPA defines the term "fiduciary advisers" to include registered investment advisers, banks, insurance companies and broker dealers, and their affiliates, employees, agents and registered representatives, who act as fiduciaries in providing investment advice to plan participants and beneficiaries.

[2] The Withdrawn Rule was issued on January 21, 2009, but its implementation was delayed on three occasions, March 20, 2009, May 22, 2009, and November 17, 2009, before it was withdrawn on November 20, 2009.

[3] A computer model would still satisfy the requirements of the Proposed Rule even if it did not make recommendations concerning (i) investment funds that achieve varying degrees of long-term appreciation and capital preservation based on a defined time horizon (*e.g.*, target-date funds), (ii) annuity options with respect to which a participant or beneficiary may allocate assets towards the purchase of a stream of retirement income payments guaranteed by an insurance company, provided that in both circumstances the participant or beneficiary is furnished with a general description of both options contemporaneously with the provision of investment advice, or (iii) qualifying employer securities (however, unless a participant or beneficiary directs otherwise, a computer model is required to take into account the fact that a participant or beneficiary has an investment in qualifying employer securities when providing a recommendation).

[4] The Proposed Rule defines an "eligible investment expert" as an individual who possesses the appropriate technical training or experience to analyze, determine and certify whether a computer model satisfies the requirements under the Proposed Rule and is prohibited from having a material affiliation or material contractual relationship with the fiduciary adviser.