

Client Alert

A report
for clients
and friends
of the firm August 2006

Investment Advice Provisions Under The Pension Protection Act

The Pension Protection Act of 2006 (the "Act") provides a statutory exemption from the prohibited transaction rules of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the Internal Revenue Code of 1986, as amended (the "Code") for certain transactions engaged in by individual account plan participants and beneficiaries pursuant to investment advice provided by a "fiduciary adviser" (which is defined in the Act and includes registered investment advisers) under an "eligible investment advice arrangement." Assuming the Act is signed by the President, this provision of the Act will be effective for advice given after December 31, 2006.

Earlier this week we released a separate Client Alert describing related provisions in the Act entitled, "New Pension Bill Will Amend ERISA's 'Plan Assets' Definition and Add Prohibited Transaction Exemptions." For a copy of that Client Alert, please [click here](#).

Exemption for Transactions Under "Eligible Investment Advice Arrangements"

The Act adds a new prohibited transaction exemption under ERISA and the Code that covers certain transactions that arise from investment advice provided through an "eligible investment advice arrangement" to participants and beneficiaries of an individual account plan who direct the investment of their accounts under the plan. The exemption applies to the provision of investment advice to plan participants and beneficiaries who self-direct their investments, regardless of whether the plan qualifies as an ERISA "404(c) plan." The exemption does not apply to investment advice provided by plan sponsors.

If the requirements under the Act are met, the following transactions are covered:

- The provision of investment advice to the participant or beneficiary of the plan with respect to a security or other property available as an investment under the plan;
- The acquisition, holding or sale of a security or other property available as an investment under the plan pursuant to the investment advice; or
- The direct or indirect receipt of fees or other compensation by the "fiduciary adviser" or an affiliate (including any employee, agent, or registered representative of the fiduciary adviser) in connection with the provision of the advice or a transaction based on the advice.

The advice must be provided by a "fiduciary adviser," which is defined as any one of the following: (1) a registered investment adviser under the Investment Advisers Act of 1940 or under State law, (2) a bank or similar financial institution, but only if the advice is provided through a trust department, (3) an insurance company qualified to do business under State law, (4) a registered broker or dealer under the Securities Exchange Act of 1934, (5) an affiliate of any of the foregoing entities, or (6) certain qualified employees, agents or registered representatives of any of the foregoing entities.

As described in more detail below, an "eligible investment advice arrangement" is an arrangement that is either a "level fee" arrangement or an arrangement that uses a computer model to provide investment advice.

Level Fee Arrangement as "Eligible Investment Advice Arrangement"

A "level" or "flat fee" arrangement is an arrangement that provides that any fees (including any commissions or other compensation) that are received by the fiduciary adviser for investment advice

or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets *do not vary depending on the basis of the investment option selected*.

While it could be argued based on past Department of Labor (“DOL”) guidance that transactions under arrangements with “flat” or “level” fees are not prohibited (and thus do not require exemptive relief), this exemption ensures the legitimacy of such arrangements and specifically designates these types of fee arrangements as exempt from the prohibited transaction rules of ERISA and the Code, provided the requirements of the Act are satisfied.

Computer Model Program as “Eligible Investment Advice Arrangement”

If an eligible investment advice arrangement provides investment advice pursuant to a computer model, the model must meet several conditions.

Objectivity Requirements

The computer model must meet five specific requirements which generally require the program to operate objectively.

- It must apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
- It must use relevant information about the participant or beneficiary, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income and preferences as to certain types of investments;
- It must use prescribed objective criteria to provide asset allocation portfolios comprised of investment options offered under the plan;
- It must operate in a manner that is not biased in favor of investments offered by the fiduciary adviser or a related person; and
- It must take into account all investment options under the plan in specifying how a participant’s or beneficiary’s account should be invested (without inappropriate weighting of any investment option).

Certification Requirement

An “eligible investment expert” must certify (in accordance with rules prescribed by the DOL) that the computer model meets the foregoing five requirements prior to its use. An “eligible investment expert” is a person who meets requirements to be established by the DOL and has no material affiliation or contractual relationship with the investment adviser or any related person. Renewal of this certification is required if there are material modifications made to the model.

Exclusivity Requirement

The only investment advice provided under this type of investment advice program must be the advice generated by the computer model. In addition, in order to be covered under the exemption, a transaction must occur solely at the direction of the participant or beneficiary. These requirements do not preclude a participant or beneficiary from seeking investment advice that goes beyond or is outside of the computer model, but only if a request from that individual was not solicited by any person connected with carrying out the arrangement.

Initial Exclusion for IRAs

The portion of the exemption relating to computer models is not available initially for individual retirement accounts (“IRAs”) or any other plan covered by section 4975 of the Code but not covered by ERISA. The DOL is directed to conduct a study as to the possibility of applying computer model investment advice programs for IRAs and other similar plans, which study must be completed by December 31, 2007.

If the DOL determines (at the end of the study or anytime thereafter) that there is a computer model investment advice program that is feasible for IRAs, then the computer model portion of the exemption will become available with respect to IRAs. If no such computer model exists, the DOL is directed to grant a class exemption for IRAs based on the provisions of the exemption created by the Act.

Requirements Applicable to All Eligible Investment Advice Arrangements

Express Authorization by Separate Fiduciary

The eligible investment advice arrangement must be expressly authorized by a plan fiduciary other than the person offering the investment advice program, any person providing investment options under the plan, or any affiliate thereof.

Disclosure Requirements

Before the initial provision of investment advice, the fiduciary adviser must provide written notice to the participant or beneficiary (which may be in electronic form) disclosing various information, including any potentially conflicting relationships regarding the provider of investment advice, the past performance and historical rates of return of plan investment options, all fees or other compensation to be paid to the fiduciary adviser or its affiliates in connection with the program and plan investments, an acknowledgement of the fiduciary adviser’s fiduciary status, and a statement that the participant or beneficiary may separately arrange for the provision of advice by another unconflicted adviser. In addition, throughout all times during the provision of investment advice, the fiduciary adviser must maintain accurate records about the information given to a participant or beneficiary, provide such information at no charge to the applicable

participant or beneficiary at least once annually and upon request of the recipient, and to provide at no charge accurate information concerning any material change to the information required to be provided under the Act. The fiduciary adviser is also required to maintain for six years records necessary for determining whether the requirements described above have been met.

The Act directs the DOL to issue a model form for the disclosure of fees and other compensation which satisfies the foregoing requirements.

Audit Requirements

With respect to an eligible investment advice arrangement for a defined contribution plan, an annual audit of the arrangement must be conducted by an independent auditor (who is unrelated to the person offering the investment advice arrangement or any other person providing investment options under the plan) for compliance with applicable requirements. The auditor must have appropriate technical training or experience and proficiency (and so represent in writing), and upon completion of the audit must issue a written report of the audit results to the fiduciary that authorized use of the arrangement.

In the case of an eligible investment advice arrangement with respect to an IRA, an audit is required as prescribed by the Secretary of Labor.

Other Requirements

- The fiduciary adviser must provide disclosures with respect to any transaction in accordance with applicable securities laws.
- The sale, acquisition or holding of the security or other property must occur *solely* at the direction of the recipient of the advice.
- The compensation received by the fiduciary adviser and affiliates must be reasonable.
- The terms of the transaction must be at least as favorable to the plan as an arm's length transaction would be.

Fiduciary Safe Harbor

There is also a "safe harbor" provision for a plan sponsor and other plan fiduciaries who select and oversee a fiduciary adviser described in the Act. Under the safe harbor, such individuals will not be treated as failing to meet their fiduciary duties under ERISA solely due to the provision of investment advice by a fiduciary adviser pursuant to an eligible investment advice arrangement that complies with the Act's requirements. This safe harbor

does not release such individuals from their continued responsibility to prudently select and periodically review the fiduciary adviser; however, under the safe harbor, they would have no duty to monitor the specific investment advice given pursuant to this exemption.

* * *

This new prohibited transaction exemption for investment advice permits sweeping changes in the manner in which advice could be given to self-directed plan participants and beneficiaries. Financial institutions should give consideration to the effects of this provision of the Act, including reviewing the existing restrictions on dealing with self-directed plans (in order to determine which restrictions would no longer be required and whether the program could be restructured accordingly), the potential development of business opportunities with plan sponsors to advise applicable plan participants, and the development of procedures to ensure compliance with the requirements of the exemption.

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