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CRS Report for Congress

Investment Advice and the Pension Protection Act of 2006

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Summary

This report examines Section 601 of the Pension Protection Act of 2006, which amends the Employee Retirement Income Security Act to allow for the provision of investment advice without fear of fiduciary liability. Prior to the enactment of Section 601, ERISA's prohibited transaction restrictions operated to discourage pension plan fiduciaries from providing investment advice to plan participants and beneficiaries. As amended, ERISA would now seem to allow for the provision of investment advice so long as such advice is provided pursuant to an eligible investment advice arrangement in compliance with the statute.

As defined contribution pension plans, which generally require a participant to direct the investment of plan assets, have become the primary vehicles for accumulating retirement savings, there has been greater awareness by many participants of the need for investment advice. Section 601 of the Pension Protection Act of 2006 ("PPA") amends the Employee Retirement Income Security Act ("ERISA" or "the act") to allow for the provision of investment advice without fear of fiduciary liability.[1] This report provides background information on investment advice and the fiduciary responsibilities imposed by ERISA. The report also examines Section 601 of the PPA and its amendment of ERISA.

Background

ERISA provides a comprehensive federal scheme for the regulation of employee pension and welfare benefit plans offered by private employers.[2] Enacted in 1974, the act

[1] P.L. 109-280, § 601 (2006).

[2] 29 U.S.C. § 1001 *et seq.* See 29 U.S.C. § 1002(1) (defining an "employee welfare benefit plan" as "any plan, fund, or program ... established or maintained by an employer ... for the purpose of providing for its participants or their beneficiaries ... medical, surgical, or hospital care or (continued...)

sought to eliminate the conflicting and inconsistent regulation of pension and welfare benefit plans by various state laws.[3] Such laws were believed to be inadequate in protecting the interests of plan participants and beneficiaries.[4]

Prior to ERISA's enactment, there was no comprehensive regulation of the individuals who managed plan assets and controlled the operation of employee benefit plans. Plan fiduciaries were regulated by a combination of federal and state laws, and by common law trust principles.[5] In many instances, plan fiduciaries were able to limit their liability by contract or were beyond the jurisdiction of a particular court.[6]

Under ERISA, fiduciaries must act "solely in the interest of the participants and beneficiaries" of a plan.[7] The act defines a fiduciary as someone who (1) exercises any discretionary authority or control with respect to the management of a plan or exercises any authority or control with respect to the management or disposition of plan assets; (2) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or (3) has any discretionary authority or responsibility in the administration of a plan.[8]

In addition to requiring plan fiduciaries to adhere to certain standards of conduct, ERISA prohibits fiduciaries from engaging in specified transactions.[9] For example, Section 406(a)(1)(C) of ERISA prohibits a fiduciary from engaging in a transaction when he knows or should know that such transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest.[10] The act also prohibits a plan fiduciary from dealing with the assets of a plan in his own interest or for his own account.[11] ERISA's prohibited transaction restrictions are believed to have discouraged the provision of investment advice.[12] Because it is perceived that "[v]irtually

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[2] (...continued)
benefits, or benefits in the event of sickness, accident, disability, death or unemployment....").

[3] Employee Benefits Law 5 (Steven J. Sacher et al. eds., 2000).

[4] *Id.*

[5] Sacher, *supra* note 3, at 623.

[6] *Id.*

[7] 29 U.S.C. § 1104(a)(1).

[8] 29 U.S.C. § 1002(21)(A).

[9] 29 U.S.C. § 1106 (identifying prohibited transactions between a plan and a party in interest or fiduciary). ERISA's fiduciary duties are identified in Section 404(a)(1) of the act, 29 U.S.C. § 1104(a)(1). In general, ERISA establishes four standards of conduct for plan fiduciaries: a duty of loyalty, a duty of prudence, a duty to diversify investments, and a duty to follow plan documents to the extent that they comply with ERISA.

[10] 29 U.S.C. § 1106(a)(1)(C). *See* 29 U.S.C. § 1002(14) (defining a "party in interest" with respect to an employee benefit plan to include, in part, any fiduciary, counsel, or employee of such a plan and an employer whose employees are covered by such a plan).

[11] 29 U.S.C. § 1106(b).

[12] *See* H.Rept. 107-262 pt. 1, at 12-13 (2001).

any transaction could fall within one of these [prohibited transaction] categories," individuals are reluctant to provide investment advice.[13]

Recognizing that participants and beneficiaries may not have a sufficient understanding of investment principles and strategies to make informed investment decisions, the Department of Labor ("DOL") issued an interpretive bulletin in 1996 that identified categories of information and materials that would not constitute investment advice for purposes of ERISA's fiduciary definition.[14] The interpretive bulletin discusses the provision of investment-related educational information to participants and beneficiaries rather than the rendering of investment advice. The interpretive bulletin contemplates the availability of information and materials that inform a participant about the benefits of increasing plan contributions, that discuss general financial and investments concepts, such as diversification, that provide a participant with asset allocation models, and that allow a participant to estimate future retirement income needs and assess the impact of different asset allocations on retirement income.[15]

In 2001, DOL issued an advisory opinion that commented directly on the provision of investment advice to participants and beneficiaries.[16] In response to an application from SunAmerica Retirement Markets, Inc. ("SunAmerica"), a provider of financial services, for an exemption from ERISA's prohibited transaction restrictions, DOL considered whether SunAmerica would violate ERISA if investment advice was provided through a program involving a computer model that applied a methodology developed, maintained, and overseen by a financial expert who was independent of SunAmerica.[17]

DOL concluded that SunAmerica would act as a fiduciary only to the extent that it was responsible for the prudent selection and periodic monitoring of its investment advisory services. Individual investment recommendations provided or implemented under the program, however, would not be the result of SunAmerica's exercise of authority, control, or responsibility such that ERISA's prohibited transaction restrictions would be violated.[18]

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[13] *Id.* at 12 (2001).

[14] U.S. Dept. of Labor, Interpretive Bulletin 96-1; Participant Investment Education, 61 Fed. Reg. 29,586 (June 11, 1996).

[15] *Id.*

[16] U.S. Dept. of Labor, Advisory Opinion No. 2001-09A (Dec. 14, 2001), *available at* [http://www.dol.gov/ebsa/programs/ori/advisory2001/2001-09A.htm] (last visited Mar. 11, 2008).

[17] Under Section 408(a) of ERISA, 29 U.S.C. § 1108(a), the Secretary of Labor may grant a conditional or unconditional exemption of any fiduciary or transaction, or class of fiduciaries or transactions, from all or part of ERISA's prohibited transaction restrictions.

[18] Advisory Opinion No. 2001-09A, *supra* note 16 at 6 ("Recommendations provided to, or implemented on behalf of, participants by SunAmerica will be based solely on input of participant information into computer programs utilizing methodologies and parameters provided by the Financial Expert and neither SunAmerica, nor its affiliates, will be able to change or affect the output of the computer programs. SunAmerica will exercise no discretion over the communication to, or implementation of, investment recommendations provided under the Program.").

Section 601 of the PPA appears to codify many of the concepts articulated in DOL's advisory opinion. In general, Section 601 amends Section 408 of ERISA, a section that identifies exemptions from the act's prohibited transaction restrictions, to recognize the permissibility of certain provisions of investment advice.

Section 601 of the Pension Protection Act of 2006

Section 408(g)(1) of ERISA, as added by Section 601(a)(2) of the PPA, states that the act's prohibited transaction restrictions shall not apply to transactions involving investment advice if such advice is provided by a fiduciary adviser pursuant to an "eligible investment advice arrangement."[19] An "eligible investment advice arrangement" is defined as an arrangement that either

> (1) provides that any fees (including any commission or other compensation) 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 any investment option selected, or
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> (2) uses a computer model under an investment advice program meeting the requirements of Section 408(g)(3) in connection with the provision of investment advice by a fiduciary adviser to a participant or beneficiary.[20]

In addition, to be considered an "eligible investment advice arrangement," an arrangement must meet other requirements identified in subsequent paragraphs of Section 408(g). These requirements include the following: the express authorization of the arrangement by a plan fiduciary other than the person offering the investment advice program, any person providing investment options under the plan, or any affiliate of either; the performance of an annual audit of the arrangement by an independent auditor; compliance with various disclosure requirements; the writing of participant notifications in a clear and conspicuous manner; and the maintenance of any records showing compliance with the relevant provisions of Section 408(g) for not less than six years.[21]

If investment advice is provided through the use of a computer model, such model must meet certain specified requirements. Section 408(g)(3)(B) of ERISA indicates that the computer model must

> (1) apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
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> (2) utilize relevant information about the participant, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments;

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[19] 29 U.S.C. § 1108(g)(1).

[20] 29 U.S.C. § 1108(g)(2)(A).

[21] *See* 29 U.S.C. § 1108(g)(2)(B) (to be an "eligible investment advice arrangement," an arrangement must also meet the requirements of 29 U.S.C. § 1108(g)(4)-(9)).

> (3) utilize prescribed objective criteria to provide asset allocation portfolios comprised of investment options available under the plan;
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> (4) operate in a manner that is not biased in favor of investments offered by the fiduciary adviser or a person with a material affiliation or contractual relationship with the fiduciary adviser; and
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> (5) take into account all investment options under the plan in specifying how a participant's account balance should be invested and is not inappropriately weighted with respect to any investment option.[22]

In addition, the computer model must be certified by an "eligible investment expert" prior to its use and in accordance with rules prescribed by the Secretary of Labor ("Secretary").[23] An "eligible investment expert" is defined by ERISA as any person who meets requirements prescribed by the Secretary and who does not bear any material affiliation or contractual relationship with any investment adviser, a related person thereof, or any employee, agent, or registered representative of the investment adviser or related person.[24]

Consistent with DOL's 2001 advisory opinion, Section 408(g)(10)(B) of ERISA provides that a plan sponsor or other person who is a fiduciary is responsible for the prudent selection and periodic review of a fiduciary adviser who is part of an eligible investment advice arrangement.[25] However, the plan sponsor or other person who is a fiduciary has no duty to monitor the specific investment advice given by the fiduciary adviser to any particular recipient of the advice.[26]

While ERISA's new investment advice provisions have been recognized generally as benefitting participants and beneficiaries, some in the financial services industry have maintained that the single flat fee that is required to be an eligible investment advice arrangement if a computer model is not used could negatively affect some money managers.[27] Although there was some discussion of amending the single flat fee requirement, technical corrections to the PPA that were adopted during the 109th Congress made no relevant changes.[28] Moreover, legislation introduced in the 110th Congress to

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[22] 29 U.S.C. § 1108(g)(3)(B)(i)-(v).

[23] 29 U.S.C. § 1108(g)(3)(C)(i).

[24] 29 U.S.C. § 1108(g)(3)(C)(iii).

[25] 29 U.S.C. § 1108(g)(10)(B).

[26] *Id.*

[27] *See* Doug Halonen, *DC Advice Provision Challenged*, Pensions and Investments, Sept. 18, 2006, at 1. According to some in the financial services industry, money managers typically charge higher fees for some strategies than for others.

[28] P.L. 109-432, § 3003(a) (2006). See *Technical Corrections Pension Bill May Not Get Done This Year, Staff Says*, Pens. & Ben. Daily (BNA) No. 176 (Sept. 13, 2006).

make additional technical corrections does not appear to include proposed amendments to the single flat fee requirement.[29]

In December 2006, DOL sought information from the public to evaluate whether there are adequate computer model investment advice programs that could be used to provide investment advice to plan beneficiaries.[30] The comments received by DOL reportedly took differing views as to the existence of such programs.[31] During an August 2007 hearing to further discuss the feasibility of computer model investment advice, some witnesses questioned the ability of a computer program to consider the full range of investments, including, for example, mutual funds, currency instruments, and hedge funds.[32] However, other witnesses indicated that the technology to support computer model investment advice is available.[33]

In December 2007, DOL identified rulemaking related to the PPA and investment advice as a regulatory priority.[34] Although DOL indicated that a Notice of Proposed Rulemaking would be published in December 2007, that document appears to remain forthcoming.

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[29] *See, e.g.*, H.R. 3361, 110th Cong. (2007); S. 190, 110th Cong. (2007); S. 1974, 110th Cong. (2007).

[30] Prohibited Transaction Exemption for Provision of Investment Advice to Individual Retirement and Similar Plans, 71 Fed. Reg. 70,427 (Dec. 4, 2006).

[31] *Speakers Voice Support, Opposition, Limits on Computer Model Investment Advice*, Pens. & Ben. Daily (BNA) No. 147 (Aug. 1, 2007).

[32] *Id.*

[33] *Id.*

[34] Prohibited Transaction Exemption for Provision of Investment Advice to Participants in Individual Account Plans (Fall 2007 Regulatory Plan), 72 Fed. Reg. 69,743, 69,878 (Dec. 10, 2007).