

MEMO# 13127

February 5, 2001

DOL ISSUES PROPOSED INDIVIDUAL EXEMPTIONS FOR TWO INVESTMENT ADVISORY SERVICES

[13127] February 5, 2001 TO: PENSION COMMITTEE No. 10-01 AD HOC COMMITTEE ON INVESTMENT ADVICE RE: DOL ISSUES PROPOSED INDIVIDUAL EXEMPTIONS FOR TWO INVESTMENT ADVISORY SERVICES The Department of Labor has published two proposed individual exemptions addressing the provision of investment advisory services with respect to retirement assets. The first proposed exemption, requested by Keystone Brokerage, Inc., would provide retroactive relief from the Code's prohibited transaction restrictions for the provision of investment advisory services to IRA owners, effective October 3, 1997 through June 30, 2000, the period during which the advisory service was offered. The second exemption, requested by Ibbotson Associates, Inc., would provide relief from the prohibited transaction restrictions of ERISA and the Code for personalized asset allocation services provided to pension plan participants. Comments on the Keystone exemption must be submitted by March 23, 2001; comments on the Ibbotson exemption must be submitted by February 21, 2001. Keystone Proposed Exemption From October 3, 1997 to June 30, 2000, Keystone provided investment advisory services to IRA owners with respect to mutual funds both affiliated and unaffiliated with Keystone.¹ The proposed exemption would provide Keystone retroactive relief from the Code's prohibited transaction provisions for the provision of such services to IRA owners and the receipt of fees in connection with the service. The proposed exemption states that Keystone and other parties to the transactions requested the individual exemption in order to obtain retroactive relief for any prohibited transactions that may have arisen during the operation of its investment advisory program.² ¹ The proposed exemption notes that Keystone discontinued the investment program effective June 30, 2000. Currently, it is providing asset allocation services under a separate program which does not involve investment in any affiliated funds or third-party funds from which it receives fees. ² Specifically, Keystone notes that there is uncertainty regarding the availability of the "service provider" statutory exemption in Code section 4975(d)(2) because the asset allocation recommendations made to IRA owners under the investment advisory program may have caused such entities to be considered fiduciaries with respect to the IRAs. ² Under Keystone's investment advisory program, known as the "KeyPremier Nautilus Series Program" or "Nautilus Program," IRA owners were provided with numerous disclosures regarding the program³ and a questionnaire on the IRA owner's investment objectives and risk tolerance. Based on the responses to the questionnaire, Keystone determined which of the available "asset allocation models" were the most appropriate for the IRA owner. Any recommendations were implemented only at the express direction of the IRA owner. An IRA account, however, could have been rebalanced on a quarterly basis in order to conform the account to the

chosen asset allocation model. Keystone charged each participating IRA an annual "investment fee" based on a percentage of assets in the IRA. This fee, however, was offset by: (1) all advisory fees, including sub-advisory fees that were paid to third party sub-advisers, (2) all administrative fees paid to BISYS, an unaffiliated service provider of the Keystone IRAs, (3) all administrative fees paid to GGA, an affiliated investment adviser, and (4) all Rule 12b-1 fees paid to Keystone and its affiliates by third party funds available under the program.⁴ Thus, the sum of the offset and the "net investment fee" always equaled the "aggregate investment fee," and the selection of affiliated funds or third party funds was revenue neutral. Additionally, the total fees paid to Keystone and its affiliates with respect to each investing IRA could not have constituted more than reasonable compensation for services provided within the meaning of Code section 4975(d)(2).

Ibbotson Proposed Exemption Under the proposed exemption, Ibbotson would deliver "asset allocation services" to pension plan participants. Specifically, the advisory service would provide personalized recommendations to plan participants regarding the allocation of their investments among the options offered under their plan. Ibbotson would provide the service either directly to plan participants through an agreement with a plan sponsor or with service providers sponsoring the investment vehicles offered to participants.⁵ To participate in the program, an independent plan fiduciary must authorize in writing the plan's participation following the receipt of extensive disclosures, such as a written disclosure describing the service and all fees and expenses associated with a service, a summary

³ The disclosures provided included: (1) a brochure describing the program, (2) an account agreement, (3) a description of the available "asset allocation models," (4) a reference guide/disclosure document outlining the mechanics of the investment advisory program, the fees charged, and the procedures for establishing accounts and making withdrawals and additions, (5) a statement regarding Keystone's affiliation or non-affiliation with parties who act as sponsors, distributors, administrators, investment advisers and sub-advisers, custodians and transfer agents of the funds, and (6) copies of applicable fund prospectuses.

⁴ IRA accounts participating in the investment advisory program only invested in funds that did not charge a front or back-end sales charge, or alternatively, such charges were waived.

⁵ "Service provider" would be defined as an entity that has been in the financial services business for at least three years, without having been convicted of any felony offense, and also must be either (i) a bank, savings and loan association, insurance company or registered investment adviser which meets the "qualified professional asset manager" (QPAM) definition in PTE 84-14, and in addition, has total client assets under management and control in an amount not less than \$250 million, or (ii) a broker dealer registered under the Securities Exchange Act of 1934, which has \$1 million in shareholders' or partners' equity and total client assets under management and control in an amount not less than \$250 million.

⁶ 30f annual plan activity and expense reports, and copies of the proposed and final exemptions. Upon such authorization, Ibbotson would provide information to participants, including a description of Ibbotson and its advisory service, an investment advisory service agreement which would specify that the service would be provided by Ibbotson and not a plan service provider, and a questionnaire designed to evaluate the participant's personal financial situation. Based on the questionnaire, the participant would receive recommendations on his or her savings rate, retirement age, and the percentage of assets that the participant should allocate to each investment option.⁶ Any recommendation, however, would be implemented only at the direction of the participant. Where Ibbotson contracts directly with a plan sponsor, the fees charged would be based on a flat fee per participant, paid by the plan or the plan sponsor. Service providers would not receive any portion of such fees or other consideration from Ibbotson. Where the advisory service is offered to participants under an existing relationship between a plan sponsor and a service provider, the fee for the service also

must be flat, but may be paid by the service provider, the plan or the participant. Additionally, a “technology licensing fee” would be charged to the service provider, based on the number of participants in the service provider’s recordkeeping system. No plan service provider would be permitted to own any interest in Ibbotson, and neither Ibbotson nor any affiliate would be allowed to own an interest in a plan service provider. Furthermore, Ibbotson’s annual revenues derived from any one service provider may not be more than 5 percent of Ibbotson’s annual revenues. In addition, neither the fees charged nor the compensation received by Ibbotson may be affected by a participant’s investment selection, and participation in the service may not cause the plan to pay any additional fees or commissions with respect to the acquisition or disposition of investments offered under the plan. Finally, the total fees paid to Ibbotson and a service provider by each participant utilizing the advisory service may not exceed “reasonable compensation” within the meaning of ERISA section 408(b)(2). Thomas T. Kim Assistant Counsel Attachment Attachment (in .pdf format) 6 The investment advice would be based on portfolios, with differing risk and return characteristics, using the plan’s investment options. The investment options would be evaluated on a quarterly basis and the recommended asset allocation would be updated once a year. Funds that do not meet certain performance criteria would be placed on a “watch list”; Ibbotson may subsequently advise the plan sponsor that such funds be replaced. Additionally, following the initial provision of advice, the program would inform participants of the need to review periodically his or her situation, particularly where significant life events, such as the birth of a child, have occurred.