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Client Alert
December 2011

# Fiduciary Investment Advice for Participants

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There is a growing concern about the quality of participant investing in 401(k) and 403(b) plans... since that is one of the critical factors in determining whether participants will accumulate adequate benefits at retirement. For example, industry studies show that many participants are invested too aggressively or too conservatively, rather than having balanced portfolios that lie between those extremes. If a participant is invested too conservatively, then his or her account will probably not grow at a rate needed to provide adequate benefits. On the other hand, if a participant is invested too aggressively, the account may suffer severe losses in the years preceding retirement.

Because of concerns about participant investing, the Pension Protection Act of 2006 included a provision that would permit providers and advisers to give potentially conflicted investment advice, if appropriate safeguards were in place. After a couple of false starts, the U.S. Department of Labor (DOL) recently issued a final regulation that more fully describes the safeguards. As a result, plan sponsors, and their plan committees, now have more opportunities to provide investment advice services to their participants. The purpose of this Alert is to discuss the key decision-points for plan sponsors.

If a plan sponsor wants to make investment advice available to participants, the plan sponsor, acting in its fiduciary capacity, needs to make certain practical and legal decisions. (Since many plan sponsors assign these fiduciary responsibilities to plan committees, this Alert refers to the plan committee as the responsible fiduciary.) Those decisions include:

1. **Discretionary versus non-discretionary**

   There are two basic forms of investment advice for participants. One is non-discretionary investment advice. In that scenario, the fiduciary adviser makes investment recommendations to the participant, but only the participant can actually implement the recommendations. The other form is discretionary advice, which is sometimes called investment management. In that case, the participant hires the investment manager to make decisions about the investment of the account and implement those decisions. In other words, the investment adviser actually manages the account, as opposed to making recommendations to the participant and relying on the participant to implement the advice – or not.

Both forms of fiduciary advice are common. However, in recent years, discretionary investment management has become increasingly more popular, because of evidence that, while investment recommendations to participants are generally helpful, many participants do not implement the advice. (Note that the new DOL regulation does not apply to discretionary investment management.)

2. **Conflicted advice versus non-conflicted advice**

If the plan committee decides to use discretionary investment management, then there is no need to consider this issue. That is because, unless there is an applicable DOL class or individual exemption, investment management services can only be provided by non-conflicted advisers. (For purposes of this Alert, "conflicted" advice means that the adviser can, directly or indirectly, increase its compensation based on the recommendations that are made. For example, if a recordkeeper has affiliated mutual funds, and the recordkeeper provides advice to participants to invest in those affiliated funds, the advice is "conflicted," because an affiliate would make more money to the extent the participants follow the advice. Similarly, if a fiduciary adviser recommends investments that pay a higher commission to the adviser or an affiliate, but could have recommended investments that pay a lower commission, the advice is considered "conflicted.")

On the other hand, if the fiduciary adviser does not have any affiliated mutual funds or other products, or cannot cause itself or an affiliate to make more money by virtue of the advice, then the advisory firm is a "pure" level fee provider. That is, it is not conflicted because it does not have the potential to increase the income for itself or its affiliates, and the conditions imposed by the regulation do not apply.

Assuming that the plan committee has decided it wants to offer non-discretionary investment advice, the committee needs to decide whether to limit the providers to those that do not have any conflicts or whether to consider advisers that do have conflicts. While, at first blush, it might seem that most committees would select non-conflicted advisers, there may be advantages to selecting conflicted providers under the following circumstances:

- The fee for the advice may be lower.
- The committee may, upon review of the conditions that apply to the conflicted adviser, decide that the restrictions are adequate to overcome any potential for the adviser to make recommendations that are imprudent or inappropriate.

We will discuss some of those conditions later in this Alert. However, at this point, we should point out that the conditions in the DOL regulation are specific and detailed. As a result, plan committees should have their ERISA counsel review the fiduciary investment program being offered by the adviser or provider to make sure that the conditions of the prohibited transaction exemption are satisfied. If they are not, the plan will have entered into a prohibited transaction.

3. **Prudent selection and monitoring of adviser**

The DOL has provided guidance on the selection of an investment adviser for participants. While the guidance goes into some detail about the specific factors to be considered, suffice it to say that the requirement is that the committee engage in a prudent process by obtaining and reviewing the "relevant" information ... and then reaching a "reasoned" decision. As with any fiduciary decision, the "relevant" factors are those that a person who is knowledgeable about the issues would consider in making such a decision. After the initial selection is made, the services of the fiduciary investment adviser must be periodically monitored, considering the same factors, but also considering the actual performance of the adviser and other factors, such as any participant complaints. Once the adviser has been prudently selected, however, the committee is not responsible for and does not need to monitor the investment recommendations given to participants. Both the selection process and the monitoring process should be documented in writing and recorded in minutes of committee meetings. In addition, any of the documentation that was reviewed for those purposes should be included in the committee's due diligence file.

The committee may consider information and data provided by the fiduciary adviser. However, the committee should seek assistance in determining the adequacy and relevancy of that data. In other words, the plan committee has a responsibility to make sure that it has received all of the information that it needs to make a prudent decision and that appropriate weight is given to the information.

If the committee decides to use advice that is potentially conflicted (that is, one of the approaches permitted under the regulatory exemption), the committee should review the regulation and the information provided by the adviser to make sure that the participant advice program fits within one of the two regulatory exemptions. The first exemption is referred to as the "level fee" exemption. The level fee exemption permits an advice provider to set up a separate entity (for example, a registered investment advisory firm) which charges a level fee for its advice to participants. That separate entity can give advice that includes affiliated mutual funds and products. Thus, it can give advice that will cause itself (or an affiliate) to make more money. To manage that conflict, the regulation has specific conditions that apply to this exemption (see below).

The second exemption is called the "computer model." In that case, the adviser must have a qualifying computer model for developing the advice and is limited to providing the advice that is generated by the computer model. However, the computer model can, as a matter of fact, recommend that a participant invest in affiliated products and/or that the participant invest in products that pay higher commissions to the adviser. To protect participants, the computer model exemption is subject to a number of conditions (see below).

The following are some of the conditions that apply to these arrangements. Keep in mind that, if all of the conditions are not satisfied, the investment advice arrangement is a prohibited transaction.

1. Conditions that apply to both the computer model and the level fee exemptions:
   - The adviser must acknowledge fiduciary status.
   - The fiduciary adviser must provide an annual audit, by an independent auditor, of its investment advice service. That audit will be delivered to the plan committee and will cover the compliance of the arrangement with the conditions in the exemption.
   - Disclosures must be made to the participants about a variety of matters, including the fees and other compensation of the fiduciary adviser or any affiliate.
   - The advice must be based on generally accepted investment theories.
   - The advice must take into account investment management and other fees and expenses.
   - The fiduciary adviser must request additional information about the participant (such as age, risk tolerance, etc.) and, if that information is provided, the adviser must take it into account.
2. Other conditions that apply only to the level feel arrangement:
   - Neither the adviser nor any employee or representative of the adviser can receive any compensation that varies depending on a participant's selection of particular investments. (This condition does not apply to entities that are affiliates of the adviser.)
3. Conditions that apply only to computer model arrangements.
   - The computer model cannot make investment recommendations that "inappropriately" favor investment options offered by the fiduciary adviser or an affiliate. (As a comment, it is curious that this requirement applies only to the computer model arrangement, and not to the level fee arrangement. It seems that it would be an essential factor in either case. As a result, we believe that good practice would be for plan committees to request a certification from any level fee provider that they will satisfy this condition as well.)
   - The computer model must be certified by an independent "eligible investment expert."

The job of the plan committee is to determine whether these conditions are satisfied, so that the plan can comfortably enter into the transaction without committing a prohibited transaction. Of course, the plan committee must also satisfy the requirements for prudently selecting and monitoring the service provider...that is a separate and independent requirement. At a minimum, the committee should obtain at the outset and then annually thereafter the following:

- The certification of computer model advice if this is the type of advice being given;
- The annual audit of its investment advice service;

- The notice being provided to the participants; and
- A written representation by the adviser that it is satisfying the conditions of the regulation.

While this may seem like an insurmountable task, it is not. In fact, the regulation was drafted in a way to provide specific requirements that, for the most part, can be verified in a straightforward fashion (including the use of information received from the fiduciary adviser). From our perspective, the main responsibilities of the committee are:

- To make sure that all of the conditions are satisfied. That is, it is not enough to simply review materials received from the provider, without knowing whether those materials cover all of the conditions and whether they satisfy them in the manner intended by the regulation.
- The plan committee needs to be aware of the specific factors that should be reviewed in order to engage in a prudent process for selection and monitoring of the fiduciary adviser. The committee should then gather information about each of those points and review them.

## Conclusion

By offering fiduciary investment advice to participants, plan sponsors can take meaningful steps for improving the quality of participant investing — and thereby the quality of benefits that participants will receive in retirement. However, to provide those services, plan sponsors need to make the critical decisions outlined in this Alert.

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