The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 22822

August 27, 2008

DOL Issues PPA Investment Advice Proposal; Call Scheduled for September 11 at 3:30 PM Eastern

[22822]

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TO: PENSION COMMITTEE No. 25-08
PENSION OPERATIONS ADVISORY COMMITTEE No. 25-08 RE: DOL ISSUES PPA INVESTMENT ADVICE PROPOSAL; CALL SCHEDULED FOR SEPTEMBER 11 AT 3:30 PM EASTERN

The Department of Labor issued a proposal to implement the investment advice provision of the Pension Protection Act of 2006. The proposal consists of regulations implementing the statutory exemption [1] and a proposed class exemption that would provide additional flexibility to provide investment advice to plan participants and IRA investors. [2] Finally, DOL made its report to Congress, as required by the PPA, as to whether any feasible computer models exist for IRAs. [3]

Comments on the proposed regulation and proposed class exemption are due by October 6, 2008.

Conference Call to Discuss

The Institute will hold a conference call on Thursday, September 11, at 3:30 P.M. Eastern Time to discuss DOL's proposal. Jon Breyfogle of the Groom Law Group will join the call. If you would like to participate in the call, please complete the attached response form and fax or email to Brenda Turner at 202/326-5841 or bturner@ici.org by 10:00 AM, Thursday, September 11. To participate, please dial 1-800-857-9891 and enter passcode 9063189.

Background

Prior to the PPA, fiduciaries who provided investment advice to plan participants or IRA investors were generally prohibited from receiving compensation from the investment products recommended; this would result in a prohibited transaction. The PPA added a statutory exemption from both ERISA's and the Code's prohibited transaction rules for advice programs in plans and IRAs meeting a series of disclosure and other conditions. [4] The statutory exemption requires the use of one of two options: either the advice must be provided pursuant to an unbiased computer model (the "computer model option") or the fees received by the adviser must not vary depending on the investment option selected by the participant (the "fee-leveling option").

On December 4, 2006, DOL issued two requests for information: one seeking information to help DOL issue implementing regulations and one to assist DOL in making its determination regarding computer models for IRAs (see below). [5] On February 2, 2007, DOL issued Field Assistance Bulletin 2007-01, which addressed a number of issues under the statutory exemption. [6]

Report to Congress

The PPA required DOL to determine, and report to Congress, whether there is any computer model investment advice program feasible for IRAs. The PPA further provided that until DOL made its determination, the computer model option was not available for IRAs. If DOL determined that no feasible computer model exists, DOL must issue a prohibited transaction class exemption that includes the conditions of the statutory exemption (other than those related to the computer model requirement). If DOL determined there was a feasible computer model for IRAs, the computer model option becomes available for advice to IRA investors.

The key question for DOL was how to interpret the requirement, in PPA, that in order for an IRA computer model to be feasible, it must "take into account the full range of investments, including equities and bonds, in determining the options for the investment portfolios" of the IRA investor. All of the commentors, including the Institute, agreed that if this requirement meant that the computer model must be able to model every possible IRA investment, then no qualifying model existed.

In its report to Congress, DOL concludes that a computer model would meet the statutory requirement to take into account the full range of investments if it takes into account all of the "generally recognized asset classes that are necessary to construct a diversified investment portfolio." Under this interpretation, DOL stated that four firms have computer models that can meet this criteria and the other requirements for a feasible IRA computer model.

DOL states that, since it has determined that there are IRA computer models that meet the criteria in the PPA, the restriction on the availability of the statutory exemption for computer model advice to IRAs is lifted as of August 21, 2008.

Proposed Regulation

DOL's proposed regulation follows most of the requirements of the statutory exemption. Noted below are significant interpretations and deviations in the proposed regulation.

Fee-leveling

In Field Assistance Bulletin 2007-01, DOL interpreted the fee leveling condition to apply to the fiduciary adviser – the entity and its employees and agents providing the advice – and not to affiliates or employees of the fiduciary adviser that are not providing advice.

The proposal would not alter this interpretation. Under the proposal, any fees received by the fiduciary adviser and any fees or compensation (including salary, bonuses, awards, promotions, commissions or other things of value) received by any employee, agent, or registered representative of the fiduciary adviser must not vary depending on the basis of any investment option selected by the participant.

However, as described below, the proposed class exemption would limit this requirement to the individual that provides advice.

The proposal incorporates into the fee-leveling option two requirements that apply under the statute to computer models. [7] First, advice under a fee-leveling program would need to apply generally accepted investment theories that take into account historic returns of different asset classes over defined periods of time. Second, advice under a fee-leveling program must take into account information furnished by the participant relating to age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and investment preferences. [8]

Computer models

The statute requires that computer models not inappropriately favor investment options that may generate greater income for the fiduciary adviser or its affiliate. The regulations would clarify that a computer model will not fail to meet this requirement merely because the only options offered to the plan are offered by the fiduciary adviser or an affiliate. However, computer models cannot be designed or operated to inappropriately favor those investment options that generate the most income for the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser.

Following the statute, the regulations require that computer models must take into account all designated investment options. This is defined to mean any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of their account. It does not include "brokerage windows," "self-directed brokerage accounts" and similar plan arrangements that enable plan participants to select investments beyond those designated by the plan. [9] The proposal would provide that a computer model is not treated as failing to take into account all designated investment options merely because it does not take into account an option that primarily invests in qualifying employer securities, so long as this limitation is disclosed.

Certification of computer models

Under the statute, computer models must be certified by an independent investment expert meeting qualifications prescribed by DOL. The proposal defines eligible investment expert as a person who, through employees or otherwise, has the appropriate technical training or experience and proficiency to analyze, determine and certify, whether a computer model meets the regulatory requirements and who does not have any material affiliation or material contractual relationship with the fiduciary adviser, with a person with a material affiliation or material contractual relationship with the fiduciary adviser, or with any employee, agent, or registered representative of the foregoing.

DOL did not define a specific set of academic or other credentials for an eligible investment expert. The proposal makes clear that the fiduciary adviser is responsible for determining whether an eligible investment expert has the requisite training and experience, and that the selection of an expert is a fiduciary act governed by section 404(a)(1) of ERISA. The proposal includes specifics on the information that must be in the written certification, but does not require a particular methodology for determining whether a program complies with the statutory and regulatory requirements.

Use of program by employees of fiduciary adviser

The statute requires that an advice program be expressly authorized by a plan fiduciary, or in the case of an IRA, the IRA investor. This authorizing person cannot be affiliated with the person offering the arrangement or any person offering investment options under the arrangement. The proposal clarifies that this restriction does not apply to employees who are IRA investors, which would allow employees of financial firms that offer advice programs (or that have investments recommended by advice programs) to take advantage of the exemption.

Annual audit

The statute requires that an advice program be audited annually by an independent auditor and that a written report on the audit be issued to the authorizing fiduciary. The proposed regulation would require that the written audit report be issued to the authorizing fiduciary within 60 days following completion of the audit. Because of the significant number of reports that an auditor would need to send to IRA investors, DOL proposes an alternative rule for IRAs. The fiduciary adviser would, within 30 days of receiving the audit from the auditor, provide the report to IRA investors or place a copy on its website and, as part of the general disclosure obligations, notify IRA investors concerning the purpose of the report and how to locate a copy of the report. In addition, if the auditor identifies noncompliance, the fiduciary adviser must submit the audit report to DOL within 30 days after receiving it from the auditor.

The proposal does not provide specific requirements on how the audit must be performed, except that the auditor must review sufficient relevant information as to whether the investment advice offered during the audit period was in compliance with the requirements. The proposal clarifies that auditors may use information obtained from sampling.

Disclosure

The statute requires that a number of disclosures be made to advice recipients. [10] DOL included a model disclosure form that could be used to satisfy the requirements, but use of the model is not mandatory. [11] The model form allows compensation and fees to be received by the fiduciary adviser or its affiliate from proprietary and non-proprietary funds to be disclosed in a range with additional specific information available on a website.

Treatment of multiple fiduciary advisers

The statute provides that a person who develops a computer model or markets the investment advice program or computer model is treated as a fiduciary. The statute allows DOL to issue rules allowing a single fiduciary adviser to elect to be treated as a fiduciary with respect to the plan. [12]

DOL proposed a separate regulation setting forth the requirements for that election. The election must be in writing, contain specific information, be provided to the plan fiduciary who has authorized use of the arrangement, and be retained in accordance with the exemption's general recordkeeping requirements. Once the election is properly made, the person identified in the election is treated as the sole fiduciary adviser by reason of developing or marketing the computer model, or marketing the investment advice program, used in an investment advice arrangement.

Definitions

Throughout the proposed regulation, DOL refers to various restrictions that would apply to persons with a "material affiliation" or "material contractual relationship" with the fiduciary adviser. The proposal defines a person with a "material affiliation" with another person as: any affiliate of such other person; any person directly or indirectly owning, controlling, or holding, 5 percent or more of the interests of such other person; or any person 5 percent or more of whose interests are directly or indirectly owned, controlled, or held, by such other person. The proposal defines "interest" as: the combined voting power of all classes of stock entitled to vote or the total value of the shares of all classes of stock of the entity if the entity is a corporation; the capital interest or the profits interest of the entity if the entity is a partnership; or the beneficial interest of the entity if the entity is a trust or unincorporated enterprise.

The proposal would provide that persons are treated as having a "material contractual relationship" if payments made by one person to the other person pursuant to written contracts or agreements between the persons exceed 10 percent of the gross revenue, on an annual basis, of the other person.

"Affiliate" is defined in the statute by reference to section 2(a)(3) of the Investment Company Act of 1940. [13] The regulations would deviate from this definition because DOL eliminated clauses (E) and (F) of section 2(a)(3). These clauses provide, basically, that an investment adviser is considered an affiliate of the investment company it advises, and that the depositor of an unincorporated investment company is considered an affiliate of

the investment company. In the preamble, DOL stated these clauses are unnecessary because they "appear to focus on persons who exercise control over the management of an investment company" and as a result are already treated as an affiliate because of clause (C) of section 2(a)(3). DOL also expressed concern about unintended consequences on investment vehicles other than investment companies.

Class Exemption

The proposed class exemption, broadly speaking, provides prohibited transaction relief for the same transactions as the statutory exemption and imposes similar conditions, including with respect to disclosure, annual audit, and record retention. Like the statutory exemption, the class exemption would provide relief from sections 406(a) and 406(b) of ERISA and section 4975 of the Code.

However, the class exemption provides additional opportunities for investment advice not available under the statutory exemption (or under the proposed regulations implementing the statute). Under the proposed 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.

The modified version of the computer model requirement is as follows. Except with respect to IRA arrangements (see below), the participant must be provided with investment recommendations generated by a computer model, generally meeting the statutory requirements. However, the computer model program does not need to meet the certification requirement if the computer model was designed and is maintained by a person independent of the fiduciary adviser and utilizes methodologies and parameters determined appropriate solely by the independent person, without influence from the fiduciary adviser. [14]

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 with certain investment education material. This material can be graphs, pie charts, case studies, worksheets, or interactive software or similar programs, that reflect or produce asset allocation models taking into account the age (or time horizon) and risk profile of the IRA investor, to the extent known. [15] These materials must be based on generally accepted investment theories, not be biased in favor of investments offered by the fiduciary adviser or someone affiliated with the adviser, and any facts and assumptions on which the models are based must be provided.

In contrast to the statutory computer model option, under the class exemption version, once the computer-generated recommendations (or in the case of IRAs described above, the investment education materials) are provided to participants, the fiduciary adviser is not restricted to providing only the advice generated by the computer model. (The statutory exemption requires that any investment advice follow the advice generated by the computer model. [16]) However, the advice provided must not recommend investment options that may generate for the fiduciary adviser (or anyone affiliated with the fiduciary adviser) greater income than other options of the same asset class, unless the adviser prudently concludes that the recommendation is in the best interest of the participant and explains the basis for that conclusion to the participant.

In addition, not later than 30 days following the provision of investment advice, the employee, agent or registered representative providing the advice on behalf of the fiduciary adviser must document the basis of any investment option(s) recommended to a participant, including an explanation as to how the recommendation relates to the computerized recommendations or investment education information provided and, with respect to any deviations that recommend investment options that may generate greater income for the fiduciary adviser (or anyone affiliated with the fiduciary adviser) than other options of the same asset class, the basis for concluding that the recommendation is in the best interest of the participant. This documentation must be retained in accordance with the exemption's general recordkeeping requirements (six years).

In lieu of utilizing the computer model-based option described above, a fiduciary adviser could, under the proposed 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 proposed regulation), the fee-leveling condition here would require only that fees and compensation (including salary, bonuses, awards, promotions, commissions or any other thing of value) 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.

Effective Date

DOL proposes to make both the regulation and class exemption effective 90 days after final publication in the Federal Register.

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endnotes

[1] The proposed regulation is available here: http://www.dol.gov/federalregister/PdfDisplay.aspx?DocId=21243.

[2] The proposed class exemption is available here: http://www.dol.gov/federalregister/PdfDisplay.aspx?DocId=21242.

[3] A copy of DOL's report to Congress is available here: http://www.dol.gov/ebsa/pdf/reporttocongress.pdf.

[4] See Memorandum to Pension Members No. 48-06, Federal Legislation Members No. 4-06, and 539 Plan Members No. 13-06 [20250], dated August 4, 2006.

[5] See Memorandum to Pension Members No. 73-06 [20660], dated December 6, 2006. The Institute submitted a comment letter in response. See Memorandum to Pension Members No. 3-07 [20831], dated February 1, 2007. DOL also held a public hearing in late July 2007, at which the Institute testified. See Memorandum to Pension Members No. 46-07 [21419], dated August 1, 2007.

[6] See Memorandum to Pension Members No. 7-07 [20843], dated February 5, 2007.

[7] See ERISA § 408(g)(3)(B).

[8] In the preamble, DOL states that, in its view, these conditions, while not referenced in the statute with respect to fee-leveling advice, are so fundamental to the provision of informed, individualized investment advice that a failure of a fiduciary to insist on these conditions would raise serious questions as to the fiduciary's exercise of prudence.

[9] This definition of "designated investment option" is identical to the definition of "designated investment alternative" proposed in DOL's participant disclosure regulation. See Memorandum to Pension Members No. 44-08, Transfer Agent Advisory Committee No. 36-08, Bank, Trust and Recordkeeper Advisory Committee No. 22-08, Broker/Dealer Advisory Committee No. 23-08 and Operations Committee No. 12-08 [22742], dated July 29, 2008.

[10] See ERISA § 408(g)(6).

[11] Congress required DOL to develop a model for disclosure of fees and compensation (see ERISA § 408(g)(8)(B)), but the model form in the proposed regulation is not restricted to disclosure of fees and compensation.

[12] See ERISA § 408(g)(11)(A).

[13] Section 2(a)(3) of the Investment Company Act reads as follows: " 'Affiliated person' of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

[14] Thus, programs modeled on the SunAmerica approach described in Advisory Opinion 2001-09A could utilize the class exemption without requiring an independent certification.

[15] This language is similar to the description of asset allocation investment education in Interpretative Bulletin 96-1. See 29 C.F.R. § 2509.96-1(d)(3).

[16] See ERISA § 408(g)(3)(D). The statute includes the following provision: "Nothing in the preceding sentence shall preclude the participant or beneficiary from requesting investment advice other than that described in subparagraph (A), but only if such request has not been solicited by any person connected with carrying out the arrangement." The proposed regulation does not address or clarify this provision. The class exemption, however, would allow the kind of "off-model" advice seemingly contemplated by the statutory language.