Legal Developments

DOL Rules Implement PPA Investment Advice Exemption

The Department of Labor ("DOL") has released its final rule implementing the statutory exemption—enacted more than five years ago in the Pension Protection Act of 2006 ("PPA")—for investment advice to participants and beneficiaries of 401(k) plans and other individual account plans covered by the Employee Retirement Income Security Act of 1974 , as amended ("ERISA"), and owners and beneficiaries of IRAs [76 Fed. Reg. 66136 (Oct. 25, 2011)]. The exemption, under Sections 408(b)(14) and 408(g) of ERISA, took effect on December 27, 2011.

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The final rule is largely based on the DOL's March 2010 proposed regulation, with several significant changes. Thus, investment providers are now free to create "advice" programs in reliance on this exemption—though it remains to be seen whether such programs in fact will be offered in large numbers.

Background

Under ERISA, providing "investment advice" is a fiduciary act. A fiduciary who advises participants about plan investment opportunities that pay the adviser fees or commissions may be subject to liability under ERISA's prohibited transaction rules. Hence, the need for an exemption.

In the PPA, Congress amended ERISA to add an exemption from the prohibited transaction rules that allows "fiduciary advisers" to provide investment advice to plan participants, and also to receive direct or indirect compensation (including sales commissions and other fees) associated with plan investments made as a result of its investment advice. To qualify for the exemption, the advice must be given under an "eligible investment advice arrangement." Under the statute, two approaches may qualify as "eligible investment advice arrangements."

The first is the so-called "level fees" alternative. Under this alternative, the arrangement must "provide[] that any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property do not vary depending on the basis of the investment option selected…." In addition, the exemption's general conditions require that the plan fiduciary of the plan using this arrangement must authorize the arrangement, the arrangement must be audited on an annual basis, and plan participants must be provided with detailed information, including program fees and the fiduciary adviser's compensation arrangement.

The second type of eligible arrangement is one that utilizes a computer model to present investment alternatives. The computer model must use generally accepted investment theories, utilize relevant participant information (which may include age, retirement age, life expectancy, risk tolerance), be objective and unbiased, and "take into account all investment options under the plan in specifying how a participant's account balance should be invested and is not inappropriately weighted with respect to any investment option." The exemption's general conditions also require, among other things, that the computer model be periodically "certified" by an independent "eligible investment expert" as meeting the requirements of the exemption.

Proposed Regulation

In March 2010, the DOL released a proposed investment advice regulation [75 *Fed. Reg.* 9360 (Mar. 2, 2010)]. The proposed regulation was issued in place of a prior set of regulations (published in the *Federal Register* on January 21, 2009, but never effective) that also included a class exemption. Unlike the 2009 version (hereafter, the "withdrawn regulation"), the 2010 proposal did not provide any relief for (1) individualized "off model" advice following investment recommendations generated from a computer model, or (2) any advice arrangement which would level fees only with respect to the individual employee, agent, or registered representative providing investment advice and not at the fiduciary adviser entity level, though it did expressly state that the DOL's prior regulations, exemptions, and interpretive and other guidance regarding the provision of investment advice are not affected.

While the proposed regulation was similar to the withdrawn regulation, the DOL revised an important condition under the "level fees" approach, which appeared to further restrict a fiduciary adviser's ability to receive compensation in connection with the advice provided to participants. The withdrawn regulation tracked the statutory exemption by requiring that any fees received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets would not vary depending on the basis of any investment option selected by a participant. The withdrawn regulation also required that any fees or other compensation received by any employee, agent, or registered representative providing investment advice on behalf of a fiduciary adviser would not vary depending on the basis of any investment option selected by a participant. The proposed regulation replaced these conditions with a new provision requiring that "[n]o fiduciary adviser (including any employee, agent or registered representative) that provides investment advice receives from any party (including an affiliate of the fiduciary adviser), directly or indirectly, any fee or other compensation (including commissions, salary, bonuses, awards, promotions or other things of value) that is based in whole or in part on a participant's or beneficiary's selection of an investment option."

In the preamble to the proposed regulation, the DOL justified this change in response to comments asserting that a fiduciary adviser's affiliates would potentially establish "economic incentives for either the fiduciary adviser, or individuals providing investment advice on its behalf, to recommend investments that pay varying fees to the affiliates." The DOL also cited Field Assistance Bulletin 2007-1 (Feb. 2, 2007), in which the DOL interpreted the level fees requirement to mean that the fees or other compensation received, directly or indirectly from an employer, affiliate, or other party, by a fiduciary adviser may not be based, in whole or in part, on investments selected by participants. While the proposed regulation is more restrictive, it did not absolutely prohibit the payment of varying fees to affiliates of a fiduciary adviser as some had predicted.

While the DOL did not make significant changes from the prior regulation regarding the framework for the computer model approach, the DOL did add a new condition requiring the computer model to be designed and operated to avoid investment recommendations that "[i]nappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future." In the preamble to the proposed regulation, the DOL explained that, while differences in fees and investment style are likely to persist in the future, differences in historical performance are less likely to persist, and therefore less likely to constitute appropriate criteria for asset allocation. Arguably, this could require the most substantial change to the way in which allocation recommendations are made. As odd as it may seem, if past investment performance is not considered an appropriate criterion, does this not suggest that such recommendations will be based, at least in large part, on fees and expenses? If this is the case, does this not suggest further that most, if not all, recommendations will include the least expensive funds, regardless of performance?

In a similar vein, in the preamble to the proposed regulation, the DOL requested comments on certain aspects of the computer model approach. In particular, the DOL asked a number of specific questions with regard to generally accepted investment theories and whether the proposed regulation should specify practices that are acceptable or unacceptable. The DOL also requested comments on the kinds of historical data that should be taken into account by a computer model and the types of criteria that are appropriate and objective.

Final Regulation

The proposed regulation implementing the investment advice exemption contained a number of general conditions that apply to both the level fee approach and the computer model approach, as well as specific requirements that apply to each. Groom Law Group and others submitted comments urging the DOL to modify or delete numerous terms and conditions of the proposal. The final rule retains many elements of the proposed regulation, but also makes a number of significant changes, as summarized below:

Fee Leveling Arrangements. The final rule changes the limitations on fees and compensation applicable to fee-leveling arrangements. The proposed regulation provided that no fiduciary adviser that provides investment advice may receive from any party (including its affiliate), directly or indirectly, any fee or compensation *that is based in whole or in part on* a participant's or beneficiary's selection of an investment option. The final regulation deletes the italicized language, and provides instead the phrase "that varies depending on the basis of," which proscribes only fees or compensation that vary based on investment selections. Thus, instead of including all fees or compensation arising from available investment options, the final rule encompasses only fees or compensation that increase or vary based on the investment selected. For example, if an adviser's bonus arrangement varied based on the overall profitability of the underlying company (and not based on the option selected), the DOL agreed that that kind of arrangement would not result in "un-level" compensation.

Arrangements Using Computer Models. The final regulation relating to computer models includes numerous changes. Significantly, the final rule substantially modified a controversial requirement that the computer model avoid recommendations that "[i]nappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future…." The final rule instead includes a "clarification" that now requires that the computer model "[a]ppropriately weigh the factors used in estimating future returns of investment options . . . ." The final rule thus recognizes that historical performance is a relevant factor in the design of a computer model.

The final rule also:

- Requires computer models to include recommendations as to employer securities and asset allocation funds;
- Provides that a computer model will not fail to satisfy the requirements merely because it does not give a recommendation with respect to an investment option that the participant asked be excluded from consideration in such recommendation; and
- Requires that the "eligible investment expert" not only be independent, but also not be someone who developed the computer model.

General Conditions. Numerous changes also were made to the general conditions applicable to both fee leveling arrangements and arrangements using computer models. The final rule:

- Clarifies that SIMPLE IRA and SEP plans are treated like IRAs for purposes of the requirement that the IRA participant or beneficiary must authorize the investment arrangement. However, the DOL asked for additional input concerning this requirement, and stated that it might consider further adjustments to the regulation in the future;
- Requires that the annual audit report identify the fiduciary adviser and the type of arrangement (fee leveling, computer models, or both). Where a computer model is used, the report also must indicate the date of the most recent computer model certification, and identify the eligible investment expert that provided the certification;
- Prohibits the auditor from having any role in the development of the investment advice arrangement, or the certification of the computer model utilized under the arrangement; and
- Adds a requirement that the fiduciary adviser provide the authorizing fiduciary with written notification that the fiduciary adviser intends to comply with the statutory exemption and regulations, that the fiduciary adviser's investment advice arrangement will be audited annually by an independent auditor for compliance, and that the auditor will furnish the authorizing fiduciary with a copy of that auditor's findings within 60 days of its completion of the audit.

The final regulation also makes corresponding modifications to the definitions section and the preamble includes useful guidance as to the DOL's views regarding various provisions of the regulation.

Conclusion

One of the few points of consensus in connection with participant-directed retirement plans is that participants need assistance in making investment decisions. While the final rule provides further clarity regarding the DOL's thinking, and definitive guidance that investment providers can use to create "advice" programs, it is also likely to be viewed by advice providers as a burdensome and expensive option. Thus, it does not seem likely that the final rule will result in appreciably more or better quality advice being provided to participants. ■