Legislation Pending on Investment Advice to 401(k) Account Clients

By Dana M. Muir

Even investment advice arrangements that do not pose any risk of conflicts of interest could be subjected to new expensive and extensive compliance requirements.

The anxiety among 401(k) participants that has resulted from the market downturn is now old news. In this period when employees are delaying their retirement dates and retirees are returning to work, many 401(k) account holders are looking for investment advice to help them get their retirement plans back on track. Numerous banks have committed substantial resources to establishing programs to provide this kind of advice. And clients have come to expect that advice. This has been a win-win situation in which banks have been able to provide a service that clients have wanted.

If enacted, legislation currently proposed in Congress would affect the ability of banks to provide investment advice to participants in 401(k) plans. The changes will affect both large and small banks. At best, banks would be required to make costly changes in the way they comply with the requirements imposed on investment advice providers. At worst, those changes will not be feasible, with the result that banks will not be able to provide a service that clients expect and 401(k) plan participants will not receive the investment advice they need and want.

The legislative effort that is under way is an unexpected reversal of efforts that have increased the availability of investment advice during this decade. From 2001 through 2006, the trend in regulation and legislation was to slowly remove barriers that prevented plan sponsors, a variety of financial institutions, including banks, and others from providing investment advice to participants in 401(k) and other qualified defined contribution (DC) accounts. The incremental approach to regulatory change resulted in a patchwork of exemptions that required some moderate compliance efforts. But Congress is now considering severely restricting financial institutions' ability to provide advice. Although advice provided by banks does not present the possibility of harmful conflicts of interest, and it is those conflicts that appeared to be the primary motivation of the legislation as originally proposed, banks would not be exempt from the changes.

Furthermore, banks have long been exempt from the securities law registration requirements that apply to other providers of investment advice. Banking regulation has been accepted as sufficient to protect banking clients who receive investment advice. Under the proposed legislation, banks would, for the first time, be subject to the same securities law registration requirements that apply to nonbank providers of investment advice. As a result, even small banks that want to continue to provide advice may be required to form subsidiaries that they then register as investment advisers under the Investment Advisers Act of 1940 (IAA).[1]

In short, the proposed legislative changes would require banks to choose between eliminating the investment advice services they provide to 401(k) account participants and complying with potentially complex and costly new requirements. This will result in unhappy clients if banks stop providing advice and more expensive advice if banks comply with the requirements. Either way, the availability of advice will be reduced, just when 401(k) plan participants most need that advice during the economic recovery.

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The Current Status of Investment Advice

The investment advice programs that banks have developed to service their 401(k) account clients vary depending on the size of the bank and other factors. As discussed below, the programs often fit within what is usually referred to as the SunAmerica model or more rarely within the level fee model. Other banks, especially small banks, have programs that are not required to comply with either model. In a final twist, some banks provide managed account options. Because bank investment advice programs would be affected in different ways depending on which category the current program fits within, it is useful to review the current legal standards.

SunAmerica Model

Most large banks that provide investment advice to 401(k) plan participants have developed advisory programs that rely on guidance given by the Department of Labor (DOL) in 2001. In what is popularly referred to as the "SunAmerica letter,"[2] the DOL approved a framework that allows financial firms, including banks, to provide advice through the use of a computer model. The model must be developed and exclusively controlled by an independent third party. The DOL defined what types of entities qualify as independent third parties.

A large bank that does not comply its investment advice program for 401(k) participants with the restrictions in the SunAmerica letter, or the level fee model discussed below, would be likely to violate what are known as the prohibited transactions provisions in ERISA.[3] ERISA is the federal law governing employee benefit plans. Those ERISA provisions typically apply to large banks because of the variety of services provided by large banks to employee benefit plans.

The advice provided through the use of computer models that have been developed in accordance with the SunAmerica letter not only does not currently violate the prohibited transactions provisions, it also is free of conflicts of interest. All advice given to 401(k) participants under these types of advisory programs must be a product of the independent computer models. Even if a bank had an interest in manipulating the investment advice to increase recommendations of its own investment products, it could not do so.

Level Fee Model

Investment advisory programs that meet strict rules, which prohibit the adviser's compensation from varying based on the investment option that is selected, rely on what is known as the level fee rules or sometimes as offset fees. I refer to them in this article as level fee arrangements. The level fee requirements apply not only to the adviser providing the advice but also to the bank itself and any affiliate of the bank. These rules also were developed by the DOL in opinion letters. Fewer banks have conformed their investment advice programs to these rules than to the SunAmerica rules.

The banks that do comply with the level fee requirements have developed a few different types of level fee arrangements. Small banks, which do not have any other relationship to the 401(k) plan in which they are providing advice, often have pure level fee arrangements. They charge for the advisory service and that is the only fee related to the plan that they receive. Larger banks frequently have more complex arrangements that involve offsets for revenue-sharing payments. For example, a large bank that charges $100 for investment advice and receives $40 of revenue sharing from mutual funds purchased as a result of implementation of the advice would credit $40 back to the plan, so that the investment advice fee remains at $100 regardless of which financial product is chosen.

Registration Exemption

Small banks sometimes do not provide any services or products to ERISA plans, other than investment advice to 401(k) plan participants who are bank clients. Since they have no other connection with a 401(k) plan, those banks would not violate ERISA's prohibited transactions provisions by providing the investment advice. Therefore, they have not had to comply with either the SunAmerica or the level fee standards. Since banks also have never been required to register as investment advisers under the IAA, small banks in this situation operated relatively free of regulation other than standard banking regulation. This was a sensible regulatory framework because the advice they provide obviously is free of conflicts of interest since they simply do not provide any other services or products to ERISA plans.

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Managed Accounts

Participants in 401(k) plans sometimes have established managed accounts. Those accounts allow the bank that provides advice to automatically implement that advice without receiving individual approval from the client in advance of each specific transaction. Instead, the client gives the bank a general authorization in advance to make investment changes in accordance with the banks' advice platform. Most managed accounts are in advisory programs that use a computer model in accordance with the SunAmerica rules.

2006 Legislation

In 2006, Congress enacted legislation designed to expand access to investment advice.[4] The new statutory provisions approved the use of independently certified computer models and level fee structures for providing investment advice. The provisions differed in some ways from the rules adopted by the DOL in the SunAmerica letter and with respect to level fee arrangements. But, banks still had the ability to rely on the SunAmerica letter or the level fee rules. Although the 2006 law permitted different arrangements, it did not require banks with existing programs that rely on computer models or level fees to change those programs.

The Congressional Proposal

In spite of the lack of reported problems with investment advice provided by banks, proposed legislation, H.R. 2989,[5] would cause many of the current methods of providing investment advice to violate ERISA or securities laws. Before June 2009 amendments to the proposed legislation, the debate had focused primarily on efforts to improve the quality of investment advice, associated disclosures and elimination of problematic conflicts of interest. The June amendments, however, go much further and, if enacted, would add significant hurdles for investment programs provided by large banks that rely on the SunAmerica letter or level fees. And smaller banks that have not had to comply with those ERISA requirements would now have to register as investment advisers under the IAA in order to continue providing advice to 401(k) plan participants. The following points explain how the proposed changes would affect the existing legal standards that apply to banks.

2006 Legislation

The 2006 legislation, which permitted additional flexibility to providers of investment advice to 401(k) plan participants, generated controversy from the beginning. The controversy increased when DOL first proposed, and then made final, regulations that arguably provided more flexibility to advice providers than mandated by the statutory language. In January, the Obama administration delayed implementation of the final regulations. As discussed above, the disagreements about the wisdom of the 2006 legislation focused on the extent to which investment advisers would be permitted to give advice to 401(k) participants in circumstances where there is a possibility of conflicts of interest. There was some recognition among observers that the current Congress might repeal the 2006 investment advice provisions. Relatively few advisory programs were established under those provisions because of the lack of clarity regarding implementation of the regulations and the potential impermanence of the legislation.

SunAmerica Model

In late June 2009, the House Education and Labor Committee amended proposed legislation (H.R. 2989) on investment advice and passed it out of committee. What surprised many observers was that in addition to repealing the provisions regarding investment advice that were enacted in the 2006 law, the June amendments would significantly restructure the SunAmerica rules. The new requirements are complex but would require significant additional compliance efforts. For example, the models would need to undergo an annual audit and provide extensive disclosures to 401(k) account clients. It may be possible, though, for banks that do not provide any financial products to any DC plans and do not receive any revenue sharing associated with plans, to conform their computer models with the proposed legislation's level fee provisions. Those provisions are discussed next.

Level Fee Model

The late June 2009 amendments that would change the SunAmerica rules also would modify the rules

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for level fee investment advice models. First, the legislation would eliminate the rules enacted in 2006, which provided additional flexibility to level fee arrangements. Second, although there is some ambiguity in the proposed language, it appears that even the level fee methods of compliance that existed before the 2006 legislation would not be available to any bank that provides any investment product to even one DC plan. Finally, many banks accept ERISA fiduciary status with respect to their provision of investment advice. The proposal would make explicit acceptance of that status mandatory for any bank that relies on the level fee rules to qualify its investment advisory program.

Registration Exemption

For the first time at least since the enactment of the IAA and probably long before, the proposed legislation would require banks to become registered investment advisers (RIAs) in order to provide advice to 401(k) plan participants. It is difficult to envision an entity regulated by the Securities and Exchange Commission (the RIA) within an entity regulated by the banking regulators. Therefore, the only choice a bank may have to comply with the RIA requirement is to establish a separate legal entity to act as an RIA. For many banks, particularly midsized and small banks, such a complex solution may not be feasible.

Managed Accounts

The proposed legislation would prohibit managed accounts in any advisory program that relies on an independent computer model. This would create a serious issue for most banks with managed accounts because those accounts usually exist within advisory structures that use independent computer models. Even if it were economically feasible for a bank to convert a computer model advisory program that currently meets the SunAmerica rules to the more stringent proposed rules, the bank would still have to eliminate its managed account feature. If the bank were committed to offering managed accounts, it would have to conform its advisory program to meet the proposed legislation's level fee rules. But, those rules may not be available to any bank that provides any investment product to even a single plan. So, many banks may be precluded from offering managed accounts to 401(k) clients.

The Results for Banks and 401(k) Plan Participants

Increasingly, 401(k) plan participants fit within one of two categories. First, there are the participants who do not want to be actively involved in their 401(k) plan. That group is benefiting from the increasing use of automatic enrollment, automatically increasing contributions and qualified default investment alternatives. Although participants have the right to opt out of these arrangements, their tendency to inertia means that many participants benefit from these automatic provisions. They are more likely to participate in 401(k) plans, save more in those plans and invest in diversified financial products than in the absence of these plan features.

The second category consists of participants who expect to take an active role in the management of their 401(k) accounts. Surveys consistently show that these participants want investment advice that will help them make good decisions. Financial institutions, including banks, have responded to this demand from their clients by developing advisory programs that meet the regulatory requirements. There has not been any indication of abuse or wrongdoing by banks that offer these programs. In fact, research done on market losses in 401(k) accounts during 2008 indicates that accounts with highly concentrated investment strategies experienced the largest losses. That kind of asset allocation is exactly the type of allocation that investment advice often would caution against.

Until the current congressional proposal, which surfaced in late June, the debate about regulating the provision of investment advice centered on the extent to which conflicts of interest should be allowed and ways to increase the quality of advice. The current debate has shifted to whether even those investment advice arrangements that do not pose any risk of conflicts of interest should be subjected to new expensive and extensive compliance requirements. The investment advice given by banks under established programs typically falls within this category of advice being provided in a way that does not create a risk of conflicts of interest.

Decreased availability of investment advice to 401(k) participants who want advice is the wrong outcome at the wrong time. The financial downturn and its effect on 401(k) accounts has focused

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account holders' attention and concern on their accounts in a way that has not occurred since DC plans became the predominate type of employer-sponsored retirement accumulation vehicle in the United States. This is a moment in time when participants want advice, and good decisions now can still make a big difference even for individuals relatively close to retirement.

Endnotes

1. 15 USC §§80b-1 to 80b-21 (2000).
2. DOL Advisory Opinion 2001-09A (Dec. 14, 2001).
3. *Employee Retirement Income Security Act of 1974*, §§1-4402, 29 USC §§1001-1461 (2000).
4. *Pension Protection Act of 2006* (P.L. 109-280), at §601(a)(2), 120 Stat. 780 (Aug. 17, 2006), *adding* ERISA §408(g).
5. H.R. 2989, 111th Cong. (2009).

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