PARTICIPANT LEVEL ADVICE:
CURRENT LEGAL AND REGULATORY ENVIRONMENT

fi360 NATIONAL CONFERENCE

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by: Marcia S. Wagner, Esq.
The Wagner Law Group
A Professional Corporation
99 Summer Street, 13th Floor
Boston, MA 02110
Tel: (617) 357-5200

Fax: (617) 357-5250
www.erisa-lawyers.com

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My role on this panel is to explain what you, as an investment advice fiduciary, cannot do in providing participant level advice and what you must do from a legal and regulatory point of view. My co-panelists will address what you should do between those two boundaries.

I. Overview

A. Conflicted Advice. Essentially, you cannot provide conflicted investment advice to plan participants. By conflicted investment advice, I mean advice to plan participants that could increase your compensation based on the investments selected by the plan participants.

B. Two Solutions. You have essentially two means for dealing with conflicted investment advice. First, eliminate your conflict of interest. Second, find an ERISA prohibited transaction exemption that authorizes you to provide conflicted advice with disclosure of the conflict to the plan participants and satisfaction of the other conditions of the prohibited transaction exemption.

You need to understand, however, that there are very few prohibited transaction exemptions that allow conflicted investment advice to be provided to plan sponsors,[1] let alone plan participants. Indeed, until the U.S. Department of Labor's ("DOL's") controversial interpretation of the Pension Protection Act of 2006 ("PPA"), I was not aware of any prohibited transaction exemptions that allow any adviser to provide conflicted investment advice to plan participants, with the exception of the prohibited transaction exemption that I obtained in 1997 for the Trust Company of the West ("TCW").

C. PPA. As you know, PPA created statutory prohibited transaction exemptions for participant level advice. However, if you take a close look at these statutory exemptions, you will discover that they impose conditions on providing participant level advice that eliminate the conflict of interest.

D. PPA Regulations. As I will explain in more detail later, the DOL has interpreted the statutory exemptions as providing conflict of interest relief by applying a controversial ethical wall concept and by granting an even more controversial class exemption as part of its final regulations implementing the statutory exemptions.

E. Delay. The Obama Administration has delayed the effective date of DOL's regulations implementing the statutory exemptions, and creating a new class exemption, because

[1] Prohibited Transaction Exemption ("PTE") 84-24 allows a broker-dealer serving as the principal underwriter for a mutual fund to receive commissions on the sale of mutual funds to a plan sponsor. PTE 84-24 requires broker-dealers to disclose the commissions to the plan sponsor before the sale is executed and satisfy certain other conditions. PTE 84-24 also allows insurance agents or brokers or pension consultants to receive commissions on the sale of insurance products to a plan sponsor under the same conditions. PTE 86-128 allows broker-dealers to receive commissions for trading individual securities if the commissions are disclosed and certain other conditions are satisfied. Although PTE 86-128 theoretically applies to broker-dealers receiving commissions for selling mutual fund shares not covered by PTE 84-24, it is not a good fit for mutual fund sales.

it was concerned that the DOL regulations would allow conflicted investment advice to plan participants. Before delving into these controversies, however, we need to review the pre-PPA DOL guidance on conflicted investment advice.

II. Pre-PPA DOL Guidance

Notwithstanding PPA, investment advisers can still rely on the DOL's pre-PPA guidance to eliminate their conflicts of interest, according to DOL Field Advice Bulletin 2007-1 and the DOL's investment advice regulations.[2] Before PPA was enacted, the DOL issued several advisory opinions that describe techniques for eliminating conflicts of interest. I will briefly review them for you.

A. Advisory Opinion 97-15A (May 22, 1997) Frost Bank. In this advisory opinion, the DOL told Frost Bank that it would not have a conflict of interest, even though it received third party payments (i.e., mutual fund 12b-1 fees), if it would offset the third party payments against its trustee and recordkeeping fees that it would have otherwise charged to the plans that it was advising. If the third party payments exceeded the bank's trustee and recordkeeping fees, the bank would credit the excess to the plans.

In the advisory opinion, the DOL noted that the bank would be an ERISA fiduciary to the extent it would:

- advise plan sponsors on which mutual funds to invest in or to make available to participants or
- reserve the right to add or remove mutual funds that it makes available to the plans.

Ordinarily, receiving third party payments from the mutual funds would make the bank's investment advice conflicted if those payments varied based upon the mutual funds selected by the plan sponsor. However, the DOL opined that the offset arrangement eliminated the bank's conflict of interest because the bank's compensation remained level regardless of which mutual funds were selected.

Although the Advisory Opinion 97-15A involved investment advice to plan sponsors, the DOL cited it in its Field Advice Bulletin 2007-1, its first guidance after PPA on providing investment advice to plan participants. Thus, investment advisers can rely on offset arrangements to eliminate conflicts of interest that might otherwise occur due to receipt of third party payments.

B. PTE 97-60 (November 4, 1997) Trust Company of the West. In 1997, I obtained Prohibited Transaction Exemption 97-60 on behalf of Trust Company of the West ("TCW"). Although this was an individual transaction exemption, it was groundbreaking

[2] 29 CFR 2550.408-1(a)(3) at 74 Federal Register 3822 (1/21/2009)

development that paved the way for the SunAmerica advisory opinion and the PPA statutory exemptions that I will discuss in few minutes.

In PTE 97-60, the DOL agreed with me that TCW could provide asset allocation advice to 401(k) plan participants, even though TCW's affiliates would receive fees that varied based on plan participant's asset allocation decisions. The key to obtaining the exemption was my recommendation that TCW hire an independent investment expert to develop and maintain an asset allocation advice program beyond the influence of TCW and its affiliates. For example, the independent investment expert could earn no more than 5% of his gross income in any year from TCW or its affiliates.

In addition, although TCW delivered the advice to the plan participants, TCW had no discretion to vary the advice. Rather, the advice was provided by the independent investment expert based on a questionnaire he developed to determine the participants' risk tolerance and financial situation. Based on the responses to the questionnaire, the expert's computer program recommended an asset allocation.

C. <u>Advisory Opinion 2001-09A (December 14, 2001) SunAmerica</u>.

In its request for an advisory opinion, SunAmerica also said it would hire an independent investment expert to develop an asset allocation advice program under an arrangement that insulated the advice from SunAmerica's influence. The SunAmerica program has three parts:

1. At a conceptual level, the investment expert develops asset allocation models with different risk/return characteristics using the expert's methodology based on generally accepted principles of modern portfolio theory.

2. Next, the investment expert applies the asset allocation models to the investments available to plan participants under a particular 401(k) plan and develops computer programs to facilitate providing advice to plan participants. The investment expert determines whether a particular plan has enough different asset classes to implement the asset allocation models. SunAmerica merely informs the plan sponsor whether this requirement has been satisfied. The investment expert also designs a worksheet to collect participant data on their retirement needs.

3. Data is collected and fed into computer programs that generate asset allocation advice that meets the participant's retirement needs.

The investment expert retains independence from SunAmerica under the following arrangements that allow it to develop the asset allocation advice program solely in the interest of the plan participants without being influenced by SunAmerica:

1. The fees paid to the investment expert by SunAmerica do not exceed 5% of the investment expert's gross income on an annual basis.

2. The investment expert's fees do not depend upon how the participants allocate their investments.

3. Neither SunAmerica's choice of the investment expert nor its decision to continue or terminate the relationship with the investment expert will depend upon SunAmerica's investment management fees generated by 401(k) plans that used its asset allocation advice program.

4. The investment expert retains sole control over the asset allocation models and computer programs, including the staff programming the computers.

5. Other than the asset allocation advice program, there are no other relationships between SunAmerica and the investment expert that would allow SunAmerica to influence the investment expert or affect the investment expert's ability to act independently of SunAmerica.

Initially, SunAmerica had applied for a prohibited transaction exemption for the asset allocation advice program. Because DOL concluded that the SunAmerica program did not create a prohibited conflict of interest, the DOL issued an advisory opinion instead of a prohibited transaction exemption.

D. Advisory Opinion 2005-10A (May 11, 2005) Country Trust Bank IRAs. In this advisory opinion, the DOL opined that that Country Trust Bank would not have a conflict of interest if it offset third party payments (e.g., 12b-1 fees) against the management fees that it charged its IRA customers for recordkeeping and investment advisory services. In this case, the bank advised its customers on how to invest IRA assets in a manner consistent with five model investment strategies.

The DOL issued the opinion under the prohibited transaction exemption rules in the Internal Revenue Code because IRS's authority to interpret those rules had been transferred to the DOL. Nevertheless, the advisory opinion is relevant for a couple of reasons. First, the DOL stated that the same analysis and conclusions would apply under ERISA if the IRAs were retirement plans. Second, the DOL extended the offset solution to potential conflicts of interest problems to investment advice provided to individuals, as opposed to plan sponsors.

E. Advisory Opinion 2005-23A (December 7, 2005) IRA Rollovers. Although this advisory opinion is not mentioned in DOL Field Advice Bulletin 2007-1, you should be aware of it because it explains when ERISA's conflict of interest rules apply to ERISA plan assets rolled over from a retirement plan to an IRA.

The advisory opinion distinguishes between two groups: (1) "a plan officer or someone who is already a plan fiduciary" and (2) someone who is "neither chosen nor promoted by plan fiduciaries," "not otherwise a plan fiduciary," "not a plan fiduciary on some other basis," or "not connected with the plan." The advisory opinion then states that:

- An adviser in the second group (i.e., someone who is not already a fiduciary) can recommend that a plan participant rollover his or her account balance to an IRA, even if the adviser will earn fees on the IRA assets after the rollover. In this situation, ERISA's conflict of interest rules do not apply to the adviser's rollover recommendation.

- An adviser in the first group (i.e., "someone who is already a fiduciary") who recommends that a plan participant rollover his or her account balance to an IRA (or who "responds to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from the plan") could violate ERISA's conflict of interest rules, if the adviser will earn fees on the IRA assets after a plan participant rolls over his or her account balance to the IRA.

An investment adviser who "is already a plan fiduciary" because he or she is providing investment advice to the plan sponsor or plan participants would need to proceed cautiously in responding to a plan participant's rollover questions. The investment adviser could only provide general information about availability—not advisability—of a rollover and refrain from recommending an IRA that will generate fees or commissions for the investment adviser.

F. Principal Rollover IRA Lawsuit. A 2008 lawsuit against Principal illustrates how ERISA can apply to assets rolled over from a retirement plan to an IRA.[3] In a preliminary ruling in the case, the federal district court allowed a class action for breach of fiduciary duty to proceed based on allegations that Principal's sales call center encouraged participants in ERISA plans who terminated employment to roll over their accounts to Principal IRAs. Allegedly, the IRA investments were restricted to Principal's mutual funds with higher fees and poorer performance than similar funds available under the ERISA plans. According to the court, the plan participants could force Principal to transfer their IRA assets back to the ERISA plans and to give up any profits made on the rollover assets, if the allegations were true.

III. Statutory Exemptions for Investment Advice

PPA amended ERISA's prohibited transaction rules[4] to encourage more employers to provide investment advice to 401(k) plan participants. To achieve this objective, the term "fiduciary advisers" is defined and the role of plan sponsors that select and monitor them is clarified. To address potential conflicts of interest, two new prohibited transaction exemptions are created: one based on fee-leveling and another based on computer-modeling.

A. Fiduciary Advisers. The two new prohibited transaction exemptions are available only to fiduciary advisers that are insurance companies, banks, registered investment

[3] *Young v. Principal Financial Group, Inc.,* No. 4:07-cv-00386 (S.D. Iowa, 2008).
[4] ERISA Section 408(b)(14) contains the exemptions. ERISA Section 408(g) contains the conditions that must be met in order to obtain relief under the exemptions. Similar provisions were also added to Internal Revenue Code Section 4975(d)(17).

advisers, registered broker-dealers and their affiliates, employees, agents, or registered representatives.[5]

B. Plan Sponsors' Role. Plan sponsors (or similar fiduciaries) still retain fiduciary responsibility for the prudent selection and monitoring of a fiduciary adviser. In addition, the plan sponsors must ensure that the fiduciary adviser contractually agrees to comply with conditions in the statutory exemptions and that the fiduciary adviser acknowledges in writing it is a fiduciary providing investment advice. However, plan sponsors need not monitor the specific investment advice given by a fiduciary adviser to a particular plan participant.

C. Fee-leveling. The fee-leveling exemption says that a fiduciary adviser can accept compensation for investment advice as long as compensation does not vary depending upon the investment option selected by the plan participant. As noted earlier, the offset arrangements described in Advisory Opinion 97-15A (Frost Bank) and Advisory Opinion 2005-10A (Country Trust Bank IRAs) are precursors of this fee-leveling statutory exemption.

D. Computer-Modeling. Similarly, the statutory computer-modeling exemption is based on Advisory Opinion 2001-09A (SunAmerica). However, the statutory exemption requires the investment expert to meet certain requirements.[6] The exemption requires the investment expert to certify that the computer model is based on generally accepted investment theories, takes into account a plan participant's situation (e.g., age or risk tolerance), uses objective criteria to make asset allocation recommendations among the investment funds available under the plan, and is not biased in favor of the funds offered by the fiduciary adviser.

E. Other Requirements. The two new exemptions require the plan sponsor (or similar fiduciary) to authorize the investment advice program and to review an annual audit of the program. The fiduciary adviser must also provide certain disclosure to the plan participants, including a model fee disclosure form[7] developed by the DOL.

F. Effective Date. The new statutory exemptions apply to investment advice provided after 2006. The DOL regulations implementing the statutory exemptions were initially scheduled to be effective on March 23, 2009. At the request of the Obama Administration, however, the DOL reopened the comment period for the regulations and postponed their effective date for 60 days until May 22, 2009.[8]

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[5] DOL's definition of "registered representatives" includes both investment adviser representatives and registered representatives. "A 'registered representative' of another entity means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(18)) (substituting the entity for the broker or dealer referred to in such section) or a person described in section 202(a)(17) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(17)) (substituting the entity for the investment adviser referred to in such section)." See 29 CFR 2550.408g-1(c)(3) at 74 Federal Register 3849 (1/21/2009).

[6] 29 CFR 2550.408g-1(b)(4)(iii) defines an "eligible investment expert" as a person who "has the appropriate technical training or experience and proficiency to analyze, determine and certify . . . whether a computer model meets the requirements" of the statutory exemption but excludes any person that has any "material affiliation" or "material contractual relationship" with the fiduciary adviser or others with certain relationships with the fiduciary adviser.

[7] The model disclosure form is an Appendix to 29 CFR 2550.408g-1 and is published at 74 Federal Register 3852 (1/21/2009).

[8] See 74 Federal Register 6007 (2/4/2009).

IV. DOL Investment Advice Regulations

Rather than provide a detailed overview of the DOL's investment advice regulations, I will use the remaining time to focus on the part of the regulations that has become controversial. Instead of using the term "Chinese Wall," I will use the term "ethical wall" to describe the source of controversy.

A. Background. Traditionally, an ethical wall has referred to policies and procedures that financial organizations have put into place to solve problems under federal securities laws. The classic example is the ethical wall established between a bank's lending department and its trust department. With the ethical wall in place, the trust department is kept in the dark about transactions between the lending department and outside firms. This enables the trust department to invest in these outside firms without violating rules on using inside information or on engaging in conflicts of interest.

Only fairly recently has DOL recognized ethical walls might be a means of solving conflicts of interest problems. In a 2004 field advice bulletin,[9] the DOL explained that a directed trustee's possession of non-public information in one part of its organization would not be imputed to those providing trust services if the directed trustee maintained procedures designed to prevent the illegal disclosure under securities, banking or other laws. Although the DOL acknowledged the value of the ethical wall to solve problems, it did not appear ready to describe how they would work under ERISA. In a footnote, the DOL states: "The [DOL] expresses no view as to whether, or under what circumstances, other procedures established by an organization to limit the disclosure of information will serve to avoid the imputation of information to a directed trustee."

After PPA's enactment, however, DOL appears to have embraced the ethical wall concept way beyond what some members of Congress had intended with the statutory investment advice exemptions.

B. Field Advice Bulletin 2007-1. In Field Advice Bulletin 2007-1, the DOL stated that the fee-leveling requirement does not apply to an affiliate of an investment advice fiduciary, unless the affiliate is also providing investment advice to the plan participants. In other words, a fiduciary adviser would not be considered conflicted as long as it complied with the fee-leveling requirement, even though the fiduciary adviser's parent company is receiving fees that varied based on the investments selected by the plan participant.

For ERISA practitioner's familiar with ERISA's controlled group rules, the implication of DOL's interpretation of the statutory exemptions was noteworthy. An organization could comply with the fee-leveling requirement simply by separately incorporating the part of the organization that would be providing the investment advice to the plan participants. The DOL did not impose limitations other than requiring the fiduciary adviser alone to comply with the

[9] Field Advice Bulletin 2004-3 (12/17/2004).

fee-leveling requirement. To understand why DOL's approach to the fee-leveling requirement is noteworthy, let's briefly review ERISA's controlled group rules.

C. Controlled Group Rules. Before ERISA, employers sponsoring tax-qualified retirement plans attempted to circumvent the nondiscrimination and similar qualification requirements by subdividing their businesses. For example, one corporation would provide a generous plan for its highly compensated employees. Another corporation would either not sponsor a plan or, if did, would provide a significantly less generous plan for nonhighly compensated employees. To avoid this circumvention, ERISA amended the Internal Revenue Code to require employers to take into account the controlled group rules in applying the qualification requirements. The controlled group rules require each plan within a controlled group to be treated as if a single corporation employed all employees of the controlled group.

On the other hand, some employers have legitimate business reasons for providing varying levels of benefits for different businesses. However, the controlled rules would have forced these employers to provide more uniform levels of benefits. To address the problem, the Internal Revenue Code also recognizes so-called "qualified separate lines of business" ("QSLOB"). With QSLOBs, an employer may apply the nondiscrimination and similar rules on a QSLOB basis rather than on an employer-wide basis under the controlled group rules. This enables the employer to vary benefits among its different QSLOBs without failing the qualification requirements. However, the requirements to establish QSLOBs are rather stiff.

In light of the controlled group concept, the DOL might have imposed some limitations on the use of separate incorporation to circumvent the fee-leveling requirement. For example, the DOL might have required the affiliate to establish policies and procedures to prevent the affiliate from using the "stick" to influence the fiduciary adviser's investment advice.[10] With this brief review of the controlled group rules, let's take a closer look at DOL's approach to the ethical wall.

D. Proposed Regulations. In its proposed regulations,[11] the DOL reiterated its position in Field Advice Bulletin 2007-1 that the statutory fee-leveling requirement applies only to the fiduciary adviser entity, not affiliated entities. In addition, however, the DOL proposed a class exemption that would extend the ethical wall concept to employee, agents, or registered representatives of a fiduciary adviser.[12] In other words, if the employees, agents, or registered

[10] The DOL regulations address only the carrot (i.e., fees or compensation). It does not address an affiliate's threat of imposing adverse conditions to influence the financial adviser's investment advice.

[11] "[I]n interpreting the scope of the fee-leveling requirement . . . [DOL] explained, [the conditions for the statutory exemption] references only the fiduciary adviser, not the fiduciary adviser or an affiliate. Inasmuch as a person . . . can be a fiduciary adviser only if that person is a fiduciary of the plan by virtue of providing investment advice, an affiliate of a registered investment adviser, a bank or similar financial institution, an insurance company, or a registered broker dealer will be subject to the varying fee limitation only if that affiliate is providing investment advice to plan participants and beneficiaries." Preamble to the proposed regulations at 73 Federal Register 49898 (8-22-08).

[12] "In an effort to accommodate a wider variety of business structures and practices, making investment advice more available while protecting participants and beneficiaries, the Department is proposing a class exemption addressing fee leveling requirements for employees, agents and registered representatives, also appearing in today's Federal Register." Preamble to proposed regulations at 73 Federal Register 49898 (8-22-08).

representatives advising plan participants satisfied the fee-leveling requirement, the fiduciary adviser could receive fees that varied based on the investment choices of plan participants.

E. <u>Final Regulations</u>. The final regulations incorporate the statutory fee-leveling and computer-model exemptions and incorporate the class exemption into one document. Again, our focus is on the ethical wall concept that the DOL embraced in the statutory fee-leveling exemption and class exemption.

1. <u>Fee-Leveling Regulation</u>. Despite criticism[13] of its controversial interpretation of the statutory fee-leveling requirement, the DOL adopted it as proposed in the final regulations. DOL's principal argument[14] in support of its interpretation is as follows:

> ". . . if the fees . . . received by an affiliate of a fiduciary that provides investment advice do not vary or are offset against those received by the fiduciary for the provision of investment advice, no prohibited transaction would result solely by reason of providing investment advice and thus there would be no need for a prohibited transaction exemption . . ."

One of the conditions in the fee-leveling regulations is critical. It requires that the compensation of the employees, agents, or registered representatives of the fiduciary adviser not vary based on the investments selected by the plan participants. For this purpose, compensation means[15] salary, awards, commissions, or other things of value. In the preamble to the final regulations, the DOL clarified that "things of value" would include trips, gifts and other things that while having a value, are not given in the form of cash.[16]

In response to a question about bonus programs for employees, agents, or registered representatives[17] based on the fiduciary adviser's overall profitability, the DOL explained almost every form of compensation that varies based on the investments selected by plan participants would likely violate the fee-leveling requirement. Nevertheless, the DOL stated that it is conceivable that a bonus program based on the fiduciary adviser's overall profitability would not violate the fee-leveling requirement if plan participants' investments are excluded from, or constituted a negligible portion of, the calculation of the fiduciary adviser's overall profitability.

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[13] "[S]ome commenters objected to the Department's implementation of the statutory [fee-leveling] provision, arguing that Congress, in an effort to eliminate the potential for conflicts of interest, intended the fee-leveling requirement to encompass not only the fiduciary adviser but also affiliates of the fiduciary adviser." Preamble to the final regulations at 74 Federal Register 3825 (1/21/2009).
[14] Preamble to the final regulations at 74 Federal Register 3825 (1/21/2009).
[15] 29 CFR 2550.408g-1(b)(3)(D) at 74 Federal Register 3847 (1/21/2009).
[16] Preamble to the final regulations at 74 Federal Register 3825 (1/21/2009).
[17] As noted above, DOL's definition of "registered representatives" includes both investment adviser representatives and registered representatives.

2. Fee-Leveling Class Exemption. Despite even stronger criticisms[18] against the class exemption, the DOL adopted the class exemption that expands the ethical wall concept by applying the fee-leveling requirement only to employees, agents, or register representatives, and not to the fiduciary adviser they represent. The conditions in the class exemption are similar to those imposed on the statutory exemptions. Of course, the fee-leveling class exemption requires that the compensation of the employees, agents, or registered representatives not vary based on the investments selected by the plan participants.[19] Similarly, the class exemption permits the use of the model disclosure form.[20]

However, class exemption imposes conditions that are not in the fee-leveling regulation. For example, the employees, agents, or register representatives must explain:

- how their advice is prudent and in the best interests of the participant;[21]
- how and why their advice deviates from computer recommendations or equivalent investment materials,[22] and
- why their advice includes investments with higher fees than other investments available under the plan in the same asset class.[23]

The class exemption also requires the fiduciary adviser to document the advice and deliver the documentation to the participants within thirty days after the advice was provided.[24] Also, the fiduciary adviser must adopt and follow written policies and procedures that are designed to assure compliance with the conditions of the class exemption.[25]

V. Key Questions

A. Independent Financial Professionals. Many financial professionals (e.g., investment adviser representatives or registered representatives) are not employees of dually-registered investment advisers and broker-dealers. Rather, they work as bona fide independent contractors. Thus, one of the key questions is whether those independent contractors and dually-registered entities can take advantage of the fee-leveling regulation as opposed to complying with the fee-leveling class exemption.

One could argue that the fee-leveling regulations apply only to the independent contractor as the fiduciary adviser, not the dually-registered entity with which he or she is registered. If so, the more strenuous class exemption requirements (e.g., documenting basis for investment advice) would not apply.

[18] "A number of commenters questioned the Department's authority to grant the proposed class exemption arguing, in effect, that the proposed class exemption is inconsistent with Congressional intent, suggesting that enactment of the statutory exemption for investment advice precluded or otherwise limited the Department's authority to grant an administrative exemption . . . ." Preamble to final regulations at 74 Federal Register 3833 (1/21/2009).
[19] 29 CFR 2550.408g-1(d)(4) at 74 Federal Register 3850 (1/21/2009).
[20] 29 CFR 2550.408g-1(d)(8)(ii)(B) at 74 Federal Register 3851 (1/21/2009).
[21] 29 CFR 2550.408g-1(d)(6)(ii)(A) at 74 Federal Register 3851 (1/21/2009).
[22] 29 CFR 2550.408g-1(d)(6)(ii)(A)(3) at 74 Federal Register 3851 (1/21/2009).
[23] 29 CFR 2550.408g-1(d)(6)(ii)(A)(2) at 74 Federal Register 3851 (1/21/2009).
[24] 29 CFR 2550.408g-1(d)(6)(ii)(B) at 74 Federal Register 3851 (1/21/2009).
[25] 29 CFR 2550.408g-1(d)(7) at 74 Federal Register 3851 (1/21/2009). See also preamble at 74 Federal Register 3835 (1/21/2009).

One the other hand, the phrase "employee, agent, or registered representative" strongly suggests that the dually-registered entity is the fiduciary adviser and the independent contractor is a registered representative.[26] Thus, if the dually-registered entity wants to receive fees that vary based on the investments of the plan participants, the dually-registered entity and the independent contractor would have to comply with the class exemption requirements.

Notwithstanding the fee-leveling regulation and class exemption, a reasonable argument could also be made based on the pre-PPA advisory opinions that independent contractors would not have a conflict of interest if they comply with the fee-leveling or offsetting methods to eliminate their conflicts of interest. The dually-registered entity would not have a conflict of interest because it is not advising the plan participants, and it typically would not be an "affiliate" of the independent contractor. That is, there would be no ownership interest between the dually-registered investment adviser and independent contractor, or the ownership interest is below the 5% threshold.[27]

B. Broker-Dealers. For dually-registered entities, the financial adviser will undoubtedly be the registered investment adviser, not the broker-dealer. Stand-alone broker-dealers have serious challenges in attempting to comply with the fee-leveling regulation or class exemption.

First, the broker-dealers need to acknowledge in writing to the plan sponsor their registered representatives are investment advice fiduciaries. That acknowledgement is a little[28] inconsistent with the broker-dealer's exemption from the Investment Advisers Act of 1940. The Advisers Act exemption allows registered representatives to provide only "incidental" investment advice in connection with brokerage transactions for which the broker-dealer receives commissions.[29] Second, commissions (i.e., variable fees) will force broker-dealers into the fee-leveling class exemption so the broker-dealer can continue to can receive commissions while providing level compensation to the registered representatives. That brings us to the third challenge: will registered representatives accept level compensation? If not, will broker-dealers embrace the computer-modeling exemption?

The errors and omissions ("E&O") policies for registered investment advisers should cover investment advice provided to clients, whether or not they are plan participants. Nevertheless, it might be a good idea to confirm the coverage. For broker-dealers, the coverage question could be more difficult. It would not be surprising to see coverage exclusions for

[26] As noted above, DOL's definition of "registered representatives" includes both investment adviser representatives and registered representatives.
[27] "Affiliate" is defined at 29 CFR 2550.408g-1(c)(5) at 74 Federal Register 3850 (7/21/2009).
[28] The acknowledgement is not totally inconsistent with the Advisers Act. If it were, Congress presumably would not have amended ERISA to allow broker-dealers to serve as fiduciary advisers.
[29] In *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007), an appeals court invalidated the SEC investment adviser exemption that attempted to allow broker-dealers to receive asset-based fees instead of traditional commissions for providing "incidental" investment advice.

advice provided as a fiduciary as opposed to "incidental" advice provided as a broker. So, the question is: have you checked your E&O coverage lately?

C. **Written Policies and Procedures.** As noted earlier, the class exemption requires fiduciary advisers taking advantage of the class exemption to adopt written policies and procedures that are designed to assure compliance with the conditions of the class exemption. From a risk management point of view, written policies and procedures are probably a good idea, even if the fiduciary adviser relies on the statutory exemptions instead of the class exemption.

In the category of written polices and procedures, I would include the disclosures required by the various exemptions. One of key questions is whether you should rely on the model disclosures developed by the DOL? They are a safe harbor, but how effective are they in communicating to plan participants or to plan sponsors concerned about what is communicated to their plan participants? For registered investment advisers, does it also make sense to include DOL's disclosures in the Form ADV?[30]

D. **Durability of Regulation and Class Exemption.** As noted earlier, the Obama Administration reopened the comment period for the investment advice regulations, including the class exemption, and delayed their effective date until May 22, 2009.[31] It is unlikely that the investment advice regulations will survive in their current form, particularly:

- the regulation allowing an affiliate of a fiduciary adviser to receive variable fees based on the investments of plan participants as long as the fiduciary adviser's fees are level; and

- the class exemption allowing a fiduciary adviser to receive variable fees based on the investment of plan participants so long as the fiduciary adviser's employees, agents, and registered representatives receive level compensation.

Even if the DOL decides to leave its investment advice regulations intact, it is also likely that Congress will legislatively override the regulations. The following statement[32] by U.S. Rep. George Miller (D-CA), the chairman of the House Education and Labor Committee, probably reflects the views of a majority of the members of Congress now:

> "We are disappointed that the Bush administration moved forward to enact a new regulation that will make it harder for workers to receive fair and honest advice when making key financial decisions about their futures. . . . Today's regulation will allow financial services companies to reap windfall profits at the expense of workers and tips

[30] SEC is proposing to completely overhaul the Form ADV, Part II that investment advisers use to satisfy the written disclosure statement requirement of SEC Rule 204-3. See SEC Release IA-2711 at 73 Federal Register 13958 (3/14/2008).
[31] Notice of proposed extension of effective date and applicability date; request for public comments on legal and policy questions relating to the final rule. See 74 Federal Register 6007 (2/4/2009).
[32] Representative Miller's statement is posted at http://edlabor.house.gov/newsroom/2009/01/chairmen-miller-andrews-statem.shtml#more.

the scales towards special interests by opening the door to conflicts of interest among the very consultants purporting to offer unbiased investment advice. . . .”

E. Pre-PPA Advisory Opinion v. Statutory Exemptions. Complying with the DOL regulations or class exemption would be more onerous than complying with the pre-PPA DOL advisory opinions. For example, the statutory exemption requires the plan sponsor to authorize the investment advice program and review an annual audit of the program. The plan sponsor must also ensure that the advisers acknowledge in writing they are fiduciaries providing investment advice and that they contractually agree to comply with requirements that the statutory exemptions imposed on fiduciary advisers. The fiduciary advisers must also provide certain disclosures to the plan participants, including a model fee disclosure form to be developed by the DOL. My questions for my fellow panelists are:

- In providing investment advice to plan participants, do you want to rely on the pre-PPA advisory opinions or on the DOL investment advice regulations implementing the statutory exemptions and class exemption?

- Will plan sponsors allow you to rely on the pre-PPA advisory opinions or will they insist that you comply with the DOL investment advice regulations?