

ERISA Section 408(g) – Investment Advice and Fiduciary Audits

Under ERISA Section 408(g), investment advisers to retirement plan assets (“fiduciary advisers”) can offer individualized investment advice under eligible investment advice arrangements through a fee leveling arrangement or proprietary computer model without running afoul of the prohibited transaction issues involving the adviser’s affiliates. Up until now this statutory exemption has not been widely utilized. However, a number of financial institutions are actively exploring ERISA Section 408(g)-compliant programs as part of their compliance strategy to address the new rule related to fiduciary advice proposed by the U.S. Department of Labor (DOL).

Fiduciary advisers relying on ERISA Section 408(g) are required to undergo an annual audit to determine whether the eligible investment advice arrangement complies with the requirements of the statutory exemption. The annual audit is a key requirement of the regulatory structure outlined in ERISA Section 408(g). The DOL regards the selection of an auditor as a fiduciary decision by the financial adviser, “which must be carried out in a manner consistent with the prudence requirements of ERISA section 404(a)(1), taking into account the nature and scope of the audit and the expertise and experience necessary to conduct such an audit.” While the DOL has provided little direct guidance on the substance of the audit, the credentials of the auditor (other than “appropriate training or experience and proficiency” in ERISA), or how the auditor approaches the audit process, it is critical that an auditor have experience not only with the DOL regulatory regime but also an understanding of the DOL’s expectations in the conduct of audits undertaken to monitor compliance with this regulatory regime.

With regard to the content of an audit, and to help meet the DOL’s expectation, the auditor shall “review relevant information to formulate an opinion as to whether the investment advice arrangement” was in compliance with the regulation during the audit period. Although the conduct of the review is left to the auditor’s discretion, there are a number of factors to consider. While an audit of compliance with internal policies and procedures can be helpful to demonstrate that the fiduciary adviser complied with the requirements of the DOL regulation, an audit that limits its examination only to such policies and procedures would, in the DOL’s view, not be sufficient. A thorough understanding of the eligible investment advice arrangement, the fiduciary adviser’s financial and other relationships with its affiliates, and the use of representative samples to determine compliance, are also key components of any successful audit. The proper scope of any sampling similarly depends on the particular facts and circumstances of a given arrangement, and there is no “one size fits all” approach for any of these engagements, as the variables include the number of affiliates, financial platforms, and products.

Depending on the nature of any preliminary finding during the course of an audit, it may be determined that, consistent with DOL guidance, both the auditor and the fiduciary adviser may need to perform additional reviews. These reviews may include, among other things, more detailed sampling to determine the extent and causes of any noncompliance. Any audit report that identifies instances of noncompliance with the statutory exemption must be submitted to the

ERISA Section 408(g) – Investment Advice and Fiduciary Audits

DOL to provide them with the opportunity to evaluate the significance of the noncompliance.

Set forth below are the primary requirements of ERISA Section 408(g) subject to an annual audit:

- **Scope:** Investment advice is provided under an eligible investment advice arrangement, using a fee leveling arrangement or proprietary computer model
- **Fee Leveling:** An eligible investment arrangement that uses fee leveling requires that:
 - Investment advice is based on generally accepted investment theories and takes into account other relevant information
 - Investment advice takes into account fees and expenses
 - Fees or other compensation for the advisor and for any affiliates of the advisor providing investment advice do not vary depending on the investment option chosen
- **Computer Model:** An eligible investment arrangement that uses a computer model must:
 - Apply generally accepted investment theories
 - Take into account investment management and other fees and expenses
 - Appropriately weigh the factors used in estimating future returns
 - Utilize appropriate objective criteria to provide asset allocation portfolios and other relevant information
 - Avoid investment recommendations that inappropriately favor or generate greater fee income for the fiduciary adviser or an affiliate
 - Take into account all designated investment options available under the plan without giving inappropriate weight to any investment option, although annuity options can be excluded, and the participant can also request other investment options to be excluded
 - The fiduciary adviser must obtain a written certification from an eligible investment expert that the model meets the requirements of the regulation
- **General Criteria:**
 - The eligible investment advice arrangement is expressly authorized by a separate fiduciary
 - Certain specified disclosures are made
 - All disclosures must be made in accordance with securities laws
 - Recipient of advice must direct investments
 - Compensation must be reasonable
 - Terms must be at least as favorable to the plan as an arm's length transaction
 - Disclosures must be written in a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant
 - Evidence of compliance must be maintained for at least six years

Adopting an arrangement designed to comply with ERISA Section 408(g) as a part of, or instead of, complying with the new administrative exemptions granted by the DOL related to investment advice (such as the “Best Interest Contract” or “BIC” prohibited transaction class exemption) is a critical business decision. Our team can work with fiduciary advisers and their counsel to help

ERISA Section 408(g) – Investment Advice and Fiduciary Audits

evaluate the pros and cons of implementing an audit approach.

As a leading independent fiduciary, Evercore Trust Company, N.A. (Evercore Trust) has extensive experience designing and conducting independent reviews and audits under various DOL prohibited transaction exemptions and other client mandates. Over the past 15 years, the Evercore Trust team has served as an independent third party assigned with fiduciary or auditing responsibilities on more exemptions than the next two competing firms combined, including many of the most complex exemptions granted by the DOL to large financial institutions and Fortune 500 corporations.

Please contact any of the following individuals to learn more about our experience and perspectives related to ERISA Section 408(g) audits:

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