

## 2010 Proposed Regulations for Investment Advisors

The U.S. Department of Labor (“DOL”) on February 26, 2010 issued revised and proposed new regulations implementing the statutory exemption for providers of investment advice to benefit plan participants and individual retirement accounts, enacted as part of the Pension Protection Act of 2006 (“PPA”). These “2010 Proposed Regulations” replace a set of final regulations issued and then revoked in 2009.

The effective date of the 2010 Proposed Regulations is 60 days after the publication of the final regulations. The DOL is accepting written comments on the 2010 Proposed Regulations until May 5, 2010.

### General Background

The Regulations and the conditions in the statutory exemption in the PPA are intended to address conflicts of interest that many advisory firms may face in providing this service to retirement plans. Very generally, Section 406(b) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) and Section 4975 of the Internal Revenue Code of 1986, as amended (the “Code”) prohibit a fiduciary from dealing with the assets of an ERISA plan in his own interest or for his own account. A fiduciary to an ERISA plan or IRA includes a person who renders investment advice for a fee or other compensation, direct or indirect, with respect to the plan's assets or has any authority or responsibility to do so, whether or not the adviser has discretionary authority.

### Pre-Pension Protection Act Guidance

Prior to the PPA, the DOL indicated that, absent a specific individual exemption, providers offering investment programs that include funds or products advised by the provider or its affiliates could provide investment advice to participants in individual account plans subject to ERISA only if: (i) the advice did not result in any additional fees or compensation (whether through products, services or revenue sharing) to the provider (or its affiliates) (for example Advisory Opinions 97-15A and 2005-10A); or (ii) such advice were provided by an independent third party that used a computer model in compliance with Advisory Opinion 2001-09A (Dec. 14, 2001) (the “SunAmerica Letter”).<sup>1</sup> Significantly, the 2010 Proposed Regulations state that they do not invalidate or otherwise affect prior DOL rulings on advisory programs, such as the SunAmerica Letter, or other exemptions or interpretive guidance.

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<sup>1</sup> These advisory opinions relate to provision of “investment advice”; the DOL also provided guidance on investor education and asset allocation tools in Interpretive Bulletin 96-1, which creates a “safe harbor” for such activities that do not rise to the level of investment advice.

## The Pension Protection Act

The PPA expanded the methods by which providers of investment advice can make advisory arrangements available to plan participants without engaging in a prohibited transaction under ERISA. The PPA permits a provider to provide investment advice either (i) by maintaining a qualified computer model investment advice program (without requiring that the program be maintained by an independent third party, as was required in the SunAmerica Letter) or (ii) by providing that any fees received by the adviser do not vary depending on the investment options selected (“fee-leveled” investment advice)<sup>2,3</sup>

The PPA Exemption contains a number of specific requirements, including (1) the advice must be non-discretionary; (2) a plan fiduciary (or IRA beneficiary) independent of the adviser must expressly authorize the arrangement; (3) an annual compliance audit must be performed and an annual written audit report must be provided to the authorizing plan fiduciary (or IRA beneficiary); (4) certain disclosures must be provided to the plan fiduciary (or IRA beneficiary) relating to the investment options and the fiduciary adviser; (5) the acquisition, sale and holding of investments must be solely at the direction of the recipient of the advice; and (6) computer models must be certified in advance by an independent expert.

## Original (Withdrawn) Regulations

In 2009, the DOL issued final regulations implementing the PPA Exemption (the “2009 Regulations”) that also incorporated a class exemption covering certain transactions not otherwise covered by the PPA Exemption. Notably, the class exemption, unlike the PPA Exemption, required level advisory fees only at the individual (employee, agent, registered representative) level rather than at the employing entity level. The class

<sup>2</sup> ERISA Sections 408(b)(14) and 408(g) and Code Sections 4975(d)(17) and 4975(f)(8) (collectively, the “PPA Exemption”).

<sup>3</sup> In 2007, the DOL interpreted the fee-leveling requirement in the PPA as applying to the individual adviser, as well as to the advisory firm employing the adviser, but not to affiliates of the adviser, such as affiliates advising mutual funds or insurance products that might be included in recommendations to the plan participant. DOL Field Advice Bulletin 2007-1. (FAB 2007-1).

exemption covered investment advice provided by individuals (employees, agents or a registered representative of an investment adviser) receiving a “level” fee. The class exemption also provided relief for investment advice given to individuals following their receipt of information generated by a computer model or, where computer modeling was not feasible, for certain IRAs and self-directed brokerage accounts (“off-model” advice).

The effectiveness of the 2009 Regulations was postponed, however, and ultimately, on November 20, 2009, the DOL withdrew the 2009 Regulations including the class exemption. In withdrawing the 2009 Regulations, the DOL noted that several commenters had raised concerns that the class exemption contained in the 2009 Regulations did not provide adequate protections to mitigate against potential conflicts of interest.

## The 2010 Proposed Regulations

The DOL’s 2010 Proposed Regulations, similar to the 2009 Regulations, provide an exemption from the prohibited transaction rules for “eligible investment advice arrangements” that use fee-leveling or computer models.

### Model Disclosure

The 2010 Proposed Regulations include a model form of disclosure, which is not mandatory but, if used, would satisfy the disclosure requirements under the PPA Exemption.

### No Off-Model Advice

The 2010 Proposed Regulations, however, do not include a proposed class exemption or any provisions similar to those contained in the 2009 class exemption. Therefore, under the 2010 Proposed Regulations, there is no exemptive relief for any individualized follow-on, off-model advice unless this advice otherwise meets the requirements of the 2010 Proposed Regulations.

### Scope of Fee Leveling

In addition, the 2010 Proposed Regulations, unlike the 2009 class exemption, apply the level-fee requirement to compensation received by the employee, agent or registered representative providing the advice, as well as to the compensation received by the employing

fiduciary advisory firm. This is consistent with the DOL's statements on this point in FAB 2007-1.

Under the 2010 Proposed Regulations, for fee-leveled advice, no fiduciary adviser (including any employee, agent or registered representative) that provides investment advice may receive from any party (including an affiliate of the fiduciary adviser), directly or indirectly, any fee or other compensation (including commissions, salary, bonuses, awards, promotions, or other things of value) that is based in whole or in part on a participant's or beneficiary's selection of an investment option. The preamble to the 2010 Proposed Regulations explains that this revised provision is intended to clarify that *any* payment received by the fiduciary adviser or used for the benefit of the fiduciary adviser (including a payment made by an affiliate of the fiduciary adviser) that is based on investments selected by participants or beneficiaries would be inconsistent with the PPA Exemption's fee-leveling requirement. This limitation applies to the fiduciary adviser entity, as well as any employee, agent or registered representative of the fiduciary adviser. Like the situations described in FAB 2007-1, however, the "level fee" requirement does not extend to affiliates of the advisory entity, such as a mutual fund sponsor or insurance company; therefore, affiliates of the advisory entity can receive varying compensation through investment funds and products.

### **Appropriate Factors for Computer Models**

With respect to computer model advisory arrangements, the 2010 Proposed Regulations add a new proposed requirement that a computer model must be designed and operated to avoid investment recommendations that inappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot be expected to persist in the future. According to the preamble to the 2010 Proposed Regulations, one example of a factor that is less likely to persist in the future is a difference in historical performance. This example has already attracted criticism and comments. By contrast, the preamble states that differences in fees and expenses or management style within an asset class are likely to persist in the future and therefore are appropriate criteria for asset allocation within the same asset class. The DOL specifically requests comments on this subject, as well as whether or to what extent the final regulation should identify specific criteria (as opposed to more general principles).

### **Conclusion**

In summary, the 2010 Proposed Regulations follow the statutory exemption. Unlike the 2009 Regulations, the 2010 Proposed Regulations do not include an accompanying class exemption (though they do include a model form of disclosure). Thus, the 2010 Proposed Regulations do not permit follow-on, off-model advice following computer model advice. The 2010 Proposed Regulations also require fee leveling at both the individual and entity level; the DOL continues to state, however, that the fee leveling requirement does not apply to affiliates of the adviser. Further, the DOL reaffirms that the 2010 Proposed Regulations do not invalidate prior guidance. Finally, the DOL raises the question whether, or to what extent, the final regulation should identify specific criteria that should be taken into account in designing computer models and whether differences in historical performance among investment options within a single asset class is a factor that should not be taken into account (because it is a factor that is less likely to persist in the future).

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## Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at [www.dechert.com/employeebenefits](http://www.dechert.com/employeebenefits).

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