Providing Investment Advice and the Pension Protection Act of 2006

BY BETSY PIPER/BACH, CIMA®, CFP®, CTFA

Fiduciaries to retirement plans created under ERISA §401 are not required to provide investment advice and education to participants in the plans. But if you are going to provide investment advice and education, you must act prudently and solely in the interest of the plan participants and beneficiaries.

Eligible Investment Advice Arrangement
The Pension Protection Act (PPA) of 2006 allows a plan sponsor to hire a fee-paid advisor affiliated with the investment vehicle to provide investment advice to participants in defined contribution plans that are participant-directed. The advisor may receive additional compensation directly or indirectly to provide the investment advice as long as the advice is offered under an “eligible investment advice arrangement” that meets the following criteria:

1. Advice must be fee-neutral (i.e., compensation cannot vary based on the advice given); or
2. Advice must be based on a computer model that is certified by an “eligible investment expert” that has no affiliation to the advisor and that meets requirements to be developed by the U.S. Department of Labor (DOL), and
3. Advisors may develop the model, but it must be certified by the “eligible investment expert.”
4. The advisor is required to submit to an annual audit by an outside auditor.
5. The plan fiduciary must authorize the service.
6. The following disclosures must be provided:
   a.) The advisor must acknowledge fiduciary status to the plan participants
   b.) The roles of all parties involved in developing the program or selecting investments
   c.) Past performance of the investments
   d.) Any fees or other compensation received by the fiduciary advisor
   e.) How participant information will be used
7. Compensation must be reasonable, as in an arms-length transaction.
8. Investment transactions may occur only at the direction of the recipient of the advice.
9. Alternatively, participants may arrange for their own advice from another advisor.

As in other ERISA relationships, the plan sponsor or plan fiduciary remains responsible for prudent selection and periodic monitoring of the advisor, but neither is responsible for the advice provided by the advisor.

What is Investment Advice?
A person will be considered to be rendering investment advice to an individual if:
1. The advice is particularized to the needs of the individual, and
2. The advice is about the value or recommendation of investing in securities or other property, and
3. The person, either directly or indirectly, has discretionary authority over purchasing or selling these securities for the individual or
4. The person renders the advice on a regular basis to the individual pursuant to a mutual agreement (written or otherwise), and
5. The individual uses the information as the primary basis for investment decisions.
What Education can be Provided to Participants that is not Investment Advice?4

Education should provide participants with the tools to make appropriate decisions. This education will not be considered “investment advice” if it’s provided under DOL guidelines regarding plan information, general investment information, asset allocation models, and interactive investment materials.

Plan information that informs a participant or beneficiary about the benefits of plan participation as well as the impact of contributions or withdrawals is not considered advice.

General investment information allows participants or beneficiaries to take the next step on their own, such as information regarding investment objectives and philosophies; risk and return, diversification, dollar-cost averaging, compounded return, and tax-deferred investment guidelines; effects of inflation; estimating future retirement-income needs; determining investment time horizons; or assessing risk tolerance.

Asset allocation models and interactive investment materials can be provided to a participant or beneficiary. The models must be made available to all plan participants and beneficiaries, describe hypothetical individuals with various time horizons and risk profiles, and be based on generally accepted investment theories. All the material facts and assumptions underlying such models need to be included.

The interactive investment materials must be based on generally accepted investment theories that take into account the historic returns of different asset classes, include all assumptions, and correlate to the information and data supplied by the participant or beneficiary.

A disclosure statement must be provided in both the asset-allocation model and the interactive-materials situation. The statement will indicate that other investment alternatives having similar risk and return characteristics may be available under the plan, and it will identify where information on those investment alternatives may be obtained as well as direct participants or beneficiaries to consider their other assets, income, and investments in addition to their interests in the plan.

What Happens with Participants Who Don’t Proactively Choose Their Investments?
The DOL contends that 404(c) only applies to transactions where participants exercise active control over their accounts. Where “default” funds are used when participants fail to provide investment instructions, 404(c) may not apply and the plan sponsor has responsibility for the participant’s investment in the default fund.5

On September 27, 2006, DOL’s Employee Benefits Security Administration published proposed regulations on the use of certain default investment alternatives that would provide a safe harbor for sponsors using these default options. (The DOL released the new regulations on October 23, 2007. See “Department of Labor Issues Final Regulations on Qualified Default Investment Alternatives” in this issue of the Monitor on page 27.)

Avoiding Personal Liability
Any fiduciary who breaches ERISA’s fiduciary obligations can be held personally liable for losses. Liability could mean that you would need to restore the profits to the plan. As discussed earlier, the definition of a fiduciary is broad, and the responsibilities are not mitigated by simply delegating fiduciary duties. A person may be a fiduciary for one function and not for another. For instance, the investment-manager fiduciary will not be the administrative fiduciary unless the manager has accepted that job function and responsibility. Once a fiduciary function has been accepted, the fiduciary becomes liable for the duties of loyalty and honesty to participants and beneficiaries under that fiduciary function. This fiduciary also may be personally liable for a breach by another fiduciary related to this fiduciary function.

When might one fiduciary become responsible for another fiduciary’s action? Consider this example: An investment consultant is paid a fee to assist a trustee in hiring an investment manager. The consultant, in the role of monitoring the performance of the investment manager, notes that commissions are being directed to an affiliate of the trustee at a rate that seems higher than reasonable. Three fiduciaries are liable for noting this activity should they become aware of it: the trustee, the consultant, and the investment manager. The plan administrator is not a fiduciary and would not be found to be a co-fiduciary for the investment function.

Note that federal law requires that each fiduciary (i.e., directors or officers of the employer) and every individual who handles plan assets (i.e., the individual who transmits contributions to the trustee) be bonded.

Ignorance, poor communication, or inexperience are inadequate legal defenses. Delegation to prudent experts and prudent oversight of them may be the only defenses a fiduciary can rely upon.

Stiff penalties are imposed upon fiduciaries for violations, and they can be imposed for up to six years after the fiduciary violation or three years after the party bringing suit had knowledge of the breach. A willful violation can carry personal criminal penalties of up to $5,000 ($100,000 for corporations) and up to one year in prison. Civil actions can be initiated by plan participants, beneficiaries, other fiduciaries, and the DOL. Losses to the plan as well as profits made from the improper use of plan assets must be restored. The DOL also can remove the fiduciary and take control of plan assets.6

How do you avoid this risk? By adhering to the following five standards required of a fiduciary:

1. Actions must be solely in the interest of the participants and beneficiaries and for the sole
purpose of providing benefits to individual participants and their beneficiaries as well as defraying reasonable expenses of administering the plan.

2. The benefit plan must be in writing. The investment policy statement should be in writing. It should provide general guidelines concerning various types or categories of investment management decisions.

3. Actions must be discharged “with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims.”

4. Investments must be diversified to minimize the risk of large losses unless it is clearly prudent not to do so.

5. These responsibilities must be carried out in accordance with the documents of the plan. An ERISA fiduciary holds the retirement future of plan participants, and this is why the DOL regulations are so narrow. Following these guidelines will provide you with a sense of accomplishment knowing that under your direction plan participants will have planned for a sound retirement.

For more information on this topic and to access an IMCA special report, “ERISA Plans: What Is Your Fiduciary Responsibility?” by Betsy Piper/Bach, visit the online store at www.IMCA.org.

Betsy Piper/Bach, CIMA®, CFP®, CTFA, is president of Cardinal Trust and Investments in McLean, VA. She earned a B.S. in special education from St. Cloud University, a M.Ed. degree from The George Washington University, and is completing a law degree at The Catholic University of America Columbus School of Law. Contact her at betsy.piperbach@cardinalbank.com.

Endnotes

2. DOL Interpretive Bulletin 29 CFR 2509.96-1.
3. ERISA § (3) 21, 29 CFR 2510.3-21(c).
7. ERISA § 404(a)(1)(B)