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BENEFITS BRIEF

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DOL Finalizes Participant Advice Exemption

The Department of Labor's ("DOL's") Employee Benefits Security Administration has released its final rule on investment advice to participants and beneficiaries in individual account plans, such as 401(k) plans, and beneficiaries of individual retirement accounts (and certain similar plans). The final rule implements the exemption under sections 408(b)(14) and 408(g) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and will take effect on December 27, 2011. The final rule is largely based on the exemption proposed on March 2, 2010 (75 Fed. Reg. 936), but makes several significant changes to those regulations. These modifications for the most part relate to the "computer model" exemption's specific requirements and to the exemption's general conditions, including the annual audit requirement, and are further described below.

Background

Under ERISA, providing "investment advice" is a fiduciary act. A person who advises plans or participants to invest in an investment product that pays the adviser or its affiliates fees or commissions may violate ERISA's prohibited transaction rules (*i.e.*, ERISA section 406(b)).

In the Pension Protection Act of 2006, Congress amended ERISA to add to ERISA's statutory exemptions ERISA section 408(b)(14) which, in conjunction with conditions specified in ERISA section 408(g), exempts from ERISA's prohibited transaction rules and corresponding provisions of the Internal Revenue Code (1) the provision of investment advice to a plan participant by a "fiduciary adviser" and (2) the adviser's receipt of direct or indirect compensation (including sales commissions and other fees) as a result of plan investments pursuant to the advice. This exemption covers advice provided by a "fiduciary adviser" under an "eligible investment advice arrangement." A "fiduciary adviser" is defined as a person (1) who is a fiduciary by reason of providing investment advice, and (2) who is a registered investment adviser, bank, insurance company, broker dealer, or any of their affiliates, employees and/or agents (including employees and agents of affiliates). ERISA § 408(g)(11)(A). Under the statute, there are two approaches by which a fiduciary adviser may offer an "eligible investment advice arrangement."

The first approach is the so-called "level fees" alternative. Under this alternative, the statute requires that 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…." ERISA § 408(g)(2)(A)(i). The exemption further requires that the plan fiduciary authorize the investment advice arrangement for the plan, that detailed participant disclosure, including all program fees and the fiduciary adviser's compensation arrangement, must be provided, and that an annual independent audit of the arrangement be conducted.

The second type of eligible arrangement utilizes a computer model. 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." ERISA § 408(g)(3)(B). The model also must be periodically "certified" by an "eligible investment expert" as meeting the requirements of the exemption. The expert must meet criteria established by the DOL and must have "no material affiliation or contractual relationship" with the fiduciary adviser. ERISA § 408(g)(3)(C).

Numerous additional conditions are imposed on all eligible arrangements, regardless of whether the arrangement uses the fee leveling or a computer model option. Among other things, these conditions require that (1) the arrangement be expressly authorized by a plan fiduciary other than the person providing the advice program; (2) the fiduciary adviser obtain an annual audit from an independent expert demonstrating compliance with the conditions of the exemption; (3) comprehensive disclosures be given periodically to participants or beneficiaries; and (4) transactions be on arms' length terms and for reasonable compensation.

Proposed Regulation and Final Regulation

In March 2010, the DOL proposed a regulation (published at 75 Fed Reg. 9630) implementing the investment advice exemption described above. The proposed regulation contained a number of requirements relating to both the level fees approach and the computer model approach, as well as general conditions that applied to both. We and others submitted comments urging the DOL to modify or delete numerous terms and conditions of the proposal. As noted, earlier today the DOL issued a final regulation implementing the investment advice exemption. The final rule, published at 29 C.F.R. §§ 2550.408g-1 and 2550.408g-2, retains many of the requirements of the proposed regulation, but also makes a number of material changes as summarized below:

> Fee Leveling Arrangements: The final rule changes the limitations on fees and compensation applicable to fee-leveling arrangements. In particular, the proposed regulation provided that no fiduciary adviser that provides investment advice receives 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 beneficiaries selection of an investment option. The final regulation deletes the italicized language and provides instead the phrase "that varies depending on the basis of" to clarify that the regulation only proscribes fees or compensation that vary based on investment selections. As explained in the preamble, the DOL believed that it may have gone too far by including all fees or compensation arising from available investment options. Thus, the provision has been revised to conform to the statute by encompassing only fees or compensation that increase or vary based on the investment selected. So, for example, if a bonus arrangement varied based on the overall profitability of the company (and not based on the option selected), the DOL agreed that that kind of arrangement would not result in un-level compensation.
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> Arrangements Using Computer Models: Unlike the rules relating to level fees arrangements, the final regulation relating to computer models included numerous changes. These changes are briefly described below.
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> In particular, the proposed regulation included a 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 [. . . .]" In the preamble to the proposed rule, the DOL explained that historic performance is not a criteria that is "likely to persist and therefore less likely to constitute appropriate criteria for asset allocation" than are "differences in fees and expenses or management style. . . ." However, in the preamble to the final regulation, the DOL noted that it received a number of comments that "opined that a complete disregard of historical performance data would be inconsistent with generally accepted investment theories…." The DOL further noted that the proposed rule "was not intended to prohibit a computer model from any consideration of an investment option's historical performance, as some commenters interpreted [,]" and that it "is not persuaded by the comments received that the provision should be eliminated, however, to avoid further misinterpretations of the provision, the requirement has been clarified" as described above. While the clarification offered by the Department is awkward, we believe the DOL's recognition that historical performance is a relevant factor in the design of a computer model is appropriate.

In addition, the final rule included the following changes:

- amends the list of investment options that are not required to be considered by the computer model. In particular, the final rule (found in paragraph (b)(4)(i)(G)(2)) removes from the list of excepted investment options employer securities and asset allocation funds meaning that the computer model must now include recommendations as to these options.

- adds a new provision which provides that a computer model will not fail to satisfy the regulation's requirements merely because it does not provide a recommendation with respect to an investment option that a participant or beneficiary requests to be excluded from consideration in such recommendation.

- with respect to the requirement that the computer model be certified by an "eligible investment expert", amends the definition of "eligible investment expert" to exclude any person that develops the computer model used by the fiduciary adviser to satisfy the exemption's requirements.

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

- clarifies that SIMPLE IRA plans 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.

- amends the annual audit requirements to require that the audit report enumerate certain basic information about the audited information. In particular, the report must identify the fiduciary adviser and the type of arrangement (fee leveling, computer models or both). In addition, if the arrangement uses computer models or both computer models and fee leveling, the report must also indicate the date of the most recent computer model certification, and identify the eligible investment expert that provided the certification.

- amends the circumstances under which an auditor will be considered independent for purposes of the annual audit requirement to provide that the person must not have any role in the development of the investment advice arrangement, or certification of the computer model utilized under the arrangement.

- adds a new provision which requires that the fiduciary adviser provide the authorizing fiduciary with written notification that the fiduciary adviser intends to comply with the statutory exemption and the regulations and 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, in the preamble, also offers useful guidance as to the DOL's views regarding various provisions of the regulation.

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In an effort to provide you with this information as soon as possible, we have not included as much analysis of the final regulation as we would have liked. Please call us if you have any questions or thoughts.