

## PENSION PROTECTION ACT OF 2006:

# Is an expanded fiduciary role the right choice for financial professionals?

The Pension Protection Act of 2006 (PPA) added new options for financial professionals who want to provide investment advice to participants. This white paper, *Pension Protection Act of 2006: Is an Expanded Fiduciary Role the Right Choice for Financial Professionals?*, highlights many of the issues financial professionals should consider when deciding whether to offer investment advice to participants.

Many plan sponsors will view participant investment advice as a valuable asset for their plans. However, their ultimate objective is that their employees be well invested, regardless of whether it results from investment advice, risk-based lifestyle funds, aged-based life-cycle funds, or managed accounts.

The issue for the financial professional is whether investment advice is the best and most effective way to accomplish that goal. That involves an understanding of the new legal provisions, as well as their burdens and benefits. Regrettably, the new rules are complex and, in some cases, difficult to implement.

This white paper is an excellent starting point for learning about and evaluating the PPA changes. It presents an easy-to-understand, yet technically correct, overview of the PPA changes and the Department of Labor guidance.

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The Pension Protection Act of 2006 (PPA) provisions open the door for more financial professionals to provide investment advice to participants of defined contribution retirement plans because of a new exemption. Of course, the opportunity to get more involved in the investment vehicles that participants use comes with greater fiduciary responsibility, because the providing of investment advice is a fiduciary act. Financial professionals who choose to assume fiduciary responsibility by providing investment advice should do so only after careful consideration and checking with their broker/dealer regarding their specific policies.

Prior to the PPA, financial professionals could provide investment advice to participants in plans subject to the Employee Retirement Income Security Act of 1974 (ERISA). However, they could do so only if their compensation for rendering the advice did not vary depending on the investments recommended. The requirement that the compensation could not vary applied not only to the adviser, but also to persons who were affiliates of the adviser. However, if the compensation was level (“pure” level fee advice), the arrangement was permissible under the law and continues to be permissible today.

The PPA amended ERISA to allow financial professionals to provide investment advice to participants under a “limited” level fee arrangement or through a computer model. Thus, financial professionals who want to offer investment advice to participants in self-directed defined-contribution plans can do so under either the pre-PPA “pure” level fee arrangement or the new options afforded by the PPA.

Our analysis will center on developments in the following areas:

- The growing need for advice
- The prescribed role of the fiduciary adviser
- Compensation and fee guidelines
- Disclosure and audit requirements
- Computer modeling
- Business implications

The new PPA provisions raise many questions, such as:

- *Will the opportunities presented by the PPA be outweighed by the **potential liability** of this new responsibility/opportunity?*
- *Do the new compliance requirements present an **unreasonable administrative burden**, or are they simply the cost of expanding a business in our increasingly complex financial world?*
- *If financial professionals can now **play an even more important role in shaping the investment structure of a client’s retirement plan**, are they obligated to do so?*

The importance of exploring these questions is best understood in the context of the more significant changes brought about by the PPA. This white paper examines the key provisions that affect financial professionals and provides a backdrop for the decision to take on this fiduciary role on behalf of participants.

## Why did lawmakers step in? *The growing need for advice*

The PPA, signed into law in August 2006 by President Bush, is the single most influential piece of federal legislation governing employee benefits since ERISA was enacted in 1974. The PPA evolved from a series of catastrophic events in the defined benefit arena, including several high-profile pension plan defaults by major corporations and widespread abuse by corporate management teams.

While these stories received the publicity, less was heard about the undercurrent of concern on the part of lawmakers that helped to drive the reform of existing laws. For years, statistics have cast doubt on the ability of participants to manage their own retirement funds. Consider these developments:

- *Only 60 percent of workers have access to an employer-sponsored retirement plan; of those, roughly 85 percent participated in one of the offered plans.*<sup>1</sup>
- *The proportion of workers having saved for retirement has fallen since a high mark in 2000 (78 percent) and has remained constant since 2001 at about 7 in 10.*<sup>2</sup>
- *About half of workers reporting this information say they have less than \$25,000 in total savings and investments.*<sup>3</sup>
- *American workers may be slow to recognize how the U.S. retirement system is changing, and those who are aware of these changes may not be adapting to them in ways that are likely to secure them a comfortable retirement.*<sup>4</sup>

### Executive Summary

Highly publicized cases of mismanaged employer retirement plans sparked a reform of existing laws. In addition, the growth in defined contribution retirement plans and concerns about the ability of participants to manage their own retirement funds set the stage for the PPA.

The PPA amendments to ERISA may present financial professionals with both enhanced opportunities (business expansion) and potential risks (fiduciary liability and prohibited transactions). Financial professionals should strive to understand the scope and impact of the PPA, especially as it relates to the services they provide to retirement plans.

Specifically, financial professionals should focus on understanding new provisions concerning the investment advisory function, fee structure, and investment advice computer models.

Deeper knowledge of these areas may help financial professionals bring greater professional value to the retirement planning process.

<sup>1</sup> Source: U.S. Department of Labor, U.S. Bureau of Labor Statistics; National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2006; Tables 1 and 6.

<sup>2</sup> Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 1994–2007 Retirement Confidence Surveys.

<sup>3</sup> Source: Excluding their home and defined benefit plans; Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2007 Retirement Confidence Survey.

<sup>4</sup> Source: Employee Benefit Research Institute, Issue Brief #304, April 2007.

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## What is the impact on financial professionals?

### *How the responsibilities have changed*

By passing the PPA, Congress acted upon a belief that individuals have put their retirement security in jeopardy due in part to a lack of overall savings or insufficient management of current retirement funds. The need for qualified expert guidance to help participants get back on track to achieve their retirement goals is of great importance.

While some assistance comes in the form of PPA provisions that permit automatic enrollment of employees, pre-defined default investments for those who fail to specify their investment choices, and automatic increases in deferral amounts over time, a significant step is the creation of the *fiduciary adviser* role.

The PPA created the role of “fiduciary adviser” — a person who is a plan fiduciary as the result of providing investment advice to plan participants. This role is another option for financial professionals who see the changing regulatory landscape as an opportunity to expand their client base and influence the investment success of individuals participating in an employer-sponsored retirement plan.

As a result, many financial professionals face an important decision: *Should I take on the added responsibilities of a fiduciary adviser?* Put simply, it may come down to one of two strategies for financial professionals to expand their business: an offensive or defensive strategy. Let’s first review what fiduciary responsibility is under ERISA and how it has changed as a result of the PPA.

## What will be required of a fiduciary adviser?

### *The role created by the PPA*

The core concept of fiduciary responsibility has not changed from its initial definition as set forth in ERISA, which defined a fiduciary as a person who:

- *exercises any discretionary authority or discretionary control over the management of a retirement plan or who exercises any authority or control over the management or disposition of the plan’s assets, or*
- *renders investment advice for a fee or other direct or indirect compensation with respect to plan assets or has any authority or responsibility to do so, or*
- *has discretionary authority or discretionary responsibility in the administration of a plan.*

Under ERISA, a person will be considered to be rendering investment advice if the person makes recommendations about the advisability of investing in securities or other properties (or gives advice as to the value of securities or other property); the advice is individualized based on the particular needs of the participant; and the advice is given pursuant to an agreement that it will serve as the primary basis for a participant's investment decisions.

In general, a financial professional acting in this capacity is expected to provide services according to five basic principles of fiduciary duty: prudence, loyalty, exclusive purpose, diversification, and adherence.

It is important that financial professionals understand the duties of a fiduciary if they are to assume an investment advisory role. The definitions and specifics regarding the rendering of investment advice to participants were refined and modified by the PPA.

Under the PPA, new requirements include submitting to a thorough evaluation as part of the selection process, entering into an Eligible Investment Advice Arrangement (EIAA) with the plan sponsor, abiding by the mandated disclosure requirements, and undergoing an annual compliance audit completed by an independent source.

By following the rules, a plan sponsor may be deemed exempt from prohibited transaction treatment for the following:

- *The provision of investment advice to participants*
- *An investment transaction entered into as a result of the advice*
- *The direct or indirect receipt of fees or other compensation by the fiduciary adviser or an affiliate in connection with the provision of the advice or the transaction pursuant to the advice*

## The Five Basic Principles of Fiduciary Duty

1

### Prudence

discharge duties with care, diligence, and sound judgment

2

### Loyalty

act solely in the best interests of the participant at all times

3

### Exclusive Purpose

act for the exclusive purpose of providing benefits to participants

4

### Diversification

take appropriate steps to diversify plan assets and minimize the risk of large investment losses

5

### Adherence

carry out all duties in accordance with the governing retirement plan documents and all applicable laws

*Under the PPA, new requirements include submitting to a thorough evaluation as part of the selection process, entering into an Eligible Investment Advice Arrangement (EIAA) with the plan sponsor, abiding by the mandated disclosure requirements, and undergoing an annual compliance audit completed by an independent source.*

*The requirements set forth by the PPA lay the groundwork for a relationship that is well defined and designed to minimize conflicts of interest.*

## Setting the ground rules

### *Compensation and fee guidelines*

The PPA establishes the requirements that must be met to establish and maintain an EIAA under which a fiduciary adviser will provide investment advice.

First, the plan fiduciaries, such as a retirement committee, are responsible for the prudent selection and periodic review of a fiduciary adviser who provides investment advice to the participants in their plan.

Department of Labor (DOL) guidance requires plan fiduciaries to use an objective process that is designed to obtain the necessary information to evaluate the fiduciary adviser, including the adviser's experience and qualifications, the quality of services offered, and the reasonableness of the fees charged. Additional considerations include the fiduciary adviser's registration in compliance with federal and state securities laws, the willingness of the adviser to serve as a fiduciary, and the use of generally accepted investment theories when providing advice.

When monitoring advisers, the DOL indicates that plan fiduciaries should consider participant comments and complaints, as well as determining whether there have been any changes in the selection factors, making sure the fiduciary adviser is adhering to the contract, and tracking how participants are using the service.

Under the PPA, the chosen fiduciary adviser enters into an EIAA, requiring that one of two conditions be met, which affords them exemption from prohibited transaction rules modified by ERISA:

- *Flat fee* – The fiduciary adviser may offer direct investment advice, but may charge only a fee that does not vary with the investments selected by the participant, or
- *Computer model* – Investment advice must be based on an approved computer model that meets certain requirements

Once the EIAA is established and executed in written form, the employer or plan sponsor is not liable for specific investment advice provided by the fiduciary adviser (though they are still responsible for the prudent selection and monitoring of the fiduciary adviser).

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## An arrangement that builds trust

### *Disclosure and audit requirements*

Any financial professional who chooses to enter into an EIAA is obligated to comply with certain disclosure requirements, including:

- *a description of the fees the fiduciary adviser is to receive in connection with the advice provided and in the transactions involved in implementing that advice*
- *disclosure of any material affiliation or contractual relationship of the fiduciary in the security or other property*
- *the scope of services provided by the adviser in relation to the advice given*

The goal is to prevent the types of conflict of interest — which are prohibited by ERISA — that might arise if fiduciary advisers were to receive additional compensation when participants invested in a certain set of investments or if a third party were paying commissions to the adviser to steer assets into certain investments.

Initially, the arrangement must be authorized by a plan fiduciary other than the investment adviser. Thereafter, an independent auditor who has appropriate technical training and proficiency must conduct an annual audit to certify that the fiduciary adviser is in compliance with the requirements of the EIAA.

Significant parts of the law have not yet been defined by the DOL, the government agency responsible for interpreting these PPA provisions. Until then, financial professionals cannot have confidence that they will comply with the law. Additionally, independent auditors are not yet prepared to provide annual audits of fiduciary advisers, primarily because it is not clear what the law requires them to do.

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## “Unbiased” technology helps to limit liability

### *Computer modeling*

Because a computer model can help remove the element of personal bias from the investment decision process, it may be used as part of an EIAA only if it meets the following criteria:

- It must be based on *widely accepted investment principles* that account for the historic returns of different asset classes over defined periods of time.
- It must utilize *relevant information about the participant*, such as age, life expectancy, risk tolerance, investment preferences, and other assets or sources of income.
- It must use *objective criteria* to provide asset allocation recommendations comprised of investment options available under the plan.
- It *must not be biased* in favor of investment options offered by the fiduciary adviser or a person with a material affiliation or contractual relationship with the adviser.
- It must *take into account all investment options* available under the plan in specifying how a participant’s account balance should be invested and cannot be weighted in favor of any particular investment option.

If these requirements are met (and the computer model is certified by an independent investment expert), investment recommendations generated by the model may be delivered to the participant.

While it is intended that these recommendations be the only source of investment advice provided by the fiduciary adviser, participants may voluntarily ask for additional investment advice to assist them with their decisions. The PPA does not specify what additional advice may be provided under these circumstances.

## If participation rates increase, will the demand for investment advice grow?

For many investment professionals, the computer model provision raises a disturbing question: *Does the PPA make a financial professional expendable?*

Obviously, eliminating investment advisers is not the intent of the new law, as the PPA clearly acknowledges the reality that many individual participants lack the necessary knowledge, resources, or ambition they need to actively manage or save retirement funds.

In response to low personal savings rates, the PPA included several provisions that enable employers to spur a higher level of savings and nudge the participants' investment decisions in the right direction. For example:

Automatic enrollment	Automatic increases	Default investments
<p>Plan sponsors now have greater freedom to automatically enroll employees in a retirement plan, provided the participant is given the choice to pick a different deferral rate or opt out.</p>	<p>Plan sponsors may choose to set the initial automatic deferral at 3 percent of pay, with automatic increases of 1 percent per year until it reaches 6 percent.</p>	<p>If participants do not select an investment option, they may be placed in a default investment option as provided by the plan. Depending on what final regulations dictate, this investment option could be a life-cycle or target-date fund or a balanced portfolio that provides exposure to a mix of asset classes consistent with long-term appreciation and/or capital preservation.</p>

While these provisions do not directly involve the provision of investment advice, they are aimed at increasing participation in defined contribution plans, which may put participants in a position where a growing nest egg may help them decide whether they may want to seek advice at some time in the future.

## What happens next?

Clearly, the PPA opens the door for financial professionals to take an active role in guiding the choices made by participants.

More than half of workers indicate they would be likely to take advantage of professional investment advice offered by companies that manage investments that are used to fund employer-sponsored retirement plans,<sup>5</sup> so there is clearly demand for the services of a qualified financial professional. At the same time, plan sponsors do not have liability for investment advice that is given.

For many financial professionals, the PPA creates circumstances that could lead to an expanded book of business and greater freedom to add value to their relationship with plan sponsors.

Some financial professionals may see the fiduciary adviser role as a marketing advantage, while others may see it as a risk they do not wish to assume. Whatever the choice, it is imperative that today's financial professionals are aware of the risks and responsibilities of the fiduciary adviser under the PPA.

Potential strategies for financial professionals who wish to capitalize on these opportunities may be considered *defensive strategies* (protecting the adviser from liability) or *offensive strategies* (geared toward expanding business).

### Defensive Strategies

- Staying ahead of the curve by studying the anticipated regulations to stay abreast of changes and gain a thorough understanding of their impact
- Positioning expertise in terms of consulting plan sponsors on the implications of the PPA, rather than actively providing investment advice to participants

### Offensive Strategies

- Actively promoting past experience and track record as an investment adviser
- Adding an educational component to seminars and presentations that demonstrates knowledge of the PPA to plan sponsors and participants
- Partnering with an organization that has extensive expertise in assisting plan sponsors with the design and implementation of retirement plans

The new PPA provisions provide financial professionals additional opportunities to offer broader resources and customized tools to existing clients and assist plan sponsors in designing more attractive retirement plan packages for their participants.

In any case, the decision to take on fiduciary responsibility is similar to any other business decision: It should be considered carefully. In most any situation, a dedicated financial professional can be integral to the success of a retirement plan.

<sup>5</sup> Source: Employee Benefit Research Institute, Issue Brief #304, April 2007.

## FURTHER GUIDANCE EXPECTED ON PPA REGULATIONS

Certain provisions introduced by the PPA are still open to approval or clarification by the DOL, Internal Revenue Service, and the Treasury Department. Any action taken pursuant to these rules, until finalized, should be carefully evaluated:

- *Fee structure* — The DOL is expected to issue a fee disclosure form that will allow fiduciary advisers to properly report fees to participants. A DOL Request for Information was issued on April 24, 2007.
- *Default investment rules* — PPA rules that provide a safe harbor from liability when participants are placed in default investments have not yet been finalized. Final rules are scheduled to be released in the summer/fall of 2007.
- *Automatic enrollment* — Although some changes are currently effective, other provisions, including the new Automatic Enrollment Safe Harbor, are not effective until plan years beginning on or after January 1, 2008. Additional guidance is expected before this effective date.
- *Investment advice computer models* — The DOL and the Treasury Department are expected to rule on whether computer models may be used for investment advice pertaining to IRAs and other types of investment accounts by December 31, 2007.
- *Tax issues* — The Internal Revenue Service recently issued Notice 2007-7 to provide guidance on certain provisions of the PPA, including vesting of non-elective distributions and rollovers for non-spouse beneficiaries.



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