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Investing Safely for Retirement Plans

Legislation Grapples With Employer Liability Issues Stemming From Poor Advice

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THE RECENT WAVE of scandals that led to the collapse of Enron, WorldCom and other leading companies has devastated the retirement income of tens of thousands of employees and retirees. These significant losses have caused some to re-examine a basic premise of the pension laws — that plan participants who are permitted to choose among investment alternatives in their retirement accounts will make rational, educated investment-related decisions. The evidence, however, strongly suggests that many participants affected by these corporate events did not understand the implications of their investment decisions, nor were their actions well advised or fully informed.

Legislative proposals have been advanced in Congress to provide participants with access to investment advice. The proposed legislation attempts to overcome the fiduciary liability concerns under current law that tend to inhibit plan sponsors from undertaking investment activities. This article reviews the current requirements under the Employee Retirement Income Security Act of 1974 (ERISA)[1] affecting a plan sponsor's decision to render investment advice and the recent steps taken by the U.S. Department of Labor (DOL) to encourage plan sponsors to undertake advisory activities.

The important distinction between investment education and investment advice is also explored. This article then considers the current legislative proposals to amend ERISA to shield plan sponsors from potential fiduciary liability with respect to providing investment advice to participants.

Under ERISA, a plan sponsor who renders investment advice under a plan is, by definition, a plan fiduciary. If that advice yields poor investment results or losses, the plan sponsor could be subject to liability under ERISA arising from participant lawsuits for breaches of fiduciary responsibility for poor investment advice.

Investment Advice

The structure of ERISA gives rise to a host of concerns for employers sponsoring retirement plans that attempt, either directly or through a third party,[2] to provide their employees with investment advice. Under DOL regulations,[3] one circumstance in which a person is considered a fiduciary by virtue of providing investment advice is when (1) the person's services include providing information pertaining to the value of, or making recommendation as to the advisability of, investments; and (2) that information is provided on a regular basis under an arrangement pursuant to which the person's services are the primary basis for investment decisions and the person is rendering investment advice based on the particular needs of the plan.

As discussed below, plan sponsors who want to provide participants with investment advice face two issues under ERISA. First, plan sponsors who directly advise participants' investment decisions face possible fiduciary liability issues. Second, plan sponsors who hire an independent adviser to avoid fiduciary responsibility risk violating ERISA's prohibited transaction rules.

• Fiduciary Liability. Under ERISA, a plan sponsor who renders investment advice under a plan is, by definition, a plan fiduciary. If that advice yields poor investment results or losses, the plan sponsor could be subject to liability under ERISA arising from participant lawsuits for breaches of fiduciary respon-

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sibility for poor investment advice.

Section 404(c) of ERISA, a provision enacted as a result of the demands of plan sponsors, provides limited relief from this fiduciary liability in pension plans that permit participants or beneficiaries to direct investments in their retirement plan accounts. To qualify for relief under this section, plan sponsors must, among other things, provide participants and beneficiaries with sufficient information about the plan's investment options to enable them to make informed investment choices.[4]

Plan sponsors have been using Section 404(c) to escape ERISA fiduciary liability. However, in satisfying the requirements of this provision, they are exposed to potential fiduciary liability if their communication extends beyond mere investment education and rises to the level of investment advice. The distinction between education and advice is discussed below.

• Prohibited Transaction Rules. In lieu of providing advice directly to participants, some plan sponsors instead retain investment advisory firms. While this may reduce (at least to some extent) the plan sponsor's exposure to the types of fiduciary breach claims discussed earlier, this may be problematic under ERISA's prohibited transaction provisions, which provide that a plan fiduciary may not deal with plan assets in his or her own interests and may not receive any consideration for his or her own personal account from any party dealing in a transaction involving plan assets.

DOL regulations promulgated pursuant to these provisions state that a fiduciary is prohibited from using the authority, control or responsibility that makes that person a plan fiduciary, to enter into a transaction involving services in which such fiduciary has an interest.[5] Similarly, a fiduciary may not use that authority, control, or responsibility to engage in a transaction from which the fiduciary (or a person in which the fiduciary has an interest) derives additional fees. Such transactions may affect the exercise of the fiduciary's best judgment, and are thus prohibited by §406(b) of ERISA.

Investment advisory firms that provide investment advice to participants are ERISA plan fiduciaries. If those firms are also sponsoring the investment vehicles being offered under the plan, the advice rendered might result in the firm receiving additional compensation. In that case, the advisory firm would be engaging in a prohibited transaction under ERISA because it would be using its authority as a fiduciary to potentially generate additional fees for itself. It could also affect the advisory firm's fiduciary judgment, which would contravene its fiduciary obligations to act in the best interests of the plan's participants and beneficiaries.[6]

On June 11, 1996, the DOL published Interpretive Bulletin 96-1 — "Participant Investment Education" — (the Bulletin),[7] in which it clarified that if a plan sponsor is merely providing investment education, then the plan sponsor is not rendering investment advice. Thus, a plan sponsor that provides education is not a plan fiduciary under ERISA, and accordingly, could not be liable for breach of fiduciary duty with respect to the investment education that it provides. The Bulletin then proceeded to clarify the difference between investment education and advice. In so doing, the DOL attempted to define investment education broadly enough to encourage plan sponsors to educate participants through a variety of investment products and services.

Advice Versus Education

The key factor distinguishing investment education from investment advice is that the latter consists of factual information about the plan and investing, while the former consists of recommendations and value judgments based on those facts. The Bulletin identified the following four categories of investment information that would not constitute rendering investment advice: (1) plan information (i.e., benefits of participation and impacts of preretirement withdrawals); (2) general financial and investment information (i.e., risk and return concepts, diversification, and dollar cost averaging); (3) asset allocation models based on hypothetical individuals; and (4) interactive investment materials (i.e., worksheets and questionnaires).

As discussed above, plan sponsors whose communication with participants clearly falls within these categories of information will not be deemed fiduciaries for this purpose. However, plan sponsors who go beyond these categories and render investment advice, either directly or indirectly through a third party, need to be wary of ERISA's prohibited transaction and fiduciary liability provisions.

SunAmerica Opinion

On Dec. 14, 2001, the DOL issued Advisory Opinion 2001-09A, which may significantly broaden the opportunity for employers to offer investment advice to plan participants permitted to direct their own account's investments.

SunAmerica proposed to offer clients a bundled arrangement for the investment of defined contribution plan assets. One aspect of this program was that SunAmerica would hire an independent investment adviser to create tailored investment portfolios for participants in the plans that adopted the program. Two types of portfolios would be offered. First, under a discretionary asset allocation service, the adviser would establish an optimum asset allocation for the participant and thereafter adjust the participant's accounts automatically to stay within the allocation parameters. Second, under a recommended asset al location service, the adviser would structure a recommended asset allocation that

the participant could choose to adopt.

The participant could opt in or out of either program. The portfolios structured by the independent adviser could potentially contain investments in products for which SunAmerica or an affiliate provides investment advisory services and from which SunAmerica, or an affiliate, could receive a fee.

The model asset allocation portfolios would be developed by an entity financially independent of SunAmerica, which would take into account individual participant data. The plan sponsor would also be provided with a disclosure statement concerning the performance and rates of return on designated investments, and the expenses and fees of SunAmerica funds that are designated investments.

Under the program, SunAmerica would pay the investment adviser a fee for its services. This fee would not vary based on the particular investments made under the model asset allocation portfolios. In addition, the plan sponsor would pay SunAmerica a flat fee for the entire bundled product. However, SunAmerica might receive additional fees if the investment adviser or the participants (based on the investment adviser's recommendations) choose asset allocation models that included investments in SunAmerica (or affiliated) products.

SunAmerica asked the DOL whether this transaction was prohibited under §406(b) of ERISA, which generally prohibits a fiduciary from selecting or recommending an investment vehicle from which it, or an affiliate, may derive additional fees. This case differed from the normal paradigm because, although the fiduciary (SunAmerica) was offering a bundled product and selecting the adviser, it had no authority to deviate from the actions of that adviser. A critical issue considered by the DOL was whether the investment services under the program should be attributed to the independent adviser or SunAmerica, the sponsor of the program.

The DOL determined that, under this program, SunAmerica would be acting as a fiduciary with respect to the selection and monitoring of the independent adviser. As such, SunAmerica would be subject to ERISA's fiduciary responsibility rules, set forth in §404, to that extent.

However, the DOL concluded that SunAmerica would not be exercising authority, control, or responsibility to generate higher fees for itself or its affiliates. Thus, the arrangement would not constitute a prohibited transaction under §406(b) of ERISA. The DOL premised its conclusions on the following facts:

- First, plan sponsors responsible for adopting the program are fully informed about, and approve, the program and the nature of the services provided, including the role of the financial expert.
- Second, the investment recommendations provided to or on behalf of the participants are the result of methodologies developed, maintained and supervised by a party (the financial expert) independent of SunAmerica and its affiliates.
- Third, the arrangement between SunAmerica and the financial expert preserves the financial expert's ability to develop model asset allocation portfolios solely in the interests of the participants and beneficiaries since the financial expert's fees are not dependent upon the fees that SunAmerica or its affiliates might receive as a result of the investments made pursuant to the portfolios in the program.

Prior to the issuance of this Advisory Opinion, there would have been little incentive for financial services firms to offer investment advice to plan participants, together with other investment advisory services, such as asset allocation services, because such firm's investment advice could not result in its receiving (or receiving additional) investment advisory fees. Under the SunAmerica Advisory Opinion, the DOL has sanctioned a program under which plan sponsors can retain an investment advisory firm to provide investment advice and investment services to plans and plan participants while simultaneously receiving advisory fees with respect to the underlying investment vehicles.

This Advisory Opinion may have two direct effects:[8] it could (1) encourage other investment advisory firms to offer similar programs; and (2) relieve concerns on the part of plan sponsors who may have been reluctant to offer such programs for fear of potential fiduciary liability.

Legislative Proposals

Currently, there are two pension reform proposals being considered in Congress. Both proposals contain provisions for amending ERISA to encourage plan sponsors to provide investment advice to participants.

The Pension Security Act (PSA), H.R. 3762, contains a provision dealing with investment advice based on legislation initially introduced by Representative John Boehner in 2001.[9] The PSA would amend ERISA by creating a prohibited transaction exemption to allow investment advisory firms that administer pension plans and sell investment products to also provide investment advice to plan participants if they disclose this potential conflict of interest to the participants and beneficiaries. Additionally, plan sponsors would have no fiduciary liability for the advice provided by such investment advisers as long as the plan sponsors prudently selected the advisers.

Critics of Representative Boehner's proposal maintain that it creates potential conflicts of interest by permitting plan sponsors to hire the same

investment firm that administers its retirement plan to give participants investment advice. This is problematic because such investment firms could favor their own investment products over competing products that might be cheaper, better or more suitable for plan participants and beneficiaries. Critics further assert that it would be unreasonable to expect that a financial services firm, which is geared toward competing in the investment marketplace, will also be able to educate and assist plan participants and beneficiaries to choose among competing investments.

Additionally, some maintain that Representative Boehner's proposal treats the symptoms, but not the problems at the heart of the investment adviser dilemma. These critics assert that the real problem is that financial services firms that render investment advice, directly or indirectly, expect to be paid for it, while those receiving advice do not want to pay for it. Offering "free" advice is an attempt at circumventing the concept of cost. Those firms most willing to offer investment advice are the same firms who also provide the investments. Thus, at best, the financial services firms are hiding the cost of their advice and, at worst, they are giving biased advice to benefit themselves, the critics say. In effect, the only advice available to the participants will be conflicted advice, say critics, and participants will either take that conflicted advice or be in the same position they are in now.

On Jan. 7, 2003, Senate Minority Leader Tom Daschle introduced the Pension Protection and Expansion Act of 2003 (S. 9). Senator Daschle's bill creates a fiduciary "safe harbor" for plan sponsors that would exempt them from fiduciary liability for prudently hiring and monitoring the performance of qualified investment advisers. The bill specifies a list of requirements that plan sponsors must fulfill in monitoring the investment adviser.

The plan sponsor must verify that the adviser acknowledges its fiduciary status and sole responsibility for the advice given, that the adviser is adequately insured, and that the adviser maintains its qualified status (pursuant to the Investment Advisers Act of 1940). If the plan sponsor meets these monitoring requirements, there will be no fiduciary or co-fiduciary liability for any losses resulting from the investment advice or any breaches by the investment adviser. Unlike the House proposal, the adviser could not be the firm that administers the plan.

Representative Boehner has criticized the investment advice provisions of the Pension Protection and Expansion Act of 2003, arguing that the bill does not require enough disclosure to participants, including the fact that it does not mandate the disclosure to participants of fee structures, compensation or affiliations with respect to the advice and services provided by third party advisers. Thus, he maintains, participants will lack the basic information they need to make informed decisions about the quality of their advice provider.

Conclusion

The significant losses in retirement accounts that resulted from the meltdown of many prominent companies underscore the critical need for participants to become "smarter" investors. While strides have been made to encourage plan sponsors and others to offer investment advice to plan participants, further steps must be taken. However, there are significant concerns that over-regulation of the private, voluntary pension system will cause employers to curtail their benefit programs.

Significant pension reform in this area remains an unfulfilled promise.[10] Whether an amendment to ERISA providing investment advice will take the form of a prohibited transaction exemption, the creation of an expanded safe harbor, or some other form remains unclear. It is apparent, however, that participants and beneficiaries need more investment education and advice to diversify and protect their retirement investments.

(1) 29 U.S.C. §1001 et seq.

(2) An employer can offer investment advice to plan investors through an independent, third party investment advisory firm. However, the employer may still remain liable for selecting and monitoring the investment adviser (and potentially liable for fiduciary breaches committed by the investment adviser on a co-fiduciary basis).

(3) 29 C.F.R. §2510.3-21 (2003).

(4) See 29 C.F.R. §2550.404(c)-1(b)(2)(B) (2003).

(5) 29 C.F.R. §2550.408b-2(e)(1) (2003).

(6) While an employer can seek an administrative exemption from the prohibited transaction provision, the costs and time required to do so is significant.

(7) 29 C.F.R. §2509 (1996).

(8) Following the SunAmerica Opinion, CitiStreet announced that it would offer plan participants fully integrated investment advice, powered by Financial Engines, which is an independent advice technology provider. See CITISTREET PROVIDES FIRST FULLY INTEGRATED ADVICE SERVICE TO RETIREMENT PLAN PARTICIPANTS, available at http://www.citistreetonline.com/com/com_sub_index.asp?lvl=4-3-0-0 (June 13, 2002).

(9) Retirement Security Advice Act (H.R. 2269).

(10) The Sarbanes-Oxley Act of 2002 (SOA), P.L. 107-204, enacted on July 30, 2002, amended ERISA in significant ways, including imposing a 30-day notice to participants affected by a blackout. It did not incorporate an investment advice provision.