



## THE PENSION PROTECTION ACT: Potential for Profits and Pitfalls

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SwEEPING reforms contained in the recently enacted Pension Protection Act (the “Act”) will provide significant opportunities for investment advisers to build additional relationships and business. One of the key provisions of the Act, which requires companies to fully fund existing defined benefit plans within the next seven years, is expected to create a push toward defined contribution plans. Another provision of the Act allows employers to automatically enroll employees into 401(k) plans. The Act also makes permanent the higher contribution limits for IRAs and 401(k)s that was passed in 2001. The combined effect of these changes will result in increased deposits and additional cash flow for advisers who sell such plans. Moreover, the lack of investment-related knowledge on the part of both

plan sponsors and employees will lead to increased demand for professional investment advice. Provisions in the act making it easier for employees to unload stock received by way of employer matching and/or profit sharing will undoubtedly create additional demand for advice.

Beginning in January 2007, the Act will allow “fiduciary advisers” to provide investment advice to 401(k) plan participants. Investment advisers, who are acting as fiduciaries to the plan, will be allowed to charge an additional fee for helping participants select specific funds for their employer-sponsored 401(k) plans. By providing employees access to professional advice, it is anticipated that more rank-and-file employees will choose to participate in employer-sponsored plans, which means more prospects for advisers to build relationships outside of the plan.

In order to take advantage of these opportunities, tough fiduciary and disclosure safeguards must be met. Investment advisers who fail to adhere to these requirements are subject to civil and criminal penalties by the Department of Labor and may be civilly liable to the participant. This article examines the requirements for advisers providing specific investment advice to plan participants under the Act and provides some useful recommendations to ensure that their practices remain compliant.

Currently, federal law requires qualified pension plans to be managed to the exclusive benefit of the plan participants. The Employee Retirement Income Security Act of 1974 (“ERISA”) and the Internal Revenue Code of 1986, as amended (the “Code”) prohibit certain transactions between an employer-sponsored retirement plan and a disqualified person. Disqualified persons include a fiduciary of the plan, a person providing services to the plan, and an employer with employees covered by the plan. An



investment adviser, who renders investment advice for a fee or other compensation with respect to any plan funds or property, or who has the authority or responsibility to do so, is prohibited from receiving consideration from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. As such, the role of investment advisers has been limited to providing “investment education” to participants in employer-sponsored retirement plans.

Section 601 of the Act creates an exemption from the prohibited transactions rules for qualified fiduciary advisers (those that are fully regulated by applicable banking, insurance, and securities laws) who provide detailed investment advice through an “eligible investment advice arrangement.” Beginning in January 2007, investment advisers can offer fiduciary advice regarding specific investment funds and products offered by an affiliate of the adviser or from which the adviser receives, directly or indirectly, additional compensation. The safe harbor covers the advice itself, the transactions made as a result of the advice (i.e., the sale, acquisition, or holding of a security or other property), as well as the fees paid to the adviser (and affiliates) in connection with the provision of the advice or an investment transaction pursuant to the advice.

The Act requires that an eligible investment advice arrangement be either:

- 1) fee neutral; or
- 2) based on a computer model under an “investment advice program” (as defined in the Act). Under the fee neutral arrangement, the adviser’s total compensation, including indirect compensation derived from the purchase or sale of securities purchased or sold in reliance on the proffered advice, can not vary based on the advice given.

If a computer model investment advice program is used, the model must:

- (1) apply generally accepted investment theories taking into account historic returns of different asset classes over defined periods of time;
- (2) utilize relevant information about the participant;
- (3) use defined objective criteria to determine asset allocation options under the plan;
- (4) not be biased in favor of any investment options offered by the fiduciary adviser or related person; and
- (5) take into account all investment options under the plan in specifying how a participant’s account balance should be invested without inappropriately weighting with respect to any investment option.

Unless the participant requests other investment advice on an unsolicited basis, the only advice that may be provided by the adviser under the computer model investment advice program is that generated by the model.

The Act also requires that the computer model be certified by an “eligible investment expert” who meets certain Department of Labor requirements and is not related to the adviser providing the model. The certification must be renewed if there are material changes to the model.

Prior to providing any specific investment advice, the Act requires advisers to disclose, in a clear and conspicuous manner calculated to be understood by the average plan participant, the following:

- (1) a statement that the adviser is acting as a fiduciary of the plan;
- (2) any fees or other compensation to be received by the fiduciary adviser or affiliate;
- (3) the types of services that will be provided by the adviser in connection with the investment advice;
- (4) any potential conflicts, including the role of any related party in the development of the investment advice program or the selection of investment



options under the plan and any relationship the fiduciary adviser has to the investments offered by the plan;

- (5) the participant's ability to arrange for advice by another unrelated adviser that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property;
- (6) the manner by which information about the participant will be used or disclosed; and
- (7) past performance and rates of return for each of the plan's investment options.

This information must be provided without charge on an annual basis, on request, or in the case of any material change. The Act provides for an annual audit of the arrangement for compliance and requires that evidence of such compliance be retained for six years. The auditor must be independent and is required to represent, in writing, their technical training or experience and proficiency to conduct the audit.

Investment advisers who deliver advice to plan participants are specifically described as "fiduciary advisers" and, therefore, must adhere to fiduciary standards. These fiduciary standards require that:

- (1) the investment transaction must occur solely at the direction of the recipient of the advice;
- (2) any fees paid out of plan assets must be reasonable in light of services rendered; and
- (3) the terms of the investment transaction must be at least as favorable to the plan as an arm's length transaction would be.

Lastly, it is important to note that while compliance with the aforementioned fiduciary standards and disclosure requirements will protect advisers from civil and criminal penalties under ERISA and the Code, the Act does not alter an adviser's obligations under existing federal and state securities laws. The fiduciary adviser must provide disclosures applicable under securities laws.

Although the aforementioned duties and disclosures appear to be exhaustive, there are some potential pitfalls worth noting. Issues relating to the adviser's fiduciary status will need to be addressed with the adviser's compliance department prior to providing any specific investment advice to plan participants. For example, many broker-dealers have taken the position that a broker is never a fiduciary and have, therefore, failed to define a fiduciary standard of care. Appropriate amendments to compliance materials and service agreements may be necessary, and enhanced fiduciary-related due diligence procedures for selecting and monitoring investment options should also be established.

Another concern, which will need to be resolved between the adviser and the firm, is that the Act fails to address whether the fiduciary advisers exemption covers advice provided to participants with respect to investments held outside of the plan. This issue is problematic insofar as it is necessary for a fiduciary adviser to inquire into the participants overall financial situation before making a recommendation within the plan. If the adviser determines that the participant has failed to diversify or is maintaining otherwise unsuitable investments outside of the plan, he/she will be faced with deciding whether to give specific advice relating to those investments for an additional fee or declining to do so because of the lack of a safe harbor.

The Act also fails to address whether an adviser is required to act as a fiduciary when an employee requests advice pertaining to investments outside of their employee-sponsored plan. Until these matters are resolved, advisers should be particularly cautious when providing specific advice to buy, sell or hold investments outside of the plan. At a minimum, the adviser should notify the participant, in writing, that



he/she is not acting as a fiduciary as to such recommendations. Given the uncertainty in this regard, any advice rendered outside of the plan should be prudent and in the best interest of the participant.

The changes brought about by the Act will provide investment advisers the opportunity to significantly grow their practice. In order to remain compliant with its requirements, however, advisers and their firms will need to act quickly in reviewing their current procedures to determine what changes are necessary. While the provisions allowing advisers to give specific investment-related advice to plan participants will go into effect on December 31, 2006, it should be noted that many technical corrections to the Act are forthcoming. Advisers and firms will need to be particularly diligent in keeping pace with this nascent and evolving body of law.

For additional information concerning this article, the Act and/or any compliance-related issues, please feel free to contact [Jason Roberts](#) by phone at (310) 937-2066 or email at [jroberts@edgertonweaver.com](mailto:jroberts@edgertonweaver.com).