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NEWSLETTER

Pension Protection Act and New DOL Guidance Open Doors for Nondiscretionary Investment Advice to 401(k) Participants

March 16, 2007

The Pension Protection Act of 2006 (the "Pension Protection Act") includes the most sweeping changes to the fiduciary provisions of ERISA since its enactment in 1974. Among the most significant changes is a new statutory exemption intended to facilitate the provision of investment advice to plan participants. The new exemption permits investment advisers who are affiliated with a plan's underlying investment options to provide individualized investment advice (but not discretionary investment management) to plan participants, if the arrangement satisfies certain conditions. Moreover, the exemption provides assurance that employers (plan sponsors) who decide to offer investment advice will not be liable for the investment recommendations made by the designated investment advisor.

Last month, the U.S. Department of Labor ("DOL") issued guidance in the form of a Field Assistance Bulletin (FAB 2007-1) to DOL enforcement personnel that favorably resolves many of the ambiguities in the statute. The options available for plan sponsors who wish to offer investment to plan participants are likely to grow substantially over the next year as plan providers roll out new products intended to take advantage of the new rules.

Background

Section 406(b) of ERISA generally prohibits fiduciaries from exercising their fiduciary responsibilities in a manner that results in a benefit to themselves or a person in whom they have an interest. In the absence of an exemption, when an investment adviser recommends to plan participants that they invest their individual accounts in investment options from which the investment adviser (or its affiliates) will receive fees or other compensation, a prohibited transaction may result.

Over the last fifteen years, DOL has taken steps to define circumstances under which investment advisers subject to a potential conflict of interest could nevertheless provide much-needed investment advice to plan participants. In particular, DOL issued several administrative individual and class prohibited transaction exemptions, including Prohibited Transaction Class Exemption ("PTCE") 77-4, that addressed the potential conflicts of interest in one of two ways. One approach was to require the investment adviser and its affiliates to ensure that the fees that they received from each of the underlying investment options would not vary, or would vary only to a de minimis degree (the "fee leveling" ap-

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proach). The other approach was to require the investment adviser and its affiliates to credit fees received from the underlying investment options against the advisory fees charged to the plan the "fee offset" approach). PTCE 77-4 employed a variation on the "fee offset" approach, but its usefulness in the 401(k) plan market was limited by its restriction on the payment of sales commissions and uncertainties as to how it applied in the context of participant-directed plans, among other issues.

In 1996, DOL issued interpretive guidance (DOL Interpretive Bulletin 96-1) in which it described several types of investment education services (sometimes referred to as "near advice"), including individualized asset allocation models, that could be provided to plan participants without being treated as "investment advice" that would trigger the application of ERISA's fiduciary responsibility rules, including the prohibited transaction rules.

An advisory opinion issued in 2001 (DOL Advisory Opinion 2001- 09A, or the "SunAmerica letter") described circumstances under which affiliated investment advisers could provide investment advice or investment management services to plan participants, provided that the advice was generated by a program developed by an "independent financial expert" without the need for a prohibited transaction exemption. In DOL's view, because the investment adviser would use a program developed by an unrelated person to generate the advice, the investment adviser would not truly be exercising the discretion that would otherwise make it fiduciary when it provided the advice.

In 2005, DOL opined (DOL Advisory Opinion 2005-10A) that investment advisers would not violate ERISA's prohibited transaction rules when they advised plan participants to invest in investment options from which they, or their affiliates, would receive fees, provided that all such fees would be credited against a plan-level investment advisory or investment management fee. This mechanism was intended to preclude the adviser from exercising discretionary authority in a manner that could increase the total amount of compensation received by the adviser in connection with the investments that it recommended.

However, none of these approaches permitted investment advisers to offer proprietary, individualized investment advice while retaining fees generated by the underlying investment options covered by the investment advisory program. Section 601 of the Pension Protection Act removes that limitation, subject, of course, to certain conditions.

New Prohibited Transaction Relief

Section 601 of the Pension Protection Act adds new Section 408(b)(14) (as well as an imperfectly drafted corresponding provision in the Internal Revenue Code) to permit investment advisers who are affiliated with some or all of a plan's underlying investment options to provide individualized investment advice to plan participants. Section 408(b)(14) provides relief for the provision of investment advice to participants in participant-directed plans by a "fiduciary adviser," as well as the acquisition, holding, or sale of securities pursuant to the investment advice and the direct or indirect receipt of fees or other compensation by the fiduciary adviser, or an affiliate thereof, in connection with these transactions.

The conditions applicable to the exemption are set forth separately in new Section 408(g) of ERISA. As described below, Section 408(g) establishes a series of general conditions applicable to the exemption, and also requires the investment advice to be provided either through a "level fee" arrangement or through an independently certified computer model, both of which are intended to

minimize the impact of any potential conflicts of interest resulting from a relationship between the investment advisor and the underlying investment funds.

The exemption is subject to a number of conditions that apply to both the "level fee" and the "computer model" approaches:

- The investment advice must be provided by a "fiduciary adviser" that is a registered investment adviser, the trust department of a bank, an insurance company qualified to do business in a State, a registered broker-dealer, or an "affiliate" of any of these entities, or an employee, agent, or registered representative of such a person who satisfies the requirements of applicable insurance, banking, and securities laws relating to the provision of advice.

- A fiduciary unrelated to the fiduciary adviser (e.g., the plan sponsor) must authorize the investment advice program.

- The fiduciary adviser must undergo an annual compliance audit, following which the independent auditor must issue a written report describing the adviser's compliance with the statutory exemption to the fiduciary who approved the advisory program on behalf of the plan. The scope of this compliance audit, including whether it must be individualized for the program offered to each plan, remains uncertain.

- The fiduciary adviser must periodically satisfy certain disclosure obligations to the participant, including a "clear and conspicuous" written notification of (i) its affiliation or contractual relationship with others involved in developing the investment advice program and selecting the investment options; (ii) the past performance and historical rates of return of all investment options available under the plan; (iii) all fees or other compensation the fiduciary adviser or its affiliates will receive in connection with the provision or advice or the acquisition, holding or sale of the securities relating to the advice; (iv) any "material" affiliation or contractual relationship with the underlying investment options; (v) any use or disclosure of participant information; (vi) the types of services provided by the fiduciary adviser; (vii) the fiduciary status of the fiduciary adviser; and (viii) a statement that the participant may separately arrange for the provision of advice by another adviser.

- In addition to the disclosure obligations described above, the fiduciary adviser must provide "appropriate disclosure" in connection with the sale, acquisition, or holding of securities or other property "in accordance with all applicable securities laws."

- Each investment transaction must occur solely at the direction of the participant or beneficiary. Thus, the exemption is not available for discretionary managed accounts.

- The terms of any acquisition, holding, or sale of securities or other property must be at least as favorable as an arm's-length transaction.

- The compensation received by the fiduciary adviser and its affiliates in connection with plan's acquisition, holding, or sale of securities or other property must be reasonable.

- The fiduciary adviser must maintain records demonstrating compliance with these conditions for at least six years from the date advice was provided.

Section 408(g) establishes additional conditions designed to safeguard plan participants against a fiduciary adviser's potential conflicts of interest. More specifically, the investment advice must either be provided through a fee-leveling arrangement under which the compensation received by the fiduciary adviser in connection with the advice, as well as the plan's acquisition, holding, and sale of the underlying investment options, does not vary depending on the investment option selected, or it must be provided through a computer model meeting certain requirements.

The fee-leveling requirement does not explicitly extend to affiliates of the fiduciary adviser, but the industry was concerned that DOL might interpret the scope of this restriction to encompass affiliates. However, in FAB 2007-1, DOL expressed its view that the fee-leveling requirement only applies to the fiduciary adviser itself, and not to its affiliates (unless the affiliate is also acting as a "fiduciary adviser" in connection with the investment advice). Thus, for example, a registered broker-dealer affiliated with the fiduciary adviser could receive varying compensation from the underlying investment options included in the fiduciary adviser's recommendations without running afoul of the "level fee" requirement. DOL based its interpretation of the fee-leveling requirement on its determination that no exemptive relief would even be necessary for the "level fee" approach if the compensation were truly level for the fiduciary adviser and each of its affiliates.

If the "level fee" requirement cannot be satisfied, the advice must be provided through a computer model that satisfies certain requirements. Where the investment advice is provided using a computer model under an arrangement that does not involve fee-leveling, the computer model must apply generally accepted investment theories and utilize relevant information about the participant, utilize prescribed objective criteria to provide asset allocation portfolios, take into account all investment options under the plan and not be "inappropriately weighted" with respect to any investment option, and not be biased in favor of affiliated investment options. The computer model may be developed by the fiduciary adviser or by another person. In either case, an independent "eligible investment expert" must certify compliance of the computer model with these conditions, in accordance with rules to be issued by DOL. A new certification will be required if "material modifications" are made to the computer model.

In light of DOL's interpretation of the "level fee" requirement to permit affiliates of the fiduciary adviser to receive varying fees from plan investments, industry interest in the "computer model" approach will likely be considerably dampened. Of course, fiduciary advisers who are eligible to rely on the "level fee" approach may also provide advice through computer models, but in those instances it appears that the computer model would not have to be certified by an "eligible investment expert."

FAB 2007-1 did not purport to address all interpretive issues arising under the new advice exemption. In December 2006, DOL published two "requests for information" ("RFIs") concerning the application of the new exemption to individual retirement account beneficiaries as well as participants in 401(k) and other individual account plans. In particular, DOL sought public comments on the feasibility of computer models to provide investment advice to individual retirement account beneficiaries, qualification standards for the "eligible investment experts" charged with certifying compliance of specific computer models with the requirements of the exemption, the certification process itself, and the form for required disclosures of fees and

other compensation received by the fiduciary adviser or its affiliates.

Another issue that may require further guidance is a provision to the effect that any person who develops the computer model or "markets" the investment advice program or computer model is to be treated as a "fiduciary adviser" and as a person who is a fiduciary by reason of providing investment advice, except as provided under rules that may be prescribed by the Secretary of Labor. The scope and significance of this deemed fiduciary status remains uncertain.

Technical corrections to the corresponding provisions in Section 4975(f)(8) of the Code will be needed to address certain cross-referencing errors, which seem to have been carried over from Section 408(b)(14) without adjustment for their placement in Section 4975 of the Code.

Plan Sponsors Relieved of Liability for Investment Recommendations

Section 408(g)(1) provides an "exemption" (in essence, a "safe harbor" from fiduciary liability) for plan sponsors who wish to arrange for the provision of investment advice to plan participants. To qualify for the "safe harbor," plan sponsors must ensure that the advice is provided by a "fiduciary adviser" and that the advice satisfies the conditions for exemptive relief under an "eligible investment advice arrangement" described in Section 408(g)(2). To qualify for the "exemption," the plan sponsor must ensure that the advice is provided under an eligible investment advice arrangement between the plan sponsor (or other plan fiduciary) utilizing fee leveling or a computer model, that the investment adviser acknowledges that it is a fiduciary with respect to the provision of advice, and that the arrangement requires the fiduciary adviser to comply with the annual audit, disclosure, and record maintenance requirements.

If a plan sponsor (or other plan fiduciary) complies with these requirements, then the plan sponsor has no duty to monitor the specific investment advice given to plan participants and beneficiaries. However, the plan sponsor remains responsible for the prudent selection and periodic review of the fiduciary adviser.

FAB 2007-1 explains that plan sponsors responsible for selecting a fiduciary adviser would be expected to engage in an "objective process that is designed to elicit information necessary to assess the provider's qualifications, including registration under application securities laws, willingness to assume ERISA fiduciary status, and the extent to which the advice to be furnished to participants will be based upon generally accepted investment theories. In monitoring the fiduciary adviser selected, the plan sponsor would be expected to review ongoing compliance with these factors, participant utilization levels relative to the fees paid by the plan, and the comments and complaints made by participants. FAB 2007-1 further clarifies that the same fiduciary duties and responsibilities apply to the selection and monitoring of an independent investment adviser who does not require exemptive relief.

Limitations of Statutory Exemption

The Pension Protection Act provides that the statutory exemption for the provision of investment advice will not "in any manner alter existing individual or class exemptions, provided by statute or administrative action." FAB 2007-1 confirms that the same principle extends to DOL's prior interpretive guidance in which it concluded that exemptive relief was not necessary, including the SunAmerica letter.

However, unlike the SunAmerica letter and certain administrative exemptions, the new statutory exemption does not cover the provision of discretionary asset management services to plan participants. In particular, the new exemption requires that "the sale, acquisition, or holding [of securities or other property] occurs solely at the direction of the recipient of the advice." Accordingly, automatic rebalancing programs would only be covered if they could be structured to eliminate any investment discretion.

Although the new exemption does not cover managed account programs, managed accounts likely will gain additional prominence under DOL's forthcoming guidance on suitable default investment options for participant-directed plans. Default investment options will, in turn, take on greater importance for plan sponsors who wish to take advantage of the provisions encouraging the use of automatic enrollment in the Pension Protection Act. The Pension Protection Act required DOL to issue guidance on the "appropriateness" of designating default investments that include a mix of asset classes (rather than the customary money market or stable value options) no later than February 17, 2007. That deadline has passed, but DOL representatives have indicated that final regulations are expected to be issued fairly soon.

The "computer model" approach is not yet available for the provision of investment advice to accountholders and beneficiaries of IRAs or similar plans. Instead, DOL has undertaken the initial feasibility study required by the Pension Protection Act to enable it to determine whether there are any computer models that would be suitable to provide investment advice to such persons. DOL is required to report the results of its initial determination of the appropriateness of computer models for this purpose to the four Committees involved in overseeing pension laws no later than December 31, 2007. Following the conclusion of its feasibility study, DOL must either certify suitable programs or grant a new class exemption describing circumstances under which investment advice might be provided. However, in light of DOL's pronouncement in FAB 2007-1 that fiduciary advisers may rely on the "level fee" alternative even if their affiliates receive varying fees and other compensation from plan investments resulting from the advice, many fiduciary advisers are likely to rely on this approach in lieu of the "computer model" approach.

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