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Department of Labor Provides Guidance on Receipt of Mutual Fund Fees

If you have questions or would like additional information on the material covered in this Bulletin, please contact one of the authors:

Donald J. Myers
(Washington, D.C.)
202.414.9231
dmyers@reedsmith.com

Michael B. Richman
(Washington, D.C.)
202.414.9289
mrichman@reedsmith.com

...or the Reed Smith attorney with whom you regularly work.

The U.S. Department of Labor ("DOL") recently issued an advisory opinion applying the ERISA prohibited transaction rules to the fee structure of a bank's asset allocation advisory program. Similar to a 2001 advisory opinion, it explains how sponsors of such programs can receive mutual fund fees without violating the prohibited transaction rules.

Asset Allocation Advisory Program

The request that resulted in the advisory opinion originally was filed as an exemption application. DOL responded with an advisory opinion because it took the view that the proposed arrangement is not a prohibited transaction, so that an exemption is unnecessary.

The advisory opinion deals with an asset allocation program similar to that described in several exemptions granted prior to December 2001, including to Bank of Oklahoma and Keystone Brokerage. The conditions to those exemptions required the program provider to offset all fees it received from mutual funds used under its program—both proprietary and outside funds—against the provider's asset allocation advisory fee. The result was a complete leveling of the fees received by the provider, so that none of its investment decisions or advisory services could increase its compensation.

Country Trust Bank (the "Bank") proposed to have individual retirement accounts ("IRAs"), including IRAs maintained by Bank employees and affiliates, invest through a program offered by the Bank that uses model investment strategies. Under the program, the Bank recommends investment of IRA assets in a manner consistent with one of five model investment strategies, and if the IRA holder approves, the Bank implements the investment. Thereafter, the Bank has authority to invest the IRA's assets in the chosen investment strategy, make certain adjustments to the strategy, and rebalance the IRA's portfolio.

Investments pursuant to the program's investment strategies are made using mutual funds. These funds may be affiliated with or unrelated to the Bank. The affiliated funds pay investment advisory and other fees to the Bank and its affiliates, and the unrelated funds pay them custodial and 12b-1 fees.[*]

The Bank charges a management fee to an IRA participating in the program for its asset allocation, custody and related services. Any fees that the Bank or its affiliates receive from sources other than the IRA, such as the mutual funds used under the program, will be applied to offset the IRA's legal obligation to the Bank. Under no circumstances would any fees received by the Bank or an affiliate from sources other than the IRA increase the total compensation received by the Bank and its affiliates. The Bank further represented that the total fees paid to the Bank and its affiliates constitute no more than reasonable compensation for the services provided to the IRA.

DOL Response

In ERISA Advisory Opinion 2005-10A (May 11, 2005), DOL addressed whether the fee structure adopted by the Bank would violate the prohibitions in section 4975 of the Internal Revenue Code of 1986 (the "Code") against fiduciary self-dealing and the receipt of compensation by a fiduciary from a third party in connection with a plan transaction—sections 4975(c)(1)(E) and (F). (ERISA does not apply because the IRAs described by the Bank are not "employee benefit plans" subject to Title I of ERISA, but DOL indicated that the same analysis and conclusions would apply for purposes of the ERISA prohibited transaction rules.)

DOL said the receipt of the affiliated and unaffiliated mutual fund fees by the Bank and its affiliates that are attributable to assets of IRAs participating in the program would not violate those prohibitions if the management fees received by the Bank are reduced by an amount equal to such fees, and the receipt of such fees does not cause the Bank's compensation to exceed the amount of the management fees agreed to by the IRA holder. However, DOL added, if the provision of services by the Bank to an IRA under the program results, in operation, in a divergence of interests between the Bank and the IRA, or an incorrect fee offset, then violations could occur. Therefore, DOL was unable to rule that the Bank's receipt of fees as a result of services provided to IRAs participating in the program would not, in operation, violate sections 4975(c)(1)(E) or (F).

Analysis

The basic holding of the advisory opinion—that there would be no violation of the fiduciary self-dealing prohibitions if the mutual fund fees are offset against the program management fee—follows directly from prior DOL authority, in particular the 1997 advisory opinion to Frost Bank. What is significant is the application of this principle to an asset allocation advisory program, an important development in view of the increasing popularity of such programs for use by plans and plan participants.

Prior to December 2001, DOL granted a series of exemptions for asset allocation advisory programs, starting in October 1992 with the "TRAK Program" offered by Shearson Lehman Brothers. Under the majority of these programs, the financial services firm recommended an appropriate allocation of assets for a plan or plan participant from among a predetermined group of mutual funds, which may or may not be affiliated with the firm, and could make subsequent adjustments to the asset allocation. The firm would receive fees from the mutual funds used under the program.

In some of these exemptions, such as the 1997 exemption for TCW, the firm avoided or minimized the potential conflict of interest by using an independent firm to develop the asset allocation advice. In most of them, though, the conflict of interest issue was addressed principally by offsetting the mutual fund fees received against the program fee charged to the plan or plan accounts, with the effect of ensuring that the firm retained no more than a certain rate of fees regardless of how the assets were invested.

In the early offset exemptions, one fund paid slightly less than the maximum fee rate even after the offset, giving rise to a fee differential. As a result, those arrangements were not completely fee neutral. This meant that the firm's advice could affect its fees, requiring an exemption from the prohibition on fiduciary self-dealing. However, in subsequent exemptions, including those to Bank of Oklahoma and Keystone Brokerage in 2000 and 2001, there was no fee differential—the arrangement was completely fee neutral to the program advisor. The only apparent reason as to why there was still a conflict of interest was that the programs used a combination of affiliated and unaffiliated mutual funds. Because the unaffiliated funds paid the advisor less than its affiliated funds, they would require a smaller fee offset. That smaller offset could arguably give the advisor a financial incentive to prefer to use them over its affiliated funds, even though its net overall fees in either case would remain the same. By requiring conditions to deal with this possibility, DOL implied that the potential conflict arising from the use of both affiliated and unaffiliated funds, even in a fee-neutral arrangement, was sufficient to necessitate exemptive relief.

In December 2001, DOL, in an advisory opinion to SunAmerica, said that asset allocation advisory programs using an independent advice provider could be structured to avoid a prohibited transaction, superseding the prior exemptions for those types of allocation advice arrangements (such as the TCW exemption). The Country Trust Bank advisory opinion achieves the same result for those asset allocation advisory programs that do not take the independent advice provider approach. So long as any mutual fund fee paid to the program provider is offset against the program fee, selecting between affiliated and unaffiliated funds does not, in DOL's view, result in an automatic, unavoidable violation of the prohibition on fiduciary self-dealing. As a result, no exemption is necessary for such a program based solely on the use of both types of funds.

Under DOL's analysis, the program sponsor must avoid allowing the use of affiliated and unaffiliated funds to create a divergence of interests in the operation of the program. The sponsor should be able to accomplish this result by assuring that it engages in a prudent process when recommending or making fund selections. This is analogous to the position taken by DOL in prior guidance, in which it has indicated that when an arrangement "in itself" does not violate the prohibition against fiduciary self-dealing, there still can be a violation based on facts and circumstances.

Conclusion

This latest advisory opinion, which builds on prior DOL pronouncements, is an important additional step in providing guidance as to how an investment manager or advisor may receive fees for its services from third parties without violating the prohibited transaction provisions of ERISA.

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[*] The advisory opinion also discusses fees paid by the affiliated mutual funds to their principal underwriter and distributor. While that entity is not affiliated with the Bank and does not provide any investment advice to the IRA holders, it could pay fees to a Bank affiliate under a dealer agreement. However, as no portion of the fees generated by investments under the program would be applied under the dealer agreement, this relationship did not affect the outcome of the advisory opinion.