

QDIA & Fiduciary Advisor



From a White Paper from Unified Trust Company, NA

Default Investment Regulations

PPA mandated that DOL publish Regs to be effective in February 2007. DOL responded by getting Proposed Regs out in record time (in just over a month). They did this by starting about two years ago.

Regulation 404(c)(5), published as an addition to the Regulations under ERISA §404(c) says:

- **Default Investment Option.** Now there is a **Safe Harbor** for fiduciary choice of default investment
- **Default must be a QDIA's.** A QDIA (Qualified Default Investment Alternative) is either:
 - A. A mutual fund, **or**
 - B. Managed by an “ERISA Investment Manager” as defined by ERISA § 3(38) and 402(c)(3) (the definition of an ERISA Investment Manager is easily confused with the “ordinary business of managing money”).

An ERISA Investment Manager means:

- A bank, RIA, or insurance company (not a broker) who:
 - Accepts fiduciary status in writing, **and**
 - Has full discretion over management of the assets in the plan
 - And, in the case of a state-registered RIA, makes the appropriate filing with the DOL
- **Form of the QDIA.** In addition to the structural requirement above, the form of the QDIA must be one of the following:
 1. **Lifecycle fund or model portfolio** (age-based or “target maturity”)
 2. **Lifestyle fund or model portfolio** (based on risk factors for plan as a whole, a “balanced” portfolio). Note that the way the Regulation reads does not make clear precisely what is included here.
 - **Single Balanced Fund.** The Reg describes a balanced fund in which the fixed/equity mix is dictated by plan demographics as a whole. For example, a plan with mostly 20-something participants would have more equities than a plan with mostly fifty-somethings.
 - **Risk-Based Lifestyle Funds/Models.** Currently, Unified Trust primarily uses risk-based models vs. age-based. These six models arguably fit any plan’s demographics well since they cover the full risk spectrum, but there is at least some question as to whether or not this approach meets the intended definition of QDIA. We believe so, and will be seeking clarification, but have no particular reason to actually need the safe harbor relief anyway – we know our approach is prudent, so no need for a safe harbor. But we’ll pursue it anyway.
 3. **Separately managed portfolio.** Remember that the manager must be an ERISA Investment Manager – not a broker. A broker is a securities salesperson, and the law does **not** recognize that role as one that can provide the investment manager service. An example of what will not qualify as a QDIA is a brokerage account managed with the help of a broker.

➤ **Effect of Using a QDIA.** The fiduciary relief of ERISA §404(c)(5) provides the following under the Proposed Regulation:

- **Fiduciaries are given 404(c) relief** with respect to the default investment as if the participant had chosen it himself. The reason this is important is that legal commentators before PPA largely agreed that a negative election investment choice – a “default” investment for participants who failed to make an affirmative election – was not eligible for relief under ERISA §404(c) due to the failure of the participant to exercise control – one of the basic requirements of 404(c).

The new Regulation clarifies that negative election need not eliminate 404(c) relief. This is helpful but not necessary in a Unified Trust plan, because the state of law pre-PPA simply said that fiduciaries had no 404(c) relief in these situations ... but that they didn't need such relief so long as they were managing participant accounts prudently.

- **Fiduciaries are not responsible for investment decisions of the QDIA manager.** Here I'll make a distinction:
 - **When using an Investment Manager.** In this case the new law simply clarifies long-standing fiduciary law.

It has long been true that “a named fiduciary will not be liable for the acts and omissions of other named fiduciaries...”¹ as long as the fiduciary does a prudent job selecting and monitoring those to whom he delegates.

- **When using a mutual fund.** Here the clarification is useful because, under prior law, a fiduciary is responsible for the acts and omissions of a non-fiduciary service provider, including a mutual fund.

Mutual fund families rarely, if ever, accept the well-defined ERISA Investment Manager status, so the safe harbor clarification is helpful in this situation.

- **Fiduciaries are still responsible for prudently selecting and overseeing the QDIA manager.** Again, same as pre-PPA law.

¹ DOL Advisory Opinion 75-8, 29CFR2509.75-8

- **Effect of NOT using a QDIA.** Current law simply provides that, absent 404(c) protection, the named fiduciary is responsible for prudent investment of a participant's account. That remains true. An example of where this might matter is that of a plan that uses model portfolios as default investments (as in Unified Trust client plans), but does not otherwise bother to comply with the QDIA requirements.

QDIA relief is an option, like the rest of 404(c)—not complying simply means the fiduciary is responsible, which is not a problem at all under current law so long as the management is prudent. We know with a high degree of confidence, for example, that Unified Trust's model portfolios represent prudent investments. Whether or not they qualify as QDIA's does not actually matter. That said, we intend to comply anyway.

Here is an example of how these provisions will interact.

- **Situation:** The mutual fund family that is the vendor for ABC Plan has a web-based tool that allows the broker to create custom portfolio allocations for plan participants. (Many vendors have these tools, so this is a common situation.)

These model portfolios are built from the funds available in the plan. The broker chooses the asset allocation. Because of the new 404(c)(5) Reg, ABC Plan – at the broker's suggestion – begins using the model portfolios as default investments.

- **Analysis:** The client probably thinks the broker is responsible for the asset allocation, and that is true from a functional standpoint, but the reality is that the broker's broker/dealer does not allow him to act as a fiduciary, therefore his legal agreements all so state. He is doing the work of a fiduciary (discretion over the model allocations) but without any formal appointment to the task—an imperfect arrangement at best.

But putting this issue aside, look at the models: probably they are prudent investments. If the client can show detailed records proving that these models are built and overseen according to a thorough, written investment policy, then there is no need for the 404(c)(5) relief.

Probably the client could not so prove, but the point is that, if the models are prudent, safe harbor relief is not needed. Regardless of whether relief is needed, it is not available: a broker cannot be an ERISA Investment Manager and the arrangement is therefore not a QDIA.

- **Stable Value as a Default.** The old stand-by of many plan sponsors and advisors was to use a money market, GIC, or stable value fund as the default investment. The new Regulation impacts such a choice as follows:
 - **Not QDIA's.** Stable value and money market funds do not qualify as QDIA's for purposes of ERISA §404(c)(5).
 - **Not prohibited.** But a prudent fiduciary may still choose fixed funds as defaults for participants where it is prudent to do so – just as they can already under current fiduciary law. Examples of where this might be appropriate:
 - For very old participants who fail to make an election;
 - For situations where money is expected to remain in place for only a short time.

➤ **Additional QDIA Requirements.**

- **Notice to participant.** 30 days before the first default investment and 30 days before each subsequent plan year. The notice must describe the default investment and how it works, and how the participant makes changes.
- **Participant did not make affirmative election.** If a participant makes an election and the sponsor/fiduciary somehow misses that election and invests the participant account in a default, 404(c)(5) relief is **not** available.
- **Quarterly, penalty-free transfers.** At least quarterly, but as often as the plan otherwise allows (usually daily in most 401(k)'s), the participant must be allowed to move all or some of his or her account to other investments without penalty.
- **IMPORTANT: By its terms, the plan must provide** that any material received concerning the QDIA such as prospectuses or proxy materials be passed through to participants. In fact, the DOL appears to expect that this requirement will result in materials that must be furnished to participants as often as quarterly (based on the estimate of the paperwork burden included in the Proposed Regs).

This requirement is important for two reasons:

- **“By its terms”** presumably means the document must be amended to make this provision effective. The practical upshot is that an advisor or sponsor will THINK that relief is available when technically it will not be in cases where the document has not been amended—and most advisors will not know to ask. Add this to your annual review checklist as something to look at.
- **“Pass through”** means it must be sent, not that it must be sent only if the participant asks for it. The problem with this requirement in most plans will be that the information is never sent. In the absence of materials being provided automatically by the vendor, it is unrealistic to expect that most sponsors will do the necessary work to actually duplicate and mail copies of this stuff throughout the year.

➤ **Examples of Advisor Cases Where 404(c)(5) Relief Is Not Available.**

- **Example #1:** A broker provides participants with “paper” model portfolios built of the funds in the plan by giving them documents that show the portfolio composition. Participants can select from several portfolios. To the degree these models are default investments, they do not qualify as QDIA's because a broker cannot be an ERISA Investment Manager under the ERISA §3(38) definition.
- **Example #2:** A number of vendors provide advisors with the ability to build model portfolios through the vendor's website from which the participants may choose. If the advisor is a broker; i.e., a broker who sells a mutual fund 401(k) product to a plan and builds models on the fund family's website for participants, then since he is a broker, he does not qualify as an Investment Manager and the portfolios cannot be QDIA's.
- **Example #3:** advisor builds model portfolios using the recordkeeper's ability to show models as investment options on an open architecture system. The Relius and SRT recordkeeping systems, for example, both have the ability to build model portfolios.

Assume in this example that the advisor is an RIA and builds the portfolios, but does **not** acknowledge fiduciary status and discretion in writing and does **not** make the appropriate DOL filings: In this case the advisor is not acting in the capacity of an ERISA Investment Manager and the portfolios are not QDIA's.

- **Example #4:** Same facts as example #3, except that the advisor meets the requirements and is a properly appointed ERISA Investment Manager, but the fact sheets and performance reports that the advisor prepares for the sponsor each quarter are not passed on to participants.

In this case, it could be argued that, by failing to pass on this information (there may be some question as to which information must be passed on, and which is not required), the sponsor has eliminated the opportunity for 404(c)(5) relief.

Remember, however, that so long as the investments are prudent this is not an issue—it is simply that the safe harbor has not been used.

- **Example #5:** Same facts as in examples 3 and 4, but in this case the RIA does not coordinate with the plan Administrator and/or TPA, and no annual notice is sent to participants. The arrangement does not meet the QDIA notice requirement and 404(c)(5) relief is unavailable. Again, so long as the investments are prudent this is not an issue—it is just that the 404(c)(5) safe harbor has not been used.

ERISA §404(c) Relief During Blackouts and Mapping

In the past, the consensus legal opinion was that ERISA §404(c) relief is not available during a blackout or after a fund mapping because one of the 404(c) requirements – exercise of control – is not met since the participant has not affirmatively elected the new investment.

This has always been an onerous point of view, because it implies the following:

- If 404(c) is not available, that means fiduciaries are responsible.
- If fiduciaries are responsible for individual's investment choices, it means they must ensure participant accounts are prudently invested.
- As a practical matter, therefore, the only way a fiduciary could be assured of protection is to manage the participants' accounts for them, prudently, by defaulting every single affected participant into a managed portfolio or lifestyle fund. It would then be up to the participant to make a new affirmative election.
- Since, in a well-managed 401(k) there are two or three fund replacements per year, on average, this suggests that participants would be constantly taken out of the investments they had elected and moved to a default portfolio. Several times per year the participant would have to re-do his or her elections.

The “no relief” viewpoint is less onerous with respect to mapping during a vendor conversion or blackout because **mapping is a lousy strategy during conversions** anyway.

Mapping

As of 2008, 404(c) relief is available after a mapping so long as certain requirements are met:

- Funds are mapped to like funds (the way everyone does it anyway)
- Notice requirements are met
- The participant does not otherwise elect not to be mapped (i.e., there must be a clear-cut opt-out mechanism).

This provision is welcome and needed since it answers the problem described above, where participants could be defaulted and re-defaulted continuously as investment managers are replaced.

Blackouts

Starting in 2008, PPA grants a limited safe harbor during blackouts that says, in brief, that:

- As long as the sponsor and fiduciaries have otherwise met their fiduciary obligations with respect to the plan and blackout;
- That they will not be responsible for losses suffered as a result of the blackout.

For example, if a plan goes into blackout on Jan 20 and emerges on February 5, and the market goes up 2% during that time, the participants have theoretically “lost” the 2% they would have gained. This PPA provision gives relief to the sponsor and fiduciaries for such hypothetical losses so long as other fiduciary requirements are met. The key here is that “meeting fiduciary requirements” is a big topic, and calls for a comprehensive, written, rigorously applied and documented fiduciary process of the sort most sponsors arguably don’t have. Assuming the proper process is in place, this is a welcome form of relief.

Fiduciary Advisers

Participant Level Only

The PPA only addressed participant level advice, not plan level. So to the degree you serve as a fiduciary at plan level, the advice provisions of PPA do not affect this service.

An exemption would not be necessary if there were no conflicts of interest so the advice provisions of PPA specifically address exemptions for situations where there is a potential conflict of interest. For purposes of discussion we’ll divide givers of participant advice into two groups: vendors and advisors (i.e., individual brokers and RIAs).

Vendors have a conflict when they have something to gain by the choice of investments (such as revenue sharing payments, or fees from proprietary funds). Therefore vendors need an exemption to give advice to participants. 401(k) advisors have conflicts when they are brokers (as most are) since they receive commissions at variable rates, more from some products than for others. Therefore they need an exemption to give advice.

The Two Exemptions

SunAmerica Letter method

This existing law clarification (from DOL AO 2003-09A, The SunAmerica Letter—the point of the SunAmerica letter was that an exemption was unnecessary) was tweaked and reinforced in PPA.

This is being referred to as the “computer model” method, and is basically for conflicted vendors who want to give participant advice. The idea is that a mutual fund family, for example, can use a third party software system that is regularly reviewed by a third party expert to give advice to participants on which of its own funds to choose. This exemption is of only nominal interest to advisors other than as a point to understand about how vendors do business.

“Fiduciary Adviser” or “Level Compensation” method

Here is the key provision for 401(k) advisors. Because this provision can impact advisors in multiple ways I cover it in the several sections below.

The Terms of the Fiduciary Adviser Exemption

Remember that ERISA §406(b) prohibits parties “at interest” from being compensated, and that you may therefore be paid only because there are specific prohibited transaction “exemptions” allowing it. — such as those “statutory” exemptions which already exist in ERISA §408.

The PPA added another statutory exemption as ERISA §408(b)(14). The exemption applies when a “fiduciary adviser” operates under an “eligible investment advice arrangement,” defined as:

- ***Revenue Neutral.*** The compensation of the advisor may not vary based on the investment options chosen—the “level compensation requirement.”
- ***Independent Fiduciary Approval.*** The arrangement must be approved in advance by an independent fiduciary (e.g., the plan sponsor).
- ***Notice to Participants.*** A notice with certain prescribed information, such as fees and parties involved in providing the advice, must be provided annually to participants by the advisor as well as in advance of advice being provided for the first time.
- ***Prudently select and monitor.*** The sponsor/fiduciary must prudently select and oversee the advisor.
- ***Participant directs the transactions.*** This exemption does not apply to a managed account program, or any arrangement whereby an advisor or investment manager exercises discretion.
- ***Independent Audit.*** The advice arrangement is subject to an ***independent audit to ensure compliance with the new rules.*** This requirement is a serious roadblock.

Will CPA firms begin adding this to their audit packages? How much will it cost to do so? When will they be ready? What about audits for plans with fewer than 100 participants, which are not required to have an audit under ERISA already, will the cost be prohibitive?

On the surface this requirement would seem to reduce the likelihood of any sponsor adopting such an arrangement for a plan unless it is already an audit plan and the auditor adds this piece to its standard audit package.

- ***The Advisor*** must be a bank, broker/dealer, insurance company, RIA, or agent/employee of one of the above.
- ***6-Year Records Requirement.*** The advisor must keep records of compliance with these rules for six years.

The Pension Protection Act of 2006: Investment Advice Provisions

By [Fred Reish](#) and [Bruce Ashton](#)

This bulletin analyzes the investment advice provisions of the Pension Protection Act of 2006 (PPA), both the good and the bad. Until the PPA, the prohibited transaction rules of ERISA (and the Internal Revenue Code) have limited the provision of investment advice to participants; it is this legal issue that the PPA seeks to resolve.

Before analyzing the details, we'll look at the background to the new law. Then we'll briefly describe what the PPA provides and finally discuss the observations, concerns and questions we have about the new exemption.

Background

Study after study has shown that, left to their own devices, many—perhaps most—participants in participant-directed plans, such as 401(k) and 403(b) plans, don't invest their accounts very well. The penalty for those participants is that they will not accumulate adequate retirement savings. Congress has been concerned about this issue, and after wrestling with it for several years, in the PPA, Congress has finally acted. The PPA encourages investment advice for participants by creating an exemption from the prohibited transaction provisions of ERISA and the Internal Revenue Code that have been perceived as an impediment to providing such advice.

To be clear, we should point out that, while the original legislative proposals would have offered some relief both for plan level advice (concerning the selection and monitoring of the investment options) and for participant-level advice, the new law addresses only advice to participants.

Before these changes in the law, the marketplace has addressed the problem of participant investing in various ways. One approach has been to encourage participants to use professionally designed or managed portfolios, such as managed accounts, risk-based lifestyle funds and age-based lifecycle funds. Another alternative has been to offer investment advice to participants, though up to now, both plan sponsors and advisers have perceived legal impediments to providing participant-level advice. Whether the PPA will have a significant impact on this remains to be seen.

In order to understand what the PPA does, it is important to understand the legal issues it seeks to address.

Pre-PPA Law

The legal issue addressed by the new provisions arises under the prohibited transaction rules.

These rules prohibit fiduciaries from engaging in conflicts of interest, such as where a fiduciary uses its authority or influence to profit from the use of plan assets, e.g., to increase its compensation. This conflict can exist at the provider level and at the adviser level.

For example, if a broker, broker/dealer or RIA (which we refer to generically as "financial advisers") gives investment advice to participants about the allocation of their accounts, they are considered fiduciaries under ERISA. (Investment advice for this purpose exists where the advice relates to the purchase, holding or sale of investments, forms the primary basis for making investment decisions and is individualized and based on the particular needs of the participant.)

A prohibited transaction would occur, for example, if a financial adviser in this situation, who is receiving commissions or 12b-1 fees, were to give fiduciary investment advice to a participant to sell one mutual fund, on which the broker receives 25 basis points, and purchase another fund, on which he receives 30 basis points. Effectively, the financial adviser causes himself to receive greater compensation because of the advice he gives — and this is prohibited.

Similarly, the problem exists if an investment provider — say, a mutual fund complex — gives fiduciary investment advice. The management fees in its funds will almost certainly vary (as will the revenue sharing it receives from unrelated mutual funds), so a prohibited transaction would occur because its advice can impact the money it makes.

So what is the “solution” offered by PPA?

The PPA Advice Provisions

To summarize:

- Under the new law, there are two situations in which a fiduciary adviser will not engage in a prohibited transaction if it gives investment advice to participants:
 1. the adviser’s compensation is “level” — that is, the amount the adviser receives for giving the advice remains the same no matter what advice is given and how the participant invests his account; or *alternatively*
 2. the advice is given through a computer model, in which case, the compensation does not have to be level.
- To qualify for either of those exemptions, the adviser must satisfy a number of requirements.
- The PPA also creates a new concept of a “**fiduciary adviser**,” which includes registered investment advisors, banks, insurance companies, broker/dealers, registered representatives of a broker/dealer, employees and affiliates of any of these entities.
- For the **computer model**, the following conditions apply:
 - The model must:
 - apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
 - utilize relevant information about the participant, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income and preferences as to certain types of investments;
 - utilize prescribed objective criteria to provide asset allocation portfolios comprised of investment options available under the plan;
 - operate in a manner that is not biased in favor of investments offered by the fiduciary adviser or a person with a “material affiliation or contractual relationship with the fiduciary adviser;” and
 - take into account all investment options under the plan and specifying how a participant’s account balance should be invested and is not inappropriately weighted with respect to any investment option.
 - The model must be certified as satisfying those rules (as well as others, that may be imposed by the Department of Labor) by an investment expert who is independent of the entity that is using the model to offer the advice.
 - The advice must be given exclusively through the model. By “exclusively,” the PPA means that all advice delivered to a participant, whether, e.g., delivered over the telephone or in a face-to-face meeting, must be based only on the results produced by the model, unless the participant requests other advice and it can be shown that this request was unsolicited by the adviser.

Note: The entity that develops the computer model or markets an investment advice program or computer model is also considered a fiduciary.

- **In both cases** — i.e., in both the level compensation and the computer model scenarios - – there are additional conditions that apply. The most important of those provisions are:
 - The compensation received by the fiduciary adviser and its affiliates must be reasonable, whether level or variable.
 - The provision of advice to participants must be approved by a plan fiduciary other than the fiduciary adviser or one of its affiliates (presumably, this would typically be the plan sponsor).
 - The adviser must make certain disclosures to the participants, including the amount and sources of its (and any affiliate's) compensation and the fact that it is acting as a fiduciary.
 - The adviser must be “audited” annually for compliance with the PPA requirements and must annually provide a compliance report to each plan sponsor that is offering the advisory services to its participants.
- The actual implementation of investment decisions based on the advice (buying, selling or holding securities) must be solely at the direction of the participant. *Comment:* In light of this requirement, the PPA does not cover investment management (that is, where the adviser has discretion to implement its investment decisions).
- The plan sponsor or another independent fiduciary must prudently select and monitor the fiduciary adviser, but so long as all the conditions of the exemption are satisfied (and the terms of the arrangement require compliance with the exemption, including acknowledgment of fiduciary status), it has no duty to monitor the advice given to the participants. In other words, the plan sponsor has no responsibility or liability under ERISA for the advice given. *Comment:* It is not entirely clear that this “exemption” (the term used in the PPA) was necessary. Some lawyers believe that, even under the prior law, the plan sponsor was not responsible for the advice given to participants so long as it prudently selected and monitored the adviser. Others reached the opposite conclusion, but the PPA now provides a definitive answer.

Observations, Concerns and Questions

We have a number of concerns and observations about the new law:

The Need to Comply. The most obvious observation is that the law creates an exemption for a situation that does not appear to be a prohibited transaction. As described above, ERISA says that a fiduciary cannot use its authority to influence the amount of its compensation. But if its compensation is already level, that is, the same regardless of the advice given, there is no prohibited transaction.

If a fiduciary adviser's compensation is already level (i.e., in the typical RIA scenario), why do we need a somewhat elaborate set of rules – including an expensive audit requirement that may increase the cost of participant advice – for obtaining an exemption for a non-prohibited transaction?

The receipt of level compensation by an investment adviser does not violate the ERISA conflict-of-interest prohibition. Since there is no prohibited transaction, no exemption is needed.

This rationale would **not** apply in the computer model situation — unless the fiduciary adviser's compensation were level. Thus, presumably, an adviser that is already receiving level compensation could continue to act without satisfying the new requirements. *Well, maybe not.*

First, there appear to be greater protections for the plan sponsor if the adviser complies with the new rules. That is, under the PPA, it is now clear, in a complying arrangement, that the plan sponsor is not responsible for the advice given by a fiduciary adviser to the participants.

The PPA also states that the plan sponsor will not be considered to have breached a duty under ERISA by offering participant-level investment advice. In both cases, these protections are conditioned on compliance with the new requirements. Result, we may see plan sponsors demanding this “safe harbor” relief, which could effectively force advisers to comply with new requirements, even if their compensation is level.

And whether or not plan sponsors demand it, fiduciary advisers wishing to provide the greatest protection for their clients will take steps to comply. Finally, it also seems likely that the requirements of the exemption will become the industry “norm.” So for competitive reasons, advisers may need to comply even though no prohibited transactions exist.

We believe that most level fee advisers will opt to comply. Indeed, several level fee advisory firms have already contacted us about developing their agreements and procedures for compliance.

ERISA already provides protections which is comparable or superior to those provided under the new PPA provisions for investment management. Under ERISA Section 3(38), an investment manager is defined as an RIA, bank or insurance company that is given discretion over plan asset investment decisions and agrees in writing that it is a fiduciary.

If the plan appoints an investment manager – at either the plan or participant level – the plan sponsor is not responsible for the manager’s investment decisions, though it is required to prudently select and monitor the investment manager.

These requirements look a lot like the PPA requirements for participant level investment advice with a major difference. Where the manager’s compensation is level, there is no prohibited transaction under ERISA, so there is no need for compliance with the PPA requirements. And, as noted, the plan sponsor receives at least the same level of protection as provided under the new law.

Compliance Burdens. Why would an adviser object to complying?

There are a number of reasons:

- The requirement that the adviser acknowledge in writing that it is a fiduciary could prevent some financial advisers in the computer model situation from taking advantage of the exemption because their broker-dealer firms will not permit them to make this acknowledgment. However, we understand that some broker-dealers permit their registered representatives to give this acknowledgment, where level fee arrangements (such as wrap accounts) can be structured. We also understand that some broker-dealers are considering the computer model approach, as are some of the mutual fund complexes. It remains to be seen if the wire houses will do so.
- The PPA provides an exemption for: (i) the provision of investment advice to participants; (ii) the purchase, sale or holding of securities based on that advice; and (iii) the receipt of compensation by the fiduciary adviser or any affiliate of the adviser.

However, in the level compensation situation, the PPA only requires that the compensation received by the fiduciary adviser, and not that received by his affiliates, be level (though the disclosure requirements do include the compensation of both the adviser and its affiliates). But this is one of the areas where the PPA is poorly drafted. That is, it is not entirely clear whether this is a distinction that Congress meant, *i.e.*, whether the compensation of the affiliates must be disclosed but only the compensation of the fiduciary adviser must be level. Our reading of the statute indicates that this is the case, but others have expressed concern about a possible ambiguity in the law.

Assuming this distinction is intended, the issue of who the fiduciary adviser in this context is extremely important, but it is not entirely clear. Is it the individual who gives the advice or his firm? Presumably, if the individual is an employee of a firm, the firm is the adviser, so its compensation related to the advice must be level. However, that is not clearly stated in the law. And, if the firm “controls” the individual on what advice to give, the fiduciary adviser would also seem to be the firm. Again, it is not clear. As a result, deciding exactly who the fiduciary adviser is — and therefore whose compensation must be level — could be problematic.

- The computer model approach may be viewed as too restrictive because of the exclusivity requirement. That is, if a financial adviser is meeting with a participant who wants advice, the adviser will be limited to providing the advice generated by the computer model and the adviser would not be able to offer individualized advice outside the model.

However, there is an exception if the participant asks for additional advice and it can be shown that he was not solicited to do so. Even here, there could be a problem in showing that the request wasn't solicited. For example, where only one out of a hundred participants requests other advice, it suggests that the adviser was not soliciting the participants for non-computer model advice. But if a substantial number of participants request additional advice, it could support a conclusion that the participants were being solicited.

Of course, all of this begs the question ... what does solicitation mean in this context? Hopefully, DOL guidance will clear up the picture. Further, while we read the law to say that the additional advice is not required to be based on the model and that the consultant can deviate from the model, we hope that the DOL will also make that clear.

- Perhaps the biggest impediment in both the level compensation and computer model situations is the burden and expense of an annual audit by an independent, qualified third party. While the law is reasonably clear on what has to be audited, it is not entirely clear on how the audit is to be conducted.

The PPA says that the auditor must verify whether the adviser has complied with the conditions of the exemption, which would cover such things as whether:

- the fiduciary adviser is one of the approved types of entities;
- the arrangement has been approved by an independent fiduciary;
- the proper disclosures are being given to the participants;
- the adviser's fees are level (where the adviser is operating under that exemption);
- or whether the advice is given exclusively by the computer model and, if not, whether the participants were solicited to ask for additional advice.

But is the term “audit” to have the same meaning as an accounting audit?

Can the “auditor” reach conclusions as an accountant does through statistical sampling ... or is something more extensive required? And does the audit relate to the conduct of the adviser generally or must it be done on a client by client basis — *i.e.*, must the report given to the individual plan sponsor relate to how well the adviser met the requirements with respect to that plan or does it look only at his overall compliance?

We assume the DOL will issue guidance on this subject to reduce the confusion. In any case, this requirement will add a level of expense that will either be passed on to the participants or will be absorbed by the advisers with deeper pockets.

Conclusion

The investment advice provisions of PPA contain significant holes in the law and some conditions that at this stage are unclear or may be unduly burdensome for advisers (other than larger level-fee advisory firms that focus on participant-level advice) and providers (other, perhaps, than the larger providers with affiliated mutual funds). We hope that DOL guidance will be forthcoming in the near future to clarify some of the key issues in the new law.

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The New Participant Investment Advice Law

By [Bruce Ashton](#)

In August, the Pension Protection Act of 2006 (PPA) became law. A key provision of the PPA relates to providing investment advice for participants in 401(k) plans, which Congress considered essential in light of numerous studies showing that most participants have neither the ability nor the desire to adequately direct their accounts. Congress has wrestled with the issues surrounding investment advice for a number of years and considered various bills that would have addressed both plan level and participant level advice. In its final form, however, the PPA only deals with advice for participants. But at least Congress came up with the formula that will help participants invest properly to accumulate adequate retirement savings. Right? Maybe not.

Before describing what the law does, let's review the law before PPA. First, a plan sponsor that made investment advice available to its participants was required to prudently select and monitor the investment adviser. Some analysts believe that the sponsor was also responsible for the advice given to the participants; others disagreed, believing that the plan sponsor was responsible only for selection and monitoring of the adviser. Suffice it to say, the law was unclear. If an adviser was a fiduciary to a plan, and if it gave advice that increased its compensation (for example, if it increases the adviser's commissions) or that of affiliated entities, it engaged in a prohibited transaction (PT). But if its compensation was the same no matter what advice it gave (called level compensation) and the compensation was reasonable, there was no PT.

Now, here's what the new provision does: it gives qualified advisers an exemption from the PT rules if the advice is given under one of two circumstances: (1) the adviser's compensation is level; or (2) the advice is provided solely through a computer model that is certified to be unbiased by a third party expert.

A qualified adviser for these purposes (referred to in PPA as a "fiduciary adviser") includes registered investment advisors, banks, insurance companies, broker/dealers, registered representatives of a broker/dealer and affiliates of any of these entities, such as a mutual fund advisory firm.

If the computer model approach is used, the compensation does not have to be level.

There are several other conditions to receiving the PT exemption in each case: (a) the adviser must acknowledge to the plan sponsor and the participants that it is a fiduciary; (b) the adviser must make various disclosures to the participants; and (c) it must provide a third party annual compliance report to the plan sponsors (though it is not entirely clear what the report must cover). If the conditions are met, the plan sponsor is not responsible for the advice, though it is still required to prudently select and monitor the adviser.

So how does this help? Perhaps in two ways: First, the uncertainty that previously existed has been clarified -- the sponsor now has a safe harbor...that is, it is not responsible for the advice given, so long as the requirements are met.

Second, plan sponsors may be encouraged to offer investment advice to their participants -- which will benefit the participants. Why? Because the existence of legal standards that advisers must meet in order to obtain the exemption may give sponsors a comfort level, at least in a practical way, that offering advice to participants is "safe."

Why are we skeptical?

Advisers that already charge level compensation may elect not to comply with the new rules, which are burdensome and expensive, because at least arguably, they don't need them because under existing rules there is no prohibited transaction and therefore, there is no need for an exemption. If that happens, there is no safe harbor protection for the sponsor – though, again arguably, the safe harbor isn't needed.

Also, in recent years, age-based lifecycle funds and risk-based lifestyle funds have become so popular that, as a practical matter, the need for participant investment advice may have been largely replaced by these “solutions.”

That said, we understand that some mutual fund companies – which need the exemption because of the variation in management fees they receive on the funds they manage and/or the revenue sharing they receive from third party mutual funds – do intend to rely on the new exemption, despite its burdens.

Investment advice to participants can be highly beneficial. Unfortunately, it may take time for the uncertainties on whether the new requirements are needed (in the case of level compensation advisers) and how to comply with some of them (e.g., the annual compliance report requirement) for advice to become a routine part of plan operation.

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Financial Advisor magazine

New Pension Law: The Good And Bad

August 17, 2006

Call it the grey lining in an otherwise silver cloud. The new Pension Protection Act of 2006 signed into law by President Bush today does much to help working Americans save and invest for retirement. But on every parade a little rain must fall.

For workers who weren't saving, the bill will allow employers the ability to automatically enroll workers in a 401(k) plan.

For workers unsure which fund to invest in, the new law will enable employers to put worker's money in a default fund that, all things being equal, is far better than a money-market account.

And, for workers who failed to increase each year the amount they set aside for retirement, the new law will give employers the ability to adjust upward automatically the percent workers set aside in their 401(k) plan.

But experts are predicting that big headaches and lawsuits will likely arise as Americans sort through the provisions that deal with the "investment advice" workers participating in a retirement plan may receive starting in 2007.

In essence, Ross Spencer, a senior editor at CCH, a publication of Wolters Kluwer Law & Business, said qualified "fiduciary advisors" will be allowed to offer personally tailored professional investment advice to help employees manage their 401(k) plans, individual retirement accounts (IRAs) and other plans.

Spencer said the advice can be delivered in one of two ways.

The fiduciary advisor can either generate portfolio recommendations for a participant based on an unbiased computer model that has been certified and audited by an independent third party or the fiduciary advisor can provide investment advice services face-to-face by charging a flat fee, such as \$500 per year per participant, that does not vary depending on the investment option chosen by the participant.

Spencer said the fiduciary advisor may be affiliated with the investment funds offered in a 401(k) plan but would have to meet disclosure, qualification and other self-dealing safeguards.

And if certain conditions are met, Spencer said that employers or what are known as plan sponsors would not be obligated to monitor the specific advice given to any particular participant or beneficiary, though they would retain the responsibility to prudently select and monitor advice providers.

Don Trone, the CEO of Fiduciary 360 in Sewickley, Pa., said the new law does not go far enough in defining the scope of services which should be provided by, and be the responsibility of, the fiduciary advisor. "The act focused on the use of computer models which deal almost exclusively on the development of a participant's asset allocation decision," he said.

According to Trone, an appropriate advice model should include asset allocation and optimization procedures, due diligence procedures for selecting investment options, due diligence procedures for monitoring investment options, an assessment of investment-related fees and expenses and an assessment of whether the plan sponsor is meeting its investment fiduciary responsibilities.

More Holes

Paul Bracaglia, an investment advisory partner with PricewaterhouseCoopers' Private Company Services, has concerns about the portfolio recommendations that will be generated for participants based on computer models as well as the advisor.

For instance, he said it's possible the computer will generate portfolio recommendations that are specific to the investment choices in a person's 401(k) plan and may not reflect a person's entire investment portfolio, including their taxable investments. And if that's the case, Bracaglia said the recommendations would be inappropriate because the data gathering process would not be holistic.

"It would be a case of garbage in, garbage out," he said. "A person's taxable and tax-deferred portfolios have to meld together to meet a person's overall goals."

Another shortcoming of the new law has to do with the fiduciary advisors delivering the advice. The law seemingly doesn't address whether advisors can give a participant advice about assets outside the 401(k) and IRA assets.

In some cases, an advisor might give advice on funds outside a 401(k) but charge a separate fee for those services. In other cases, the advisor may decline to provide a participant with advice about assets outside of a 401(k) or IRA because the new law provides no safe harbor for the advisor to do so.

Bracaglia said employees should ask their employers the following five questions to learn more about their company's fiduciary advisor and what they are and are not permitted to do:

- Will the fiduciary advisor take into account assets I maintain outside of my 401(k) plan in developing their suggested strategy?
- Will the fiduciary advisor provide advice on my non-401(k) assets?
- What level of oversight will my company provide on the fiduciary advisor to ensure it is providing appropriate services, without jeopardizing confidentiality?
 - If I am not happy with the fiduciary advisor that has been assigned, what recourse do I have?
 - If I am working already with an investment advisor, can I use that advisor as my fiduciary advisor (and have those fees paid by the company)?

Bracaglia said employers, many of whom are not yet trained to search for and select a fiduciary advisor, will have to determine whether a prospective fiduciary advisor is truly independent. And the due diligence required is not insignificant.

"While the new law is a step in the right direction, what prevents the advisor from offering biased advice or attempting to sell products outside the scope of the company's benefits/retirement offerings - actions that could open the door to serious liability issues for the sponsoring company," Bracaglia said.

Louis Harvey, president and founder of market-research firm Dalbar Inc., said the new law could expose employees to unethical fiduciary advisors if employers ignore the due diligence requirement. "Disclosure is not enough when it comes from the unethical advisor, be it an independent or a firm," Harvey said in an email.

Harvey did note that the plan sponsor would be liable for the advice given to employees if the sponsor cannot document that it performed the required due diligence on the advisor.

Positive On Balance

Despite all the new law's shortcomings, Trone and others say the positives far outweigh the negatives and workers are likely to be far better off under the new law.

For instance, Trone said the biggest positive is that the new law forces broker-dealers to at long last formally define a fiduciary standard of care and the instances when the fiduciary standard will be applicable to brokers.

"Up-to-this point," Trone said, "broker-dealers have, for the most part, refused to acknowledge any circumstance under which their brokers may be deemed to have fiduciary status; the NASD has never defined an investment fiduciary standard of care for broker-advisors; and the SEC has skirted the issue of whether a broker-advisor could be deemed to have fiduciary status by making permanent an exemption for broker-dealers to register as investment advisors as long as the broker's advice was incidental to the sale of a financial product or the execution of a transaction."

All that is about to change, said Trone, and for the better.

House Pension Funding Reform Bill Would Enable Employers to Provide Professional Investment Advice for Employees

H.R. 2830 Would Remove the Potential for Liability As Long As Advice Is Provided Through a Qualified Advisor

As employees have become increasingly reliant on their 401(k) plans for their retirement income, they have sought greater assistance from their employers in obtaining professional advice on selection of investments. Frequently, employees do not feel they have sufficient knowledge to make sound decisions, and often invest their money too conservatively to ensure adequate retirement savings. However, under current ERISA and Internal Revenue Code rules, employers may be held liable for individual investment advice provided by professional advisors, thus discouraging them from providing access to such advice. As described below, H.R. 2830, the pension reform bill that recently was passed by the House Workforce Committee, would eliminate employer liability if such advice was provided by a qualified advisor, as defined in the bill, and certain disclosure, transactional and recordkeeping requirements were fulfilled. Similar provisions could be considered when the Senate Finance Committee considers its version of pension reform legislation.

ERISA Discourages Employers From Offering Independent Investment Advice to Employees

Employers do not typically offer their employees access to investment advice because ERISA strongly discourages the practice. Under current law, an employer that engages an investment advisor to counsel employees remains potentially liable for individual trading losses that result, even if the advice was reasonable. ERISA's "prohibited transactions" rules prohibit transactions or the provision of services between a retirement plan and an investment advisor that is also administering the company's retirement plan, thus limiting the pool of potential advisors. Further, ERISA and related Labor Department interpretations prohibit a fiduciary such as a third-party plan administrator from making recommendations to plan participants that affect the timing or amount of the fees it collects from the advice. Such violations can saddle employers with a 15 percent excise tax penalty, even if there is no showing of harm or risk to the plan.

House Pension Reform Bill Would Lift Employer Liability for Investment Advice By "Fiduciary Advisors" If Requirements Met

H.R. 2830 would eliminate employer liability for investment advice, as long as the advice is provided by an investment advisor, called a "fiduciary advisor," pursuant to a contract, and certain disclosure, terms of the advice, and recordkeeping requirements are met. A fiduciary advisor is defined as a registered investment advisor under either federal or state law, and also includes banks, insurance companies, and registered broker-dealers, as well as their affiliates, employees, and agents. **To maintain the limitation on liability, the plan sponsor has a duty to prudently select a fiduciary advisor, which includes reviewing the advisor's qualifications.**

House Pension Reform Bill Would Require Enhanced Disclosure, Arm's-Length

Transactions The fiduciary advisor must disclose in writing five elements of the arrangement, in addition to any disclosures required by securities laws: (1) the fees or other compensation the advisor receives from providing the advice and the sale or acquisition of securities; (2) the affiliation or contractual relation to any asset recommended, purchased or sold; (3) any limitation on the fiduciary's ability to provide advice (such as the inability to analyze and recommend employer stock); (4) the types of advisory services provided; and (5) that the advisor is acting as a fiduciary of the plan with respect to the advice provided. The plan participant must direct any sale or purchase of securities and the compensation received by the advisor must be reasonable, keeping in mind the prices and terms generally available in the services. The advisor is also subject to certain recordkeeping requirements.

Opponents Seek Additional Restrictions Although nearly identical legislation has passed the House three times with bipartisan support, Democrats opposed to the provisions either oppose any exemptions from the prohibited transactions rules or argue that as written, the exemption in the bill is subject to impermissible conflicts of interest. They recommend that fiduciary advisors should be required to offer two advisors – the affiliated advisor and an “independent” advisor – thus effectively doubling the cost without necessarily improving the quality of service.

Opponents Argue That Remedies and Disclosure Are Inadequate Opponents of the bill further argue that ERISA does not provide a “meaningful remedy” for breach of fiduciary duty. The legislative history of ERISA makes clear that a full range of legal and equitable remedies are available for such breaches under ERISA. Opponents have also claimed that the definition of fiduciary advisor does not ensure qualified investment advisors. Yet, the sponsors point out that the definition of fiduciary advisor is based upon ERISA's definition of “investment manager,” an individual in charge of managing plan assets who possesses much greater authority over them than individuals who provide advice that participants may accept or reject. In addition, as noted above, the plan sponsor has a duty to prudently select the fiduciary advisor. If the advice is provided through a company (rather than by an individual), the entity has a fiduciary duty to provide an individual who is trained in, and is capable of providing the necessary advice for plan participants. Opponents have also argued in favor of having the advisor provide a disclosure to the participant each time advice is provided. In response, the sponsors point out that the bill already requires the Department of Labor to design and disseminate a model disclosure form, and disclosure is already required at the first meeting and any time a material item changes in the disclosure.

Registered Rep

Deciphering the Rules of Retirement Advice

By John Churchill

Oct 1, 2006

Tom is one of Merrill Lynch's top brokers. He has more than a \$1 billion in assets under management. But Tom (not his real name) has been living with a dark secret, which explains the need to conceal his identity: He built most of that book by selling 401(k) plans to dozens of businesses and, in the process, he repeatedly violated regulations that forbid registered persons from dispensing anything that could be construed as investing advice to plan sponsors or participants.

Tom — and other advisors who sell retirement plans — have worked around the strictures of the 1974 Employment Retirement Income Security Act (ERISA), which forbade them from assuming a fiduciary role because lawmakers assumed that brokers could not be trusted not to hornswoggle plan participants.

The closest they could come to offering advice was providing educational information, which guys like Tom say is not sufficient to convince first-time investors to make wise decisions about participating in company-sponsored plans.

"If you got me in a court of law I'd say I only give education," Tom says. "But I give advice. Look, we give a seminar and guys will walk up afterwards and say. 'What's a stock?' We're just looking out for their interests."

In June, Congress enacted the Pension Protection Act, the most sweeping retirement legislation since ERISA, which incorporated changes that the securities industry lobbied long and hard for, including permission for reps who sell retirement programs to start dispensing investment advice, albeit within strict limitations.

So, is Tom – and perhaps thousands of Toms across the country – ready to come out of the closet and declare himself to be a retirement advisor without shame. Not exactly.

Title VI of the legislation, the provision dealing with investment advice, is designed to remove some of the barriers preventing players in the 401(k) business from assisting plan sponsors and their participants.

However, **major firms** such as Merrill Lynch **say** for now **they prefer to stick to the computerized third-party advisory plans that they have been using under a Department of Labor (DOL) exemption to ERISA's "prohibited transaction" rule, which forbids any activity that would actually result in transactions** (i.e., sales of products or services for a fee).

Therefore, fiduciary advisors **affiliated** with a 401(k) record-keeper / investment manager, such as Fidelity, whose fees are affected by participant elections, i.e., commission-based advisors (brokers), can continue to use computer-generated advice.

Title VI extends the exemption to all reps, who do not work directly for a 401(k) service provider, such as Fidelity, as long as the reps take on fiduciary status and:

- the investment advice is either generated by a third-party computer model that uses objective criteria and meets certain other specific requirements, or
- a fee-neutral compensation arrangement is used (flat fee)

Advice About Giving Advice

Title VI, far from being a clear-cut signal for reps to dive into the retirement advice business, does, however, open the door wider to advice giving. But, because of the provision's confusing legalese and multiple terms and conditions, firms are not at all clear yet about how far they can go.

For example, the provision allows plan participants to get additional advice from the advisor – but only after using the computer model and only if the advisor does not solicit the additional advice business from the plan participant.

Fred Reish, an ERISA attorney with Los Angeles-based Reish Luftman McDaniel & Reicher, says that no one knows what that means. “How would anyone know they can ask for advice if they're not told they can ask?” says Reish.

Because of unknowns like these, Bo Bohannon, the director of retirement plans at Raymond James & Associates, says his firm is eagerly waiting for the Secretary of Labor's clarifications, expected in the coming months.

In the meantime, Don Trone, CEO of Fiduciary360, a fiduciary research and consulting firm, says “a number of firms from the smallest to the largest b/ds,” including wire houses he wouldn't name, “have been seeking advice on implementing fiduciary standards of care.” So firms are getting ready to push the DOL to interpret the law in a way that will give them the clear signal that it's safe for their reps to become 401(k) fiduciaries. But, until then, they won't be changing their policies.

“The new law really codifies what we've been doing for the past three years,” says Kevin Crain, director of institutional product and sales for Merrill Lynch's retirement group. With a waiver from DOL, in 2003, Merrill Lynch created Advice Access, a **computer system** that takes information about investment goals and risk tolerance of 401(k) plan participants and spits out asset allocation and fund recommendations. **Because the system is run by Ibbotson & Associates, Ibbotson is the fiduciary, not Merrill Lynch.**

Advice Access is available to 300,000 plan participants and 60,000 have used it to select retirement-savings portfolios. Crain says he expects the program to expand as a result of the new PPA legislation.

Smith Barney parent Citigroup allows members of Citigroup Institutional Consulting (CIC), the firm's elite institutional advisor force, to serve as fiduciaries to 401(k) plan sponsors on a “case-by-case basis,” but does not allow Smith Barney advisors to serve as fiduciaries to plan participants.

Smith Barney advisors can sell its proprietary TRAK 401(k) program to plan sponsors. TRAK works like the Merrill/Ibbotson system, directing employees to any of 11 asset-allocation models, depending on their inputs. Participants receive ongoing investment advice, portfolio monitoring and performance analysis, all for a level annual fee. **TRAK was exempted by the DOL in 1997 from the prohibited transaction rule because of the fee arrangement.** As with Merrill's Advice Access, the owner of the system (in this case Citigroup), not the advisor, is the fiduciary.

For now, Smith Barney's only reaction to the Title VI rules will be to spruce up TRAK, says Norm Nabhan, the head of Smith Barney's Consulting Group. But, he acknowledges, there is growing pressure from plan sponsors (employers) to obtain investing advice from the securities firms. “The plan attorneys, the lawyers who draw up all the documents, are more and more asking for fiduciary representation,” he says.

Trone predicts that all firms will eventually permit reps to assume fiduciary roles in the 401(k) business. “What I think is starting to happen — and will happen — more is that plan sponsors, fed up with the lack of results from education, will say, ‘I want advice,’ and that comes with a fiduciary duty,” says Trone. He adds that, in considering their options, the brokerage firms will have to acknowledge the new competition from firms like Fidelity and other record-keeper/invest managers that the Act now allows to provide advice.

The most forceful argument for allowing advice, says Trone, is the falling participation rates in retirement plans and the specter of millions of Americans without adequate retirement savings, a big impetus for the reforms in the PPA bill. Participation rates in 401(k) plans linger around 70 percent of eligible employees, but less than 10 percent contribute the maximum amount allowed.

According to the Employee Benefit Research Institute (EBRI), the average account balance among its database of 17.6 million 401(k) participants – 37 percent of the estimated total in the U.S. – was \$58,328 at the end of 2005. The median account balance was \$19,398.

Those numbers are likely to rise because of the Act. However, **the immediate goal of the Pension Protection Act, as the name telegraphs, was to shore up traditional defined benefit retirement plans – and protect the federal insurer, the Pension Benefits Guarantee Corp. (PBGC), from hundreds of billions of dollars in claims from participants in failed plans.**

Since the introduction of 401(k) plans, which employees mostly fund, the majority of employers have opted out of traditional retirement plans. According to the PBGC, less than 40,000 companies offer defined benefit plans today, down from more than 100,000 in 1985.

The PPA forces traditional defined benefit pension plans to be fully funded on an ongoing basis and underfunded plans have seven years to catch up – and it requires more conservative (read: costlier) actuarial and investment assumptions. **Result**, corporate-finance experts predict that the Act will **encourage more companies to scrap traditional pension plans.**

Before Congress passed the PPA, Verizon and IBM had already announced plans to freeze their defined benefit plans and move all new retirement benefits to their 401(k) plans, producing estimated savings in the billions of dollars.

The new law also encourages greater employee participation in 401(k)s, IRAs and other retirement vehicles by providing or extending over 20 tax benefits.

The good news for financial advisors – even if they never waded into the 401(k) business – is that the greater the participation in employee-directed retirement plans, the bigger the pot of money that will be available for rollovers.

According to Financial Research Corp., a market researcher, \$1.9 trillion in rollovers will come out of company-sponsored plans between 2005 and 2010. “That’s what all the firms want,” says Tom, the Merrill advisor who says a good chunk of his business already comes from clients who started out as students in his 401(k) “education” classes.

The best route to those rollovers, however, is selling the 401(k) plans first. And, as Tom attests, the way to cultivate that business is to provide something more substantial than a half hour in the cafeteria and a literature drop.

So, will the firms help make this possible? Will they open the closet door and let their Toms come out as fiduciaries? In his rounds with firms, Trone thinks change is definitely afoot. “I’d advise anyone thinking about leaving their firm because it doesn’t provide fiduciary services to wait six months.”

32 Years of ERISA

From legislative act to implementation, a look at major developments relevant to ERISA since its birth.

Sept. 2, 1974 — President Gerald Ford signs the Employee Retirement Income Security Act of 1974 (ERISA), Public Law No. 93-406.

Revenue Act of 1978 — Congress establishes the concept of 401(k) and cafeteria plans.

Multi-Employer Pension Plan Amendments Act of 1980 — Congress establishes rules relating to union pension plans and withdrawal ability.

Tax Equity Act of 1984/Retirement Equity Act of 1984 — Congress continues to revamp welfare benefit plans and deals with the gender gap in retirement plans.

Tax Reform Act of 1986 — Congress makes sweeping changes in the Internal Revenue Code by tightening discrimination testing under Section 401(k) plans and imposing salary deferral limits.

Unemployment Compensation Amendments of 1992 — Congress changes distributions from qualified pension plans, including rollover rules relating to transfers to IRAs and qualified plans.

Uruguay Round Agreements Act of 1994 — General Agreement on Tariffs and Trade — Congress increases premiums for defined benefit plans and imposes additional requirements on underfunded plans to provide detailed funding and financial information.

Small Business Job Protection Act of 1996 — Congress authorizes a new type of simplified retirement income plan for small employers and amends the distribution requirement for pension plan distributions.

Tax Relief Act of 1997 — Congress provides for Roth IRAs.

Economic Growth and Tax Relief Reconciliation Act of 2001 — Congress increases limitations on elective deferrals to 401(k) plans and creates additional contribution rights for employee/participants age 50 and over.

Pension Protection Act of 2006 — forces corporations to shoulder their defined benefit obligations, seeking to relieve the strain on the already underfunded Pension Benefit Guarantee Corporation (PBGC). The bill also allows 401(k) and like sponsors to offer employees automatic enrollment, increases contribution limits to IRAs and allows qualified fiduciary investment advisors to provide previously forbidden investment advice to defined contribution plan participants.*

Source: The law firm of Sachnoff & Weaver in Chicago, with the exception of the "Pension Protection Act of 2006."



Investment Advice Provisions of the Pension Protection Act of 2006 (PPA '06) (Title VI, Subtitle A, Section 601)

Current regulations under ERISA prohibit certain transactions between a qualified plan and its fiduciaries. One of the definitions of a fiduciary is one who provides plan-related investment advice for compensation.

These rules prevent commission-based advisors from rendering advice to participants, as the participants' selections impact the advisors' compensation. While fee-based advisors have more flexibility, present law holds plan sponsors liable as fiduciaries for any advice given to participants and the subsequent results of that advice.

The Pension Protection Act of 2006 ("PPA") changes the playing field. Effective January 1, 2007, both fee and commission-based advisors meeting certain requirements will be able to offer investment advice to participants in 401(k) and other defined contribution plans.

A covered advisor (one registered with the appropriate securities and/or insurance regulatory entities as well as banks and similar financial institutions) must enter into a formal agreement with a plan sponsor to provide advice to that sponsor's participants. The agreement must require the advisor to comply with the appropriate legal requirements and *must acknowledge the advisor's status as a plan fiduciary*.

In addition, the advisor must provide a notice to the participants at least once per year that includes the following information:

- *Acknowledgment of advisor's status as a plan fiduciary*
- All compensation to be paid to the advisor or any related party
- Any material affiliation between the advisor and the plan's investment options
- Role of any related party in developing the advice or offering plan investments
- All services provided by the advisor in connection with the advice
- How participant information will be used or disclosed
- Ability of participants to seek other independent advice
- Past performance and rates of return for all investment options in the plan

Upon satisfying these requirements, fee-based advisors, e.g. those whose compensation is not impacted by the participants' actual investment choices, can offer advice to the plan participants. Those whose compensation is affected by participant elections, i.e. commission-based advisors, can offer computer-generated advice.



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The computer model must meet several additional requirements. The model must...

- be based on generally accepted investment theory including historical returns of different asset classes over time
- use relevant information about the participant
- use objective criteria to build asset allocation models
- not be biased towards investment options offered by the advisor or an affiliated party
- take into account all plan options without inappropriate weighting towards options offered by the advisor or any affiliated party

The model must be certified by an independent investment expert and re-certified any time there is a material change. The advisor is not permitted to offer any advice other than that generated by the model. A participant must make an affirmative election to implement any of the advice provided.

Both fee-based and computer-generated advice programs must be audited each year by an independent expert to ensure compliance with all the rules outlined above. The auditor must provide a written report to the plan sponsor detailing the results.

Plan sponsors implementing a so-called “eligible investment advice program” must abide by the normal prudence requirement in selecting an advice provider; however, sponsors are not required to monitor the specific advice given to participants. More importantly, plan sponsors enjoy a waiver of fiduciary liability with regard to such a program.

As long as the advisors’ compensation is reasonable in light of the services provided, they are entitled to an exemption from the prohibited transaction rules with regard to the advice as well as any transactions that result.