

MEMO# 13493

May 9, 2001

DOL ISSUES TWO FINAL INDIVIDUAL EXEMPTIONS FOR INVESTMENT ADVISORY SERVICES

[13493] May 9, 2001 TO: PENSION COMMITTEE No. 32-01 INVESTMENT ADVICE AD HOC COMMITTEE RE: DOL ISSUES TWO FINAL INDIVIDUAL EXEMPTIONS FOR INVESTMENT ADVISORY SERVICES The Department of Labor has published two final individual exemptions addressing the provision of investment advisory services with respect to retirement assets. The first exemption, granted to Keystone Brokerage, Inc., provides retroactive relief from the Code's prohibited transaction restrictions for the provision of advisory services to IRA owners, effective October 3, 1997 through June 30, 2000, the period during which the service was offered. The second exemption, granted to Ibbotson Associates, Inc., provides relief from the prohibited transaction restrictions of ERISA and the Code for personalized "asset allocation services" provided to pension plan participants.¹ The conditions imposed under the two final exemptions are virtually identical to those provided in the proposed exemptions. No comments were submitted in response to the Keystone proposed exemption. With regard to the Ibbotson exemption, the only comment submitted was from the applicant. The few changes requested by Ibbotson, all of which were incorporated in the final exemption, are discussed below. Keystone Final 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. The final exemption provides 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 conditions imposed under the proposed and final exemptions are substantively identical. Under Keystone's investment advisory program, IRA owners were provided with numerous disclosures regarding the program 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 six "asset allocation models" were the most appropriate for 1 For a description of the proposed exemptions, see Institute Memorandum to Pension Committee No. 10-01 and Ad Hoc Committee on Investment Advice, dated February 5, 2001. 2the IRA owner. Under the exemption, any recommendations must have been implemented only at the express direction of the IRA owner. Rebalancing of IRA accounts, however, was permitted in order to conform the account to the chosen asset allocation model. With respect to fees, the annual "investment fee" charged to participating IRAs had to be offset with the following: (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.²

Thus, the sum of the offset and the “net investment fee” always had to equal the “aggregate investment fee,” and the selection of affiliated funds or third party funds was required to be revenue neutral. Additionally, under the final exemption, the total fees paid to Keystone and its affiliates with respect to each investing IRA could not constitute more than reasonable compensation for services provided within the meaning of Code section 4975(d)(2). Ibbotson Final Exemption Under the final exemption, Ibbotson may deliver personalized “asset allocation services” to plan participants regarding the allocation of their investments among the options offered under their plan. Ibbotson may 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. Participants may access the advisory service through computer software or written communications. To qualify under the exemption, an independent fiduciary must authorize in writing the plan’s participation, following the receipt of extensive disclosures. Upon such authorization, Ibbotson must provide information to participants, including a description of Ibbotson and its advisory service, an investment advisory service agreement which must 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. Any recommendation, however, could be implemented only at the direction of the participant. As in the proposed exemption, the final exemption prohibits plan service providers from owning any interest in Ibbotson, and neither Ibbotson nor any affiliate may 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.³ In addition, neither the fees charged nor the compensation received by Ibbotson may be affected by a participant’s 2 IRA accounts that participated 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. ³ Where Ibbotson contracts directly with a plan sponsor, the fees charged may be based on a flat fee per participant, paid by the plan or the plan sponsor. Service providers may 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” may be charged to the service provider, based on the number of participants in the service provider’s recordkeeping system. ³ 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). In its comments to the Department, Ibbotson requested several changes, all of which were incorporated into the final exemption. First, because the website through which the advisory service will be provided will be housed on a service provider’s site (or a site maintained on its behalf), and not on a separate Ibbotson website, the reference to “Ibbotson’s” website was deleted and additional clarifying language was added to the representation. Second, the word “tolerance” was deleted in describing the questionnaire filled out by participants because it might cause participant confusion. Third, Ibbotson’s representation regarding the number of years covered by the sets of asset returns and inflation data used in the advisory program was changed — from 40 years to 70 years. Finally, the Department granted Ibbotson’s request for a retroactive effective date. The exemption, therefore, is effective as of the proposed exemption’s date of publication, January 22, 2001. Thomas T. Kim Assistant

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.