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DOL Adopts Final Regulation on Exemption for Participant-Level Investment Advice

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The U.S. Department of Labor (DOL) has adopted a final regulation to implement the statutory exemption from the prohibited transaction rules of the Employee Retirement Income Security Act of 1974, as amended (ERISA), for the provision of investment advice to plan participants and beneficiaries and owners of individual retirement accounts (IRAs). Under this rule, a financial services firm, such as a registered investment adviser, bank, or registered broker-dealer, may provide advice on investments in its proprietary investment products, or on other investments that would result in fees or other payments to the firm, if the firm complies with a fee-leveling requirement or the advice is furnished using a certified computer model. The effective date of the final regulation is December 27, 2011.

This LawFlash provides a brief overview of the statutory exemption and the final regulation and highlights some of the main issues raised by the comments. The concluding section offers some observations about the practical impact of the regulation and the current status of the law on participant investment advice.

FINAL REGULATION

Scope of Relief and Basic Requirements

The exemption provided by Section 408(b)(14) of ERISA covers transactions that arise from the provision of "investment advice" of the type that would make one an ERISA fiduciary to plan participants who direct the investment of their individual accounts. The specific transactions covered include the provision of the advice itself, investment transactions made pursuant to the advice, and the receipt by the advising fiduciary or an affiliate of any direct or indirect fees or other compensation in connection with the foregoing.

The advice must be provided by a "fiduciary adviser" under an "eligible investment advice arrangement." A "fiduciary adviser" is defined as a registered investment adviser, bank (but only if the advice is provided through its trust department), insurance company, or registered broker-dealer, or an affiliate or employee, agent, or registered representative of the foregoing. An "eligible investment advice arrangement" is an arrangement that does either of the following:

- Provides 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 for purposes of investment of plan assets, do not vary depending on the basis of any investment option selected (the "fee leveling" approach)

- Uses a computer model under an investment advice program meeting specified requirements in connection with the provision of investment advice by the fiduciary adviser (the "computer model" approach)

Each of the approaches is subject to conditions specific to its particular category and to conditions that apply to both categories. The principal condition to the fee-leveling approach is that the fiduciary adviser's fees not vary on the basis of the selected investments, as discussed further below. The principal conditions to the computer model approach are (1) requirements concerning the operation of the computer model and (2) independent certification of the model. Conditions that apply to both include specified disclosures to the plan participants receiving the advisory services that are designed to highlight the fiduciary adviser's potential conflicts of interest in providing the advice, disclosure to and authorization by an independent plan fiduciary or IRA beneficiary, and an annual independent audit of the advice program's compliance with the requirements of the statutory exemption and final regulation.

Scope of the Fee-Leveling Requirement

A question was raised soon after enactment of the exemption as to the extent fees must be leveled to meet the fee-leveling requirement. DOL took the position that, under the statutory language, only the fees or other compensation of the "fiduciary adviser" itself may not vary, so that this condition does not extend to compensation received by affiliates of the fiduciary adviser. DOL noted that if the fees and other compensation received by the fiduciary's affiliates do not vary or are offset against the fiduciary's fees, there would not be any prohibited transaction for which an exemption would be necessary.

Rejecting requests to require that fees to affiliates be subject to leveling, DOL confirmed its position in its regulation. Thus, the final regulation provides that no fiduciary adviser, including any employee, agent, or registered representative of the fiduciary adviser, that provides investment advice may directly or indirectly receive any fee or other compensation—including commissions, salary, bonuses, awards, promotions, or other things of value—from any party (including an affiliate) when that compensation varies depending on the participant's selection of particular investment options. Consequently, the fee-leveling requirement does not apply to compensation received by the fiduciary adviser's affiliates, unless the affiliate is also a provider of the investment advice.

Some of the comments asked about the language encompassing bonuses, awards, promotions, and other things of value, and whether, under this language, particular compensation arrangements or structures would meet the fee-leveling requirement. DOL responded that it intends the fee-leveling requirement to be broadly applied, to ensure the objectivity of the investment advice recommendations. Accordingly, "almost every form of remuneration that takes into account the investments selected by participants . . . would likely violate the fee-leveling requirement of the final rule." On the other hand, a compensation or bonus arrangement based on an organization's overall profitability may be permissible if the plan and IRA investment advice and investment option components are excluded from, or constitute a negligible portion of, the profitability calculation. DOL pointed out that this will depend ultimately on the details of the particular program, which will be subject to review by an independent auditor.

In its original proposal, DOL had noted the general rule that a party seeking to avail itself of a statutory or administrative exemption from the prohibited transaction provisions bears the burden of establishing compliance with the conditions of the exemption. Therefore, DOL expects that parties offering investment advisory services under the exemption will maintain, and be able to demonstrate compliance with, policies and procedures designed to ensure that fees and compensation paid to fiduciary advisers, at both the entity and individual level, do not vary on the basis of any investment option selected. DOL further expects that compliance with such policies and procedures will be reviewed as part of the annual audit required by the exemption and addressed in the compliance report.

Conditions Applicable to Computer Model Programs

Exclusivity Requirement

The regulation reflects the statute's "exclusivity" requirement—the only investment advice provided under the program may be the advice generated by the computer model. This does not preclude the participant or beneficiary from requesting investment advice beyond the computer model results, but only if such request has not been solicited by any person connected with carrying out the arrangement.

The original regulation, which was published in January 2009 at the end of the Bush administration but ultimately withdrawn by the incoming Obama administration, included a class exemption to permit the fiduciary adviser to provide "off model" advice—advice beyond what is generated by the computer model. This relief was subject to conditions that included authorization, disclosure, and a variation on the statutory exemption's fee-leveling provision. The class exemption was not included in the reproposal of the regulation in March 2010 or the October 2011 final regulation.

Computer Model Requirements

The computer program used by the model must take into account all "designated investment options" available under the plan (except annuities), without giving inappropriate weight to any investment option. "Designated investment options" are defined as any investment option designated by the plan into which participants may direct their account investments, but not including self-directed brokerage or similar arrangements that enable participants to select investments beyond those designated by the plan.

The proposal had permitted employer securities investment options to be excluded from consideration. Many advice providers prefer not to advise on employer securities investments because their focus is on developing allocations across asset classes rather than to a single company stock. However, this exclusion was removed in response to comments. On the basis of the comments, DOL now believes that it is feasible to develop a computer model capable of addressing investments in employer securities, and that participants may benefit significantly from this advice to help them avoid overconcentration in equity securities of a single company.

DOL also removed the exclusion for asset allocation funds. Such funds were originally excluded because the funds seemed redundant in view of the purpose of the advice being to develop an asset allocation. Based on its recent consideration of target date funds and similar investments, however, DOL has now concluded that it is feasible to design computer models with this capability.

Nevertheless, as DOL noted in the preamble to the final regulation, participants may request that an investment option be excluded from consideration.

Availability of Computer Model Program Relief to IRAs

The computer model portion of the exemption was not available initially for any plan covered by Section 4975 of the Internal Revenue Code but not covered by ERISA, a category that most prominently includes IRAs. DOL was to conduct a study as to the feasibility of applying computer model investment advice programs for IRAs and similar plans. Following this study, DOL determined that there are computer model investment advice programs that meet all the criteria necessary for the exemption to be available for the provision of investment advice to IRAs. The final regulation reflects the decision to include IRAs in the relief for computer models.

The key difference between plans and IRAs that affects the feasibility of computer modeling is that plans typically limit available investments to a designated set of options, whereas an IRA may have no such limit. In fact, as indicated above, the definition of "designated investment options" that must be taken into account by a computer model specifically excludes self-directed brokerage windows through which a participant may select potentially unlimited investments. A comment asked whether an IRA with an unlimited investment universe would be treated in the same manner as a self-directed brokerage window. DOL responded that while computer models should, with few exceptions, be required to model all investment options available under a plan or through an IRA, it is not reasonable to expect that all computer models would be capable of modeling the entire universe of investment options. Accordingly, a model would not fail to meet the conditions of the regulation merely because it limits its buy recommendations to those investment options that can be bought through the plan or IRA, even if the model is capable of providing hold and sell recommendations with respect to other investments. DOL said that in such instances, the plan participant or IRA beneficiary must be fully informed of the model's limitations in advance of the recommendations, to be able to assess the usefulness of the recommendations.

Computer Model Design and Operation Criteria Issues

In the March 2010 reproposal, DOL solicited comments on whether to further define the concept of "generally accepted investment theories" on which the computer model must be based, the use of historical data such as past performance data, and the appropriate criteria to consider in developing asset allocation recommendations. This generated a number of comments.

Most of the comments took the position that DOL should not specifically define or identify generally accepted investment theories, or prescribe the parameters for computer models. They emphasized that economic and investment theories and practices continuously evolve over time, so that defining these matters at a particular point in time might limit fiduciary advisers or require them to use outdated methodologies. They also said that the other requirements of the regulation would be sufficient to protect plan participants against specious methods or inappropriate consideration of factors. The comments also addressed the concept of using historical data, making the point that generally accepted investment theories require the use of historical performance data, but only in ways that recognize statistical uncertainty.

After considering the comments, DOL said it did not have a sufficient basis for determining appropriate changes to the "generally accept investment theories" standard. There did not appear to be any consensus on what investment theories and practices are generally accepted (other than modern portfolio theory, which DOL viewed as already reflected in the rule), and DOL was concerned about limiting fiduciary advisers' ability to apply innovations, which could potentially lower the quality of investment advice. DOL agreed with the commenters that the other conditions in the rule, including the independent certification requirement, provide sufficient safeguards against the inappropriate application of investment theories.

Many comments expressed concern about the requirement that the computer model not "inappropriately distinguish among options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future," which was new in the reproposal. In addition to concerns about this condition being too vague or too restrictive, several construed the condition, in the context of other conditions and DOL statements (including the issues raised for comment), as strictly prohibiting, or strongly cautioning against, any consideration of historical performance data, which arguably cannot "confidently be expected to persist in the future." Some comments said that completely disregarding historical performance data would be inconsistent with generally accepted investment theories. Such a condition could possibly result in requiring the model to focus only on fees and expenses, they added, which would unjustifiably create a clear bias in favor of passive investment styles over active investment styles. DOL responded that the condition was not intended to prohibit a computer model from any consideration of historical performance, but rather to ensure that this and other factors would be evaluated by attaching weights to those factors based on the surrounding facts and circumstances, and not giving inappropriate weight to past performance. To avoid misinterpretation, DOL clarified the provision to emphasize the need to appropriately weight the factors used in estimating future returns.

Noncompliance – "Pattern or Practice" Issue

A controversial issue under the original proposed regulation arose from a provision describing the effects of noncompliance. First, the regulation stated that the exemption would not apply to any transaction with respect to which the applicable conditions have not been met. That was not an issue standing alone. Second, though, the regulation added that the relief also would not apply in the case of a "pattern or practice of noncompliance" with any of the applicable conditions, during the period over which the pattern or practice extended. This latter provision raised a number of questions as to what constitutes a "pattern or practice," and whether this approach was overly harsh.

The provision is preserved in the final regulation. DOL said it is important to identify both individual violations and patterns of violations. While isolated or accidental occurrences would not constitute a pattern or practice of noncompliance, the presence of intentional, regular, and deliberate practices involving more than isolated events or individuals, or institutionalized practices, would almost always constitute a pattern or practice. DOL said it will consider whether the noncompliance appears to be part of either written or unwritten policies or established practices, whether there is evidence of similar noncompliance with respect to more than one plan or arrangement, and whether the noncompliance is within the fiduciary adviser's control. DOL emphasized that one of the most significant deterrents to noncompliance is the potentially significant excise taxes that could be imposed, so extending the tax liability to a period over which a pattern or practice occurs creates additional incentives "to be vigilant in assuring compliance."

Status of Prior DOL Guidance on "Investment Advice"

DOL had previously said that the enactment of the new statutory exemption does not invalidate or otherwise affect prior DOL guidance concerning investment advice, but that it merely provides a new exemption from the prohibited transaction rules for certain advice arrangements. DOL mentioned in particular Interpretive Bulletin 96-1, which discusses categories of investment-related information and materials that constitute "investment education" rather than "investment advice"; Advisory Opinions 97-15A and 2005-10A, which permit a fiduciary investment adviser that receives fees from plan investments to avoid a prohibited transaction by offsetting those fees against the fees the plan is otherwise obligated to pay; and Advisory Opinion 2001-09A (the SunAmerica letter), which describes an arrangement for providing advice using independent parties that would not result in a prohibited transaction. This position reflects the legislative history under the Pension Protection Act.

DOL cited and reaffirmed this discussion in the preamble to the final regulation.

OBSERVATIONS

The statutory exemption for participant investment advice represented a recognition by Congress that plan participants and IRA beneficiaries are increasingly responsible for managing the investments of their retirement accounts, and thus are in need of professional investment advice to assist them in this role. The resulting provision was a compromise between those who favored broad disclosure-based exemptive relief, and those who were concerned that such relief would leave participants overly vulnerable to adviser conflicts of interest. The consequence is a framework that limits relief to two specific approaches to providing advice: fee leveling and computer models.

The fee-leveling approach has been available since the effective date of the statutory provision in 2006, but the computer model approach could not be used pending DOL guidance. Now that a final DOL regulation has been issued, plan sponsors and plan providers can evaluate whether it makes sense for them to pursue the computer model approach.

The question is whether these approaches would better facilitate the provision of investment advice to plan participants. There is a perception that "one-on-one" ways of delivering advice, which could be undertaken using a computer model under the exemption or fee leveling, would be more popular with smaller companies. This is reflected in DOL's cost/benefit analysis. Some firms have already been preparing to offer computer model programs, including to the small company plan market, while others are waiting to see what the level of demand will be.

The computer model approach parallels in many respects the arrangement described in the SunAmerica letter. Under the SunAmerica approach, a program sponsor can retain an independent financial expert to formulate the advice given to plan participants on investments in the program sponsor's proprietary funds, with the effect that the resulting investments do not cause the program sponsor to have engaged in a prohibited transaction. The advice must be generated by computer programs written by independent computer programmers, using the financial expert's methodologies and parameters, and the program sponsor must not be able to change or affect the output. Additionally, the financial expert's compensation cannot be related to the fee income that the program sponsor would receive from the participants' investments. Several firms have adopted the SunAmerica approach.

One of the concerns that firms have had with the SunAmerica approach is the requirement to use an independent expert—many prefer to be able to describe the program's advice as their own product. The Section 408(b)(14) exemption permits firms to provide their own advice in the form of a computer model but subject to a number of conditions, including independent certification and an annual audit. A downside of both approaches is that neither permits "off model" advice—advice beyond that generated by the computer program or model—which may affect the usefulness by plan sponsors and plan participants. (The DOL guidance does indicate that additional advice can be provided to a participant under the statutory exemption if the participant makes an unsolicited request.) In view of these issues, the question for advice providers is whether the costs and burdens presented by the new rules are offset by the added benefits.

On the more general issue of finding ways to make advice more available to plan participants and IRA beneficiaries, there have been no further legislative developments. This leaves the available approaches as (1) providing only investment "education" that avoids being treated as fiduciary investment advice under ERISA; (2) providing fiduciary investment advice that avoids violating the prohibited transaction rules by either (i) not involving the payment of fees or other compensation to the advising party in connection with the recommended investments or (ii) offsetting or otherwise leveling the fees received in connection with the investment advice across the adviser's affiliated group of companies; (3) following the approach in the SunAmerica letter of using advice formulated by an independent expert; or (4) using the fee-leveling or computer model alternatives under the statutory exemption. Each of these approaches has its advantages and disadvantages for both the advice provider and the plan participants/IRA beneficiaries, and will have to be evaluated on an individual basis.

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