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August 23, 2006

**Re: Pension Protection Act of 2006 – Investment Advice for Defined Contribution Plans**

Dear Clients and Other Friends:

The Pension Protection Act of 2006 (“PPA”) signed by President Bush last week offers an expanded opportunity for financial services firms to provide investment advice to defined contribution plan participants.

In allowing for investment advice under defined contribution plans, Congress felt that ERISA guidelines needed to be clarified and expanded so that financial services firms could more readily provide participants advice that is sorely needed. Therefore, beginning in 2007, a new statutory prohibited transaction exemption allows the provision of investment advice for participants in 401(k) and other defined contribution plans.

**A. Participant Investment Advice Permitted**

PPA adds a new prohibited transaction exemption that allows investment advice to be provided to defined contribution plan participants. This new prohibited transaction exemption is added as new ERISA §§ 408(b)(14) and 408(g) and Internal Revenue Code §§4975(d)(17) and 4975(f)(8).<sup>1</sup> The new exemption applies to investment advice provided by a “fiduciary adviser” meeting the requirements of Part G of this letter under an “eligible investment advice arrangement” which meets either of the following requirements:

1. It provides that any fees received by the fiduciary adviser for investment advice or with respect to a plan investment transaction do not vary depending on the basis of any investment option selected (such fees include any commission or other compensation);<sup>2</sup> **or**
2. It uses a computer model under an investment advice program (as described below) to provide investment advice to a plan participants and beneficiaries.

<sup>1</sup> Under this new exemption, the following transactions are exempt from prohibited transaction treatment:

1. the provision of investment advice;
2. an investment transaction (i.e., a sale, acquisition or holding of a security or other property) pursuant to the advice; and
3. the direct or indirect receipt of fees or other compensation by the fiduciary adviser or its affiliates in connection with provision of the advice or an investment transaction pursuant to the advice.

<sup>2</sup> Though this provision seems simple enough, its wording and the relative lack of legislative history describing it in detail raise questions about the extent to which it requires fee offsets of affiliated parties’ fees as contemplated under prior law and DOL guidance. No doubt the DOL will weigh in with its interpretive guidance at some point.

Both types of programs must satisfy the requirements outlined in parts C through H of this letter. In addition, computer model programs must meet the requirements outlined in B.

**B. Computer Model Investment Advice Program**

A computer model under an eligible investment advice arrangement must:

1. apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
2. use relevant information about the participant or beneficiary (e.g., age, life expectancy, risk tolerance, availability of other assets and sources of income);
3. use prescribed objective criteria to provide asset allocation portfolios comprised of investment options under the plan;
4. operate in a manner that is not biased in favor of any investment options offered by the fiduciary advisor or related person; and
5. take into account all the 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.

Before a computer model is used, the following certification requirement must be satisfied:

- In accordance with Department of Labor regulations to be issued, an eligible independent expert (see the third bullet point below) must certify that the model meets the DOL rules.
- The certification must be reviewed if there are material changes to the model as determined under the DOL regulations.
- An "eligible investment expert" is a person who meets requirements prescribed by the DOL regulations and who does not bear any material affiliation or contractual relationship with any investment advisor or related person.

If a computer model is used, the only investment advice that may be provided under the eligible investment advice arrangement is the advice generated by the computer model, and any investment transaction pursuant to the advice must occur solely at the direction of the plan participant. This requirement, however, does not preclude a plan participant from requesting other investment advice, but only if the request has not been solicited by any person connected with carrying out the investment advice arrangement under the plan.

**C. Authorization of Independent Fiduciary**

The arrangement must be expressly authorized by a plan fiduciary other than:

1. the person offering the investment advice program;
2. any person providing investment options under the plan; or
3. any affiliate of 1. or 2.

Generally, the plan sponsor as named fiduciary will be the plan fiduciary that authorizes an advice arrangement. Alternatively, an independent fiduciary could be retained by the plan sponsor to authorize an advice arrangement.

**D. Annual Audit Required for Eligible Investment Advice Arrangements**

Eligible investment advice arrangements must be audited annually for compliance with applicable requirements. An independent auditor must perform this annual audit. An “independent auditor” is an entity that is unrelated to the person offering the investment advice arrangement or any person providing investment options under the plan. The auditor must have appropriate technical training or experience and proficiency and provide written representation of such experience and proficiency. The auditor must issue a report of the audit results to the fiduciary that authorized use of the arrangement.

**E. Fiduciary Adviser Notice Requirements**

Before the initial provision of investment advice, the fiduciary adviser must provide written notice (which may be in electronic form) to the recipient of the advice, including:

1. the role of any related party in the development of the investment advice program or the selection of investment options under the plan;
2. past performance and historical rates of return of each investment option offered under the plan;
3. any fees or other compensation relating to the advice to be received by the fiduciary adviser or affiliate;
4. any material affiliation or contractual relationship of the fiduciary adviser or affiliates in the security or other property involved in the investment transaction;
5. the manner and under what circumstances any participant or beneficiary information will be used or disclosed;
6. the types of services provided by the fiduciary adviser in connection with the provision of investment advice;
7. the adviser’s status as a fiduciary of the plan in connection with the provision of the advice; and
8. that the recipient of the advice is free to obtain investment advice from other sources if they so choose.

This information must be maintained in accurate form and must be provided to the recipient of the investment advice, without charge:

1. annually;
2. on request; and
3. upon any material change.

The written notice must be accurate and comprehensive and written in a way that may be understood by the average plan participant. The fiduciary adviser must maintain records of this notice for at least six years. The Department of Labor is directed under this provision to issue a model form for the disclosure of fees and other compensation.

## **F. Other Requirements**

- The fiduciary adviser must provide applicable securities law disclosures.
- An investment transaction must occur solely at the direction of the participant or beneficiary receiving the advice.
- Compensation received by the fiduciary adviser or affiliates in connection with an investment transaction must be reasonable.
- The terms of the investment transaction must be at least as favorable to the plan as an arm's length transaction would be.

## **G. Who Can Serve as a "Fiduciary Adviser"?**

"Fiduciary adviser" is defined as a person who is a fiduciary of the plan by reason of the provision of investment advice to a participant (or beneficiary) and who is also:

1. a registered investment adviser under the Investment Advisers Act of 1940 or under State laws;
2. a bank or savings association – but only if the advice is provided through a trust department that is subject to periodic examination and review by Federal or State banking authorities;
3. an insurance company qualified to do business under State law;
4. a broker or dealer registered under the Securities Exchange Act of 1934;
5. an affiliate of the preceding; or
6. an employee, agent or registered representative of any of the preceding who satisfies requirements of applicable insurance, banking and securities laws relating to the provision of advice.

A person who develops the computer model or markets the investment advice program or computer model is treated as a person who is a plan fiduciary by reason of the provision of investment advice and is treated as a fiduciary adviser.

Fiduciary advisers who breach their fiduciary duty will be personally liable for any failure to act solely in the interest of the participant, and may be subject to various ERISA penalties.

## **H. Prudent Selection of Fiduciary Adviser Required**

The new exemption requires the employer or other person who is a plan fiduciary (other than the fiduciary adviser) to prudently select and periodically review the fiduciary adviser. The employer or plan fiduciary does not have the duty to monitor the specific investment advice given by a fiduciary adviser. The new exemption allows for plan assets to be used to pay for reasonable expenses in providing investment advice.

To obtain relief under the new exemption, the terms of the arrangement between the employer or other plan fiduciary and the fiduciary adviser must require compliance by the fiduciary adviser with the new exemption. Also, the fiduciary adviser must acknowledge in writing that it is a plan fiduciary with respect to the provision of the advice.

## **I. Computer Model Investment Advice Program – Application to IRAs**

Initially, at least, the new investment advice provisions including computer models do not apply to individual retirement accounts and other individual arrangements such as health savings accounts, Archer medical savings accounts, and Coverdell education savings accounts. However, PPA directs the Labor Department to conduct a feasibility study to determine whether there are any computer model investment advice programs that would be appropriate for IRAs. If the DOL determines that no appropriate computer model programs are available, PPA requires DOL to grant a class exemption defining how investment advice can be provided to IRA participants.

The DOL feasibility study is supposed to be completed by December 31, 2007, which likely means that IRA investment advice programs will not be available until 2008 or later.

### **Conclusion**

As more and more employers wind down their defined benefit plans and rely more heavily on defined contribution plans to provide retirement benefits, it becomes increasingly important to help defined contribution plan participants obtain satisfactory investment returns. The investment advice programs permitted by PPA should help participants to achieve better investment results.

We predict that most financial services companies holding 401(k) and other defined contribution plan assets will develop or otherwise offer investment advice programs that satisfy the requirements outlined above. Employers should review these programs carefully and seriously consider implementing such programs.

We welcome your inquires about the new investment advice rules.

Sincerely,

Theodore K. Rice  
Theodore K. Rice

TKR/jks/rah