Section of Taxation

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@abanet.org

TAXATION
A Section of the American Bar Association

May 27, 2009

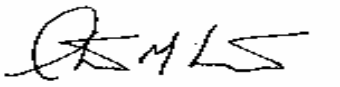
Mr. Fred J. Wong
Office of Regulations and Interpretations
Employee Benefit Security Administration
U.S. Department of Labor
Frances Perkins Building
200 Constitution Avenue, N.W.
Room N-5669
Washington, DC 20210

Re: Comments on Regulations Relating to the Exemptions for the Provision of Investment Advice Under Section 408(B)(14) and Section 408(G) of ERISA

Dear Mr. Wong:

Enclosed are comments on regulations relating to the exemptions for the provision of investment advice under section 408(B)(14) and section 408(G) of ERISA. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,



Stuart M. Lewis
Chair - Elect, Section of Taxation

Enclosure

cc: Hon. Douglas Shulman, Commissioner, Internal Revenue Service
Clarissa C. Potter, Acting Chief Counsel, Internal Revenue Service
Eric A. San Juan, Acting Tax Legislative Counsel, Department of the Treasury

AMERICAN BAR ASSOCIATION SECTION OF TAXATION
COMMENTS ON REGULATIONS RELATING TO THE EXEMPTIONS FOR THE PROVISION OF INVESTMENT ADVICE UNDER SECTION 408(B)(14) AND SECTION 408(G) OF ERISA

These comments (these "Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Andrew L. Oringer of the Section's Committee on Employee Benefits (the "Committee"). Substantive contributions were made by Steven J. Friedman and Steven H. Sholk. These Comments were reviewed by Kurt L.P. Lawson, Chair of the Committee, by David A. Mustone, Immediate Past Chair of the Committee, by Bruce Pingree on behalf of the Section's Committee on Government Submissions, and by the Quality Assurance Group of the Committee, which is chaired by Pamela Baker and whose members are selected from the Committee,. The Comments were further reviewed by Priscilla E. Ryan, the Section's Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Andrew L. Oringer
212-819-8561
andrew.oringer@whitecase.com

Kurt L.P. Lawson
202-637-5660
kllawson@hhlaw.com

Date: May 27, 2009

EXECUTIVE SUMMARY

On January 21, 2009, the Department of Labor (the "Department") published final rules on the provision of investment advice to participants and beneficiaries of participant-directed individual account plans and individual retirement accounts (the "Advice Rules").[1] The rules implement statutory prohibited transaction exemptions under section 408(b)(14) and section 408(g) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"),[2] which was added by section 601(a)(1) and (2) of the Pension Protection Act of 2006 ("PPA '06"),[3] and also include an administrative class exemption granting additional relief.

After the Advice Rules were published, the Administration instructed heads of executive departments and agencies to consider extending the effective date of regulations that had not yet become effective for 60 days.[4] These comments are submitted in response to a request for comments on legal and policy questions under the Advice Rules that the Department made in response to the Administration's instructions.[5]

We recommend that the Advice Rules be amended to:

A. Clarify that a participant's or beneficiary's written or computer-generated instructions automatically to implement computer-driven investment advice satisfies the "solely at the direction" requirement under section 408(g)(3)(D)(ii);

B. Provide safe harbors (i) for the use of modern portfolio theory as a generally accepted investment theory and (ii) for the qualification of an eligible investment expert based on satisfaction of enumerated requirements as to experience, education, professional certification and professional organization licensing; and

C. (i) Clarify that, in conducting a compliance audit under section 408(g)(5), the auditor is not required to evaluate whether the fiduciary adviser has satisfied its ERISA prudence obligation in providing investment advice, (ii) clarify that the audit should evaluate the fiduciary adviser's compliance with the requirements of the exemptions on an overall basis rather than with respect to each plan to which the fiduciary adviser provides investment advice, and (iii) provide a regulatory safe harbor for the qualification of an independent auditor based on satisfaction of enumerated requirements as to experience, education, professional certification and licensing.

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1 74 Fed. Reg. 3,822 (Jan. 21, 2009).

2 Unless otherwise indicated, all section references herein are to sections of ERISA.

3 Pub. L. No. 109-280 (2006).

4 74 Fed. Reg. 4,435 (Jan. 26, 2009).

5 74 Fed. Reg. 6,007 (Feb. 4, 2009).

COMMENTS

I. BACKGROUND

The subjects of these Comments are the new prohibited transaction exemptions for the provision of investment advice in section 408(b)(14) and section 408(g), which were added by section 601(a)(1) and (2) of PPA '06. The exemptions apply to two types of arrangements: a fee leveling arrangement and a computer model. The exemption for a fee leveling arrangement grows out of a series of individual exemptions previously granted by the Department for arrangements with level or substantially level fees among funds.[6] The exemption for a computer model grows out of Prohibited Transaction Individual Exemption 97-60,[7] which led to Advisory Opinion 2001-09A (Dec. 4, 2001) (commonly referred to as the SunAmerica opinion).

PPA '06 added section 408(b)(14) and (g) to ERISA (and corresponding provisions of the Internal Revenue Code of 1986, as amended) to provide statutory prohibited transaction exemptions for the plan sponsor and other plan fiduciaries who provide participants and beneficiaries with investment advice. When the statute's requirements are met, the following transactions are exempt from prohibited transaction treatment: (i) the provision of investment advice; (ii) an investment transaction (i.e., the sale, acquisition, or holding of a security or other property) pursuant to the advice; and (iii) the receipt of fees or other compensation by the fiduciary adviser (or an affiliate thereof) in connection with the provision of the advice, or an investment transaction made pursuant to the advice.

The exemptions apply to the provision of investment advice by a fiduciary adviser under an eligible investment advice arrangement.[8] An eligible investment advice arrangement is an arrangement which: (i) satisfies certain statutory requirements; and (ii) either (A) provides that any fees, including commissions or compensation, received by the fiduciary adviser for investment advice (or with respect to an investment transaction) do not vary depending on the investment option selected, or (B) uses a computer model under an investment advice program that meets specified requirements.[9] In addition, the arrangement must be expressly authorized by a plan fiduciary other than the person offering the investment advice program, any person providing investment options, and any affiliate of these persons.[10]

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6 *See, e.g.*, Prohibited Transaction Individual Exemption 2000-45, 65 Fed. Reg. 54,315 (Sept. 9, 2000).

7 62 Fed. Reg. 59,744 (Nov. 11, 1997).

8 *See* § 408(g)(1).

9 *See* § 408(g)(2).

10 *See* § 408(g)(4).

When an eligible investment advice arrangement provides advice pursuant to a computer model, the model must: (i) apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time; (ii) use relevant information about the participant or beneficiary (to the extent furnished); (iii) use prescribed objective criteria to provide asset allocation portfolios comprised of investment options under the plan; (iv) operate in a manner that is not biased in favor of any investment options offered by the fiduciary adviser or related person; and (v) take into account all the investment options under the plan in specifying how a participant's account should be invested without inappropriate weighing of any investment option.[11] An eligible investment expert must certify to the fiduciary adviser, before the model is used, that the model meets these requirements.[12] The certification must be renewed if material changes are made to the model. Unlike prior Department precedent, the new statutory exemption permits investment providers to use their own certified models, rather than requiring those provided by third parties.

When a plan uses a computer model, the only investment advice that may be provided is the advice generated by the computer model, and any investment transaction must occur solely at the participant's direction.[13] This requirement does not preclude the participant from requesting other investment advice, as long as the request has not been solicited by any person connected with carrying out the investment advice arrangement.

In addition, the exemption requires that: (i) the fiduciary adviser provide the disclosures required by the securities laws; (ii) an investment transaction occur solely at the direction of the recipient of the investment advice; (iii) the compensation received by the fiduciary adviser or affiliates in connection with an investment transaction be reasonable; and (iv) the terms of the investment transaction be at least as favorable to the plan as an arm's length transaction would be.

An annual audit of the investment advice arrangement for compliance with the exemptions' requirements must be conducted by an independent auditor that is unrelated to the person offering the arrangement or any person providing investment options (or their affiliates).[14] The auditor must have appropriate technical training or experience and proficiency, to which the auditor must certify in writing. Finally, the auditor must issue a report of the audit results to the fiduciary who authorized the arrangement.

Before the initial provision of any investment advice, the fiduciary adviser must provide written notice to the recipient of the advice containing certain information, including information relating to: (i) the role of any related party in the development of the investment advice program or the selection of investment options; (ii) the past

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11 *See* § 408(g)(3)(B).

12 *See* § 408(g)(3)(C).

13 *See* § 408(g)(3)(D).

14 *See* § 408(g)(5).

performance and rates of return for each investment option offered; (iii) any fees or other compensation to be received by the fiduciary adviser or affiliate; (iv) any material affiliation or contractual relationship of the fiduciary adviser or affiliates in the security or other property involved in the investment transaction; (v) the manner and circumstances in which any participant or beneficiary information will be used or disclosed; (vi) the types of services provided by the fiduciary adviser; (vii) the adviser's status as a plan fiduciary; and (viii) the ability of the recipient of the advice separately to arrange for the provision of advice by another adviser that has no material affiliation with, and receives no fees or other compensation in connection with, the investment.[15] This information must be provided to the recipients of the investment advice without charge, at least annually, upon their request, and whenever there is a material change to the program or to the retirement options.[16]

II. DISCUSSION

A. Standing Instructions to Implement Computer Advice

1. Summary

Section 408(g)(3)(D)(ii) states that transactions pursuant to computer-generated investment advice must occur "solely at the direction of the participant or beneficiary."

2. Recommendation

We recommend that the Advice Rules be amended to clarify that a participant's or beneficiary's written or computer-generated instructions automatically to implement computer-driven investment advice satisfies the "solely at the direction" requirement under section 408(g)(3)(D)(ii).

3. Explanation

We understand that program designs involving automatic implementation of participant instructions are being used in the market and are useful to participants who wish to proceed in this manner. Without the clarification we propose here, participants desiring the beneficial service of automatic implementation could have their wishes unnecessarily frustrated. We recommend that, as long as the program otherwise satisfies the exemption, the exemption permit participants to have their standing instructions automatically followed when they knowingly decide to use the program. The standing instructions can provide for automatic rebalancing, or the allocation of future contributions to specified investment options, or both. The preamble to the Advice Rules[17] (the "Advice Preamble") allows a preauthorization for rebalancing.[18] In addition

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15 *See* § 408(g)(6)(A).

16 *See* § 408(g)(6)(B).

17 74 Fed. Reg. 3,822 (Jan. 21, 2009).

18 *Id.* at 3,833.

to rebalancing, we recommend that the advice rules allow for participant preauthorization for allocations of future contributions to specified investment options. If the Department is concerned that participants might lose track of the significance of standing instructions, it could consider requiring, as an additional safeguard, that the standing instructions be reissued periodically (e.g., annually) by the participant.

B. Generally Accepted Investment Theories and Eligible Investment Expert

1. Summary

Section 408(g)(3)(B)(i) requires a computer model to apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time. The Advice Rules apply this requirement to both fee leveling arrangements and computer models.

Section 408(g)(3)(C) requires that an eligible investment expert certify to the fiduciary adviser, prior to the utilization of the computer model and in accordance with rules prescribed by the Secretary of Labor, that the computer model satisfies the requirements of section 408(g)(3)(B). The Advice Rules define an eligible investment expert as a person that, through employees or otherwise, has the appropriate technical training or experience and proficiency to analyze, determine and certify that the computer model satisfies the requirements of section 408(g)(3)(B).

2. Recommendation

We recommend that the Advice Rules be amended to provide safe harbors: (i) for the use of modern portfolio theory as a generally accepted investment theory; and (ii) for the qualification of an eligible investment expert based on satisfaction of enumerated requirements as to experience, education, professional certification and professional organization licensing.

3. Explanation

We believe that a major goal of the Advice Rules should be to provide certainty for affected parties. As noted in the preamble to Interpretative Bulletin 96-1, [19] modern portfolio theory is widely accepted in the investment community as a prudent method of investing. Accordingly, we recommend that the Advice Rules be amended to provide a safe harbor for modern portfolio theory as a generally accepted investment theory.[20]

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[19] 61 Fed. Reg. 29,586, 29,587 (June 11, 1996).

[20] *See Laborers National Pension Fund* v. *Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317 (5th Cir. 1999) ("In general, the regulations provide that the fiduciary shall be required to act as a prudent investment manager under the modern portfolio theory rather than under the common law of trusts standard which examined each investment with an eye toward its individual riskiness"), *cert. denied sub nom., Laborers National Pension Fund* v. *American National Bank & Trust Co.*, 528 U.S. 967 (1999); *Meyer v. Berkshire Life Insurance Co.*, 250 F. Supp. 2d 544 (D. Md. 2003) (failure to invest in accordance with modern portfolio theory was evidence of breach of

In addition, because an eligible investment expert's certification of the computer model is one of the primary methods for preventing a fiduciary adviser's conflict of interest from adversely affecting the quality and integrity of the investment advice, we also recommend that the Advice Rules be amended to provide a safe harbor for the qualifications of an eligible investment expert based on satisfaction of enumerated requirements.

The Department stated in the Advice Preamble that it is difficult to define a specific set of credentials that would satisfy the requirements for an eligible investment expert.[21] As difficult as it might be for the Department, it will often be even more difficult for fiduciary advisers to make this determination, given that different fiduciary advisers likely will ascribe different levels of importance to the credentials of an investment expert (which could result in a wide range of expertise among the investment experts selected for certifying the proper utilization of a computer model). If the Department is concerned that there may be inappropriate reliance on such a safe harbor, the Department could provide that the safe harbor creates a presumption that a person is an eligible investment expert, and that the Department can overcome the presumption by clear and convincing evidence that the plan sponsor's use of the presumption was inappropriate.

C. Audit Requirement

1. Summary

Section 408(g)(5) requires that an independent auditor conduct an annual audit of the investment advice arrangement for compliance with the exemptions' requirements. Section 408(g)(5) also requires the independent auditor to have appropriate technical training or experience and proficiency and represent so in writing.

2. Recommendation

We recommend that the Advice Rules be amended to (i) clarify that, in conducting a compliance audit under section 408(g)(5), the auditor is not required to evaluate whether the fiduciary adviser has satisfied its ERISA prudence obligation in providing investment advice; (ii) clarify that the audit should evaluate the fiduciary

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ERISA obligation to diversify investments), *aff'd*, 372 F.3d 261 (4th Cir. 2004); Preamble to Interp. Bull. 96-1, 61 Fed. Reg. 29,586, 29,587 (June 11, 1996) (referring to generally accepted investment theories that take into account the historic returns of different asset classes (*e.g.*, equities, bonds, or cash) over defined periods of time "to assure that, for purposes of the safe harbors, any models or materials presented to participants or beneficiaries will be consistent with widely accepted principles of modern portfolio theory, recognizing the relationship between risk and return, the historic returns of different asset classes, and the importance of diversification"); *see also* Advisory Opinion 2001-09A (Dec. 4, 2001) (fiduciary did not violate certain provisions of section 406(b) where, among other things, investment advice and investment management programs applied modern portfolio theory).

[21] Advice Preamble, 74 Fed. Reg. at 3,827.

adviser's compliance with the requirements of the exemptions on an overall basis rather than with respect to each plan to which the fiduciary adviser provides investment advice; and (iii) provide a regulatory safe harbor for the qualification of an independent auditor based on satisfaction of enumerated requirements as to experience, education, professional certification and licensing.

3. Explanation

The exemptions do not create new fiduciary obligations, nor do they obligate the auditor to monitor the adviser's compliance with its fiduciary obligations under any other provisions of ERISA.[22] Further, section 408(g)(10)(B) provides that the plan sponsor and other plan fiduciaries do not have any duty to monitor the specific investment advice given by a fiduciary adviser to any particular recipient of the advice. Thus, we view the audit rule as requiring only that the auditor opine on procedural compliance with the exemptions.

We do not believe that conducting a broad prudence audit was what Congress intended. The legislative history refers to "an annual audit of the arrangement for compliance with applicable requirements."[23] Thus, we recommend that the Department clarify that the "applicable requirements" constitute procedural compliance with the exemptions' requirements.

We also do not believe that Congress intended the compliance audit be performed on a plan-by-plan basis. The statute requires an audit of the "arrangement." An arrangement can cover numerous plans. Inherent in the use of the term "audit" is the concept that the auditor obtain sufficient information to formulate an opinion. As long as professional standards allow for a reasonable sampling of the plans covered by the arrangement to serve as sufficient information, we believe it should not be necessary for the compliance audit to be done on a plan-by-plan basis. The Department stated in the Advice Preamble that the auditor must review "sufficient information"[24] and that nothing in the Advice Rules "precludes the auditor from using sampling, as determined reasonably appropriate by the auditor." There is no indication in the Advice Rules or the Advice Preamble as to whether such sampling relates to the investment advice provided by the fiduciary adviser in general (i.e., with respect to the group of plans for which the fiduciary adviser is responsible for providing investment advice). A requirement to conduct sampling on the investment advice provided by the fiduciary adviser with respect to each plan (rather than the group of plans for which the fiduciary adviser is responsible

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22 The legislative history contains no such requirement. *See, e.g.*, Staff of the J. Comm. on Taxation, 109th Cong., *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006* at 129 (Comm. Print 2006) (the "Technical Explanation"); Staff of the J. Comm. on Taxation, 109th Cong., *General Explanation of Tax Legislation Enacted in the 109th Congress* at 441 (Comm. Print 2007) (the "Blue Book").

23 Technical Explanation, at p. 129.

24 Advice Preamble, 74 Fed. Reg. at 3,830.

for providing investment advice) could be unduly burdensome depending on the fiduciary adviser being audited. For this reason and also to provide much needed certainty, we recommend that the Department clarify that "sufficient information" does not require a plan-by-plan audit as long as professional standards are otherwise satisfied. We believe our approach would avoid undue expense for affected plans, and is, in our experience, consistent with accounting industry practices for the auditing of financial statements.

In addition, because we believe the Advice Rules were intended to provide certainty, we recommend that they be amended to provide a safe harbor for the qualifications of an eligible investment expert based on satisfaction of enumerated requirements. As noted above, even though it is difficult for the Department to develop such a list of qualifications, it will often be even more difficult for fiduciary advisers to do so, and if the Department is concerned about inappropriate reliance on a safe harbor, it can provide that the safe harbor merely creates a presumption that a person is qualified.