

MEMO# 23241

February 9, 2009

DOL Finalizes Investment Advice Rules and Proposes to Delay Effective Date

ACTION REQUESTED

[23241]

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TO: PENSION COMMITTEE No. 4-09
PENSION OPERATIONS ADVISORY COMMITTEE No. 5-09 RE: DOL FINALIZES INVESTMENT
ADVICE RULES AND PROPOSES TO DELAY EFFECTIVE DATE

On January 21, 2009, the Department of Labor issued final rules implementing the investment advice provision of the Pension Protection Act of 2006. [1] The new rules were proposed to go into effect on March 23, 2009. Pursuant to an instruction from Rahm Emanuel, the President's Chief of Staff, to the executive agencies, [2] DOL on February 4 proposed to extend the effective date of the rule by 60 days and asked for comments on questions of law and policy concerning the rules. [3]

Comments on the proposal to extend the effective date are due February 18, 2009. Comments on issues of law and policy concerning the rules are due by March 6, 2009.

Subject to member input, the Institute plans to file a comment letter by March 6 expressing support for the PPA provision and explaining why the rules help to provide guidance and resolve ambiguities in the statutory language. Please let the undersigned know (mhadley@ici.org or 202-326-5810) if there are other issues that should be addressed in a comment letter.

Structure of Final Rule

Initially, DOL proposed both a regulation and a class exemption. [4] DOL combined these into a single final regulation. [5] The provisions on both the statutory exemption and class exemption remain unchanged for the most part, but DOL made a number of clarifying and other changes in response to comments and included some clarification in the preamble.

We describe the most important below, although this is not exhaustive.

Relief Afforded by the Rule

DOL clarified in the preamble that investment advice covered by the exemption would not be the direct result of a participant's exercise of control and a fiduciary adviser would not be relieved from liability under section 404(c) of ERISA because the participant actively elected to implement that advice. In addition, DOL clarified that recommending investment managers to participants may itself constitute investment advice. DOL declined to extend the relief of the exemption to advice provided to plan fiduciaries and plan sponsors.

Fees

DOL made a few changes related to fees. First, DOL added a new provision specifically requiring an advice program to take into account investment management and other fees attendant to recommended investments. In addition, the final rule requires the disclosure of all fees or other compensation that a fiduciary adviser or an affiliate might receive in connection with any rollover or other distribution of plan assets or the investment of distributed assets. The model form was modified to reflect this requirement. DOL rejected a suggestion that a fiduciary adviser be required to disclose the profitability of various plan investment options.

Consideration of Factors

The proposal had required that investment advice take into account information relating to "age, life expectancy, retirement risk, risk tolerance, other assets or sources of income and investment preferences." The Institute and others had asked DOL to clarify that the fiduciary adviser need not take into account every listed factor. DOL retained the requirement, clarifying that fiduciary advisers must request this information but to the extent it is not provided by the participant it need not be taken into account (and advice may still be provided). DOL also modified the list to refer to "time horizons" and give life expectancy and retirement age as examples.

Fee-leveling

The Department generally retained the rules regarding the application of the fee-leveling condition from the proposal. In response for requests for more guidance on the application of the fee-leveling condition to bonus programs, the Department included the following guidance in the preamble:

[A]lmost every form of remuneration that takes into account the investments selected by participants and beneficiaries would likely violate the fee-leveling requirement of the final rule. On the other hand, it is conceivable that a

compensation or bonus arrangement that is based on the overall profitability of an organization may be permissible to the extent that it can be established that the individual account plan and IRA investment advice and investment option components were excluded from, or constituted a negligible portion of, the calculation of the organization's profitability.

Computer Models

The final regulation includes some changes relating to the computer model condition. First, DOL clarified that a computer model would not be treated as inappropriately favoring investments affiliated with the fiduciary adviser merely because the computer limits "buy" recommendations to those options available through the plan or IRA, provided the participant is fully informed of the model's limitations.

The proposal allowed computer models to exclude consideration of qualifying employer securities, and the Institute and others asked for clarifications. DOL clarified that absent a specific request from a participant to exclude employer securities, the computer model must take into account the fact that the participant has this investment when giving advice on the remaining assets. If the participant requests that the assets not be taken into account, the model can follow that instruction.

Finally, the Department included a rule allowing computer models to exclude target date funds and other investments, products or services that allocate assets to varying degrees of long-term appreciation and capital preservation through equity and fixed income based on a time horizon or level of risk.

In-house Plans

The proposal allowed fiduciary advisers to offer advice programs under the exemption to its or its affiliates' employees' IRAs, and the Institute asked that this be extended to in-house ERISA plans. DOL agreed to make this change, with two conditions. First, the advice arrangement must be the same one offered to unaffiliated plans in the ordinary course of business. Second, DOL clarified in the preamble that fiduciaries must ensure that a fiduciary adviser is prudently selected and that the fiduciaries do not violate the self-dealing rules in section 406(b) of ERISA.

Audit Requirement

Despite a number of comments expressing concern, DOL retained a requirement that, in the case of arrangements involving IRAs, the fiduciary adviser must send DOL a copy of the auditor's report if the report identifies any instances of noncompliance.

Pre-authorization by Participant

The PPA requires that any investment must occur solely at the direction of the recipient of

the advice. The Institute and others had requested confirmation that this condition would not be violated by programs that automatically rebalance an account based on a prior authorization. DOL agreed that maintenance of a pre-approved asset allocation structure would not be the exercise of discretion so long as the participant is informed of and approves the specific circumstances under which rebalancing will occur and which investments will be used. If the particular investments that might be utilized for purposes of rebalancing a participant's account are not known and the fiduciary adviser is given the discretion to select the required investments, the participant must be given advance notice of the intended investments and at least 30 days to object. In addition, if a different asset allocation structure will be recommended, the participant must affirmatively consent to its implementation.

Class Exemption

Like the proposal, the class exemption provides additional opportunities for investment advice not available under the statutory exemption implemented by the final regulations. Under the class exemption, fiduciary advisers must still utilize one of two options: either a modified version of the computer model option or modified version of the fee-leveling option.

In contrast to the statutory computer model option, under the class exemption version, once the computer-generated recommendations are provided to participants, the fiduciary adviser is not restricted to providing only the advice generated by the computer model. As in the proposal, in the case of an IRA with respect to which the types or number of investment choices reasonably precludes the use of a computer model meeting the requirements of the statute, before providing other investment advice covered by this exemption, IRA investors must be furnished instead with certain investment education material. DOL extended this exception to brokerage windows and similar arrangements in plans. If a plan has both a brokerage window and designated investment options, the participant must also be furnished with recommendations generated by a computer model on the designated investment options.

DOL declined to provide further guidance on when the type or number of investments "reasonably precludes" use of a computer model, because DOL believes this will be an "evolving, rather than static, standard."

In lieu of utilizing the computer model-based option described above, a fiduciary adviser could, under the class exemption, use a modified version of the fee-leveling condition. Unlike the statutory exemption (as interpreted in Field Assistance Bulletin 2007-1 and the regulation), the modified fee-leveling condition requires only that fees and compensation received, directly or indirectly, by an employee, agent or registered representative providing advice on behalf of the fiduciary adviser pursuant to this exemption (as distinguished from any compensation received by the fiduciary adviser on whose behalf the employee, agent or registered representative is providing the advice) do not vary depending on the basis of any investment option selected by a participant. DOL retained the framework of the fee-leveling condition unchanged.

Regulatory Impact Analysis

In its regulatory impact analysis for both the investment advice proposal and the proposal on participant disclosure, DOL had estimated that participants paid fees and expenses on investments that were on average 11.3 basis points higher than necessary. The Institute's comments on the participant disclosure regulation disagreed with this analysis, although explained in detail why the Institute believes the regulation will have significant benefits in terms of lower search costs and better information to make investment decisions. [6]

In the regulatory impact analysis of the final investment advice rule, DOL "refined and strengthened" its analysis, and concluded that the estimate that fees and expenses are on average 11.3 basis points higher than necessary "lacks adequate basis and should be disregarded." After a review of the literature, DOL concludes that it cannot determine whether and to what degree participants pay inefficiently high investment prices. DOL concludes that the adoption of the rule will overall reduce investment errors and yield positive results, even if the magnitude is uncertain.

Michael L. Hadley
Associate Counsel

endnotes

[1] A copy of the final regulation is available here:
<http://www.dol.gov/federalregister/PdfDisplay.aspx?DocId=21997>.

[2] The memorandum, similar to others issued upon previous changes in administration, directs agencies to consider extending for 60 days the effective date of any regulation that has been published in the Federal Register but not yet taken effect, and to reopen the comment period for 30 days to allow interested parties to provide comments on issues of law and policy. A copy of the memorandum is available here:
<http://edocket.access.gpo.gov/2009/E9-1639.htm>.

[3] A copy of the announcement proposing to delay the effective date is available here:
<http://www.dol.gov/federalregister/PdfDisplay.aspx?DocId=22040>.

[4] See Memorandum to Pension Members No. 49-08 [22823], dated August 27, 2008.

[5] The regulation describing the statutory exemption and the class exemption is contained in 29 C.F.R. § 2550.408g-1. As with the proposal, DOL included a separate section, 29 C.F.R. § 2550.408g-2, setting forth the requirements that must be satisfied for a single fiduciary adviser to be treated as a fiduciary under an eligible investment advice arrangement.

[6] See Memorandum to Pension Members No. 52-08, Transfer Agent Advisory Committee No. 49-08, Bank, Trust and Recordkeeper Advisory Committee No. 29-08, Broker/Dealer Advisory Committee No. 31-08 and Operations Committee No. 17-08 [22854], dated September 9, 2008.

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