IRAlert

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TO: IRA Group Distribution

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RE: DOL Holds Hearing on Computer Model Investment Advice Programs for Individual Retirement Accounts

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On July 31, 2007, DOL held a public hearing to obtain information on the feasibility of using computer models to provide investment advice to participants with individual retirement accounts ("IRAs"). See 72 Fed. Reg. 34,043 (June 20, 2007). The Pension Protection Act ("PPA") provided a new statutory exemption from ERISA's prohibited transaction restrictions for the provision of investment advice through "eligible investment advice arrangements." The exemption allows the use of an unbiased computer model to supply such advice.

The PPA directed DOL to determine no later than December 31, 2007 whether using a computer model to provide investment advice to IRA holders was feasible. PPA § 601(b)(3)(B). DOL previously issued a request for information to assist in making this determination. 72 Fed. Reg. 70,427 (Dec. 4, 2006); see IRAlert Newsletter (March 30, 2007). If DOL determines that the use of a computer model with respect to IRAs is not feasible, the PPA requires DOL to issue a class exemption.

The central issue at the public hearing was the meaning of the PPA requirement that any computer model must "take[] into account the full range of investments, including equities and bonds, in determining the options for the investment portfolio of the account beneficiary." PPA § 601(b)(3)(B)(ii). Because of the ambiguous statutory language and lack of legislative history, DOL has significant intepretive discretion. The meaning of "full range of investments" will be a critical factor in DOL's ultimate feasibility determination.

Some commenters argued that the "full range of investments" language requires a computer model to take into account every single investment available to IRAs, including individual stocks, bonds, and mutual funds. Commenters based this argument upon a difference in statutory language with the new exemption provision addressing 401(k) plans. The exemption itself only requires a computer model providing investment advice to 401(k) participants to "take[] into account all investment options under the plan." PPA § 601(a)(2)(g)(3).

The investment options available to IRAs are significantly broader than those available to 401(k) participants. For example, 401(k) plans typically offer a limited menu of investment options selected by the plan sponsor. In contrast, potential IRA investments are nearly unlimited. In addition to stocks, bonds, and mutual funds, IRAs may invest in foreign securities, currency instruments, futures, options, insurance products, hedge funds, limited partnerships, and group or collective trusts. IRAs may not invest in collectibles and life insurance. Should this interpretation of "full range of investments" prevail, a computer program would have to consider each of the individual investments available to IRAs in all of these asset classes.

However, some commenters interpreted the feasibility provision more narrowly to only require a computer program to consider the full range of asset classes available to IRAs. In this respect, one commenter discussed its use of forecasting technology to predict investment outcomes and optimization technology to select portfolios for IRAs. According to the commenter, these computer models consider individual mutual funds, stocks, and exchange traded funds, but do not currently include bonds.

Commenters were in accord that no computer model currently in use could take into account all of the individual investments available to IRAs. Use of a computer model would be further complicated because regular monitoring and updating of individual investments would be necessary to provide accurate investment advice.

One commenter noted that even if the narrow interpretation of "full range of investments" prevailed, computer models would have significant difficulty considering certain "nonstandard" asset classes (including options, swaps, negotiated instruments, and limited partnership interests) for which sufficient historical behavior data is not available. Another commenter addressed the difficulty of accounting for subclasses of assets, such as the variety of categories of stocks (i.e. small cap, large cap, and growth, to name a few). However, another commenter argued that these difficulties could be lessened by requiring a computer model to consider only the range of investments in which a typical investor invests and by allowing investors to choose between investment menus. One commenter stressed the need for tailored investment advice of the kind that cannot be offered by a computer model.

The public hearing is part of a larger context of investment advice issues being considered by DOL in connection with both qualified plans and IRAs. DOL is considering issuing regulatory guidance on a range of issues under the new exemption including certification requirements for computer modeling programs, qualification requirements for "eligible investment experts," and disclosure of investment advice fees. Commenters at the hearing took the opportunity to urge DOL to issue further regulatory guidance regarding the new investment advice exemption, particularly with respect to the "level fees" approach, the alternative to the use of a computer model.

Please let us know if you have any questions or need any further information.