

October 26, 2011

DOL Releases Final PPA Participant Advice Regulation

On October 25, 2011, the Department of Labor (DOL) published its [final regulation](#) implementing the ERISA prohibited transaction exemptions for participant investment advice enacted in the Pension Protection Act of 2006 (PPA). This final regulation brings to a conclusion an almost five-year process to implement the PPA exemptions permitting “level fee” and “computer model” advice for retirement plan participants and IRA beneficiaries. In broad scope, the final regulation retains the general structure and terms of the Obama Administration’s [March 2, 2010 proposal](#), with several refinements and clarifications. The regulation is effective as of December 27, 2011.

Background

The shift towards participant-directed retirement plans that took hold in the 1990s had the unintended consequence of reducing the portion of retirement assets that are invested with the benefit of professional investment advice. Moreover, the businesses already in service relationships that could accommodate that advice — the retirement platform, product and service providers that evolved to serve the defined contribution and IRA markets — often have been impeded by ERISA from providing investment advice. To the extent those providers (or an affiliate) had an economic stake in the investment options available and thus in the investment choices made under the retirement plan or IRA, an ERISA prohibited transaction generally would occur if the investment advice would cause the provider to be an ERISA fiduciary. (Providing “investment advice for a fee,” within the meaning of ERISA § 3(21), is one of the three ways to become an ERISA fiduciary.)

Even before the PPA, DOL issued guidance elucidating circumstances in which investment support for participants would not raise this prohibited transaction concern:

- Investment “education” is not, in DOL’s judgment, investment “advice” and thus can be provided to participants without committing a prohibited transaction.¹
- If properly structured, the investment advice function can be outsourced to an independent financial expert, as a means to avoid the prohibited transaction concern.²
- Similarly, reducing the amount due to the provider for its services by the fees or other economic benefits accruing to the provider or its affiliate by reason of the investment choices made under the plan — that is, enterprise-wide fee leveling — avoids the prohibited transaction concern.³

Also, certain class exemptions issued by DOL providing relief for specific investment transactions at least arguably include relief for any investment advice leading to those transactions. Where prohibited transaction concerns were present, however, there was no comprehensive ERISA solution for providing investment advice to participants, and that regulatory gap (coupled with the incremental cost of investment advice) meant that no more than 10% of participants and IRA beneficiaries were making investment choices with the benefit of professional assistance.

¹ [Interpretive Bulletin 96-1](#), 29 C.F.R. § 2509.96-1.

² [Advisory Opinion 2001-09A](#) (Dec. 14, 2001).

³ [Advisory Opinion 2005-10A](#) (May 11, 2005); [Advisory Opinion 97-15A](#) (May 22, 1997).

Recognizing the importance to national retirement security of improving the quality of the investment choices made by plan participants and IRA beneficiaries, Congress undertook in the PPA to provide at least that comprehensive legal solution. Both the House and Senate versions of the bill contained an investment advice exemption that would allow these well-positioned providers, among others, to offer investment “advice” without enterprise-wide fee leveling; a more conditional exemption was included in the House bill, a somewhat less conditional version in the Senate bill. The conference committee agreement generally favored the House version, which was enacted as section 601 of the PPA and provides relief for certain “level fee” and “computer model” advice arrangements.⁴

Starting in December 2006, the Bush Administration commenced a regulatory process that culminated in the [January 21, 2009, publication of a regulation](#) not only implementing the statutory exemptions, but completing the logic of the legislation by adding administrative exemptions for “modified level fee” and “off-model” advice. The Obama Administration took exception to this and other “midnight regulations” of the Bush Administration and, in this case, ultimately withdrew the January 2009 regulation in favor of its own March 2010 proposal. The March 2010 proposal differed from the January 2009 regulation in the following important respects:

- DOL did not retain the modified level fee and off-model administrative exemptions; and
- In enumerating the details of the computer model advice program, DOL added in the proposal that the model may not “[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.” That limitation was intended specifically to exclude consideration of historic rates of return of a particular investment.

The Final Regulation

The final regulation makes limited changes to the March 2010 proposal. Among the more significant developments:

- With commendable intellectual honesty, DOL again declined to move away from its position in [FAB 2007-1](#), the January 2009 regulation and the March 2010 proposal that affiliates of the fiduciary adviser may, under the level fee exemption, receive revenue that varies with investment choices. This means that a structurally separate fiduciary adviser can provide exempted level fee advice, even if affiliates are investment product or service providers that receive varying revenue by reason of the investment choices made by the participant taking account of the advice. DOL refined the formulation of the level fee requirement applicable to the fiduciary adviser.
- DOL receded on its proposal to exclude from consideration in computer models the historical performance of a particular investment. DOL concluded that it did not have a basis to add this constraint to the statutory “generally accepted investment theories” standard, relying instead on the fiduciary responsibilities of the persons selecting the model for the plan and on the certification of the model by an independent investment expert to guard against specious, unorthodox or inappropriate use of historical performance data. Performance data for a particular investment, if utilized, may not be “inappropriately weighted” in comparison to the other factors considered in developing the model advice, however.
- DOL made explicit a requirement under both the level fee and computer model exemptions that the fiduciary adviser request from the participant age, time horizon, risk tolerance and other specified

⁴ The exemptions are codified in ERISA §§ 408(b)(14) and 408(g), and in IRC §§ 4975(d)(17) and 4975(f)(8).

information, and added a requirement of notice from the fiduciary adviser to authorizing plan fiduciaries.

- DOL modified the plan investment options that may be excluded from consideration under a computer model.

A detailed summary of the operation of the final regulation, with other clarifications and refinements noted, is attached at the end of this alert.

The practical import of these exemptions on the investment advice available to plan participants and IRA beneficiaries remains uncertain. The conditions imposed by Congress under these exemptions range from meaningful (in the case of the level fee exemption) to formidable (in the case of the computer model exemption). Providers that require prohibited transaction relief to offer participant advice will have to assess whether the compliance costs and risks under the exemptions are acceptable. If not, except where DOL's preexisting guidance offers workable solutions, the desire to protect the potential recipients of such investment advice may mean that such advice remains less widely available than optimal.



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Statutory Exemptions	Level Fee	Computer Model
Scope		
Plans covered	ERISA plans and IRAs (including Archer MSAs, HSAs and Coverdell educational savings accounts) that: <ul style="list-style-type: none"> Are individual account plans, and Permit participants⁵ to direct investments of assets in their individual accounts. <div style="border: 1px solid black; padding: 5px;"> Clarification: DOL made it clear that the exemption may be used with SIMPLE and SEP IRAs. </div>	
Transactions exempted (per ERISA § 408(b)(14) and IRC § 4975(d)(17))	<ul style="list-style-type: none"> Provision of investment advice to a participant with respect to a security or other property available as plan investment. <div style="border: 1px solid black; padding: 5px;"> Clarification: Because DOL considers individualized recommendations with respect to the selection of an investment manager to be fiduciary investment advice, that recommendation is potentially within the scope of the exemptions, as are short-term extensions of credit and other routine transactions necessary for efficient securities transactions. DOL deferred any discussion of the potential applicability of the exemptions to rollover advice. </div> <ul style="list-style-type: none"> Acquisition, holding or sale of a security or other property pursuant to the investment advice.⁶ Direct/indirect receipt of fees or other compensation by the “fiduciary adviser”⁷ or an “affiliate” (or their employees, agents or “registered representatives”) in connection with the investment advice or investment activity pursuant to the advice. 	
Scope of exemption	From ERISA § 406 and IRC § 4975. No apparent limitation on the scope of § 406(b) relief.	
Conditions		
Fiduciary adviser	Advice is provided by a fiduciary adviser pursuant to level fee or computer model arrangement.	
Level fee	Fees or other compensation for investment advice or investment activity received <ul style="list-style-type: none"> directly or indirectly by an employee, agent or registered representative who provides advice on behalf of fiduciary adviser; or by the fiduciary adviser may not vary depending on the investment option selected by participant.	<div style="border: 1px solid black; padding: 5px;"> Revision: DOL switched to a “varies” formulation, rather than the more amorphous “based on” formulation in the proposal. </div>
	Level fee requirement does not extend to affiliates of the fiduciary adviser.	

⁵ References to “participants” generally include beneficiaries and IRA owners/beneficiaries as well.

⁶ For convenience, this summary refers to these transactions as “investment transactions.”

⁷ See “Definitions,” below, for an explanation of this and other defined terms.

Statutory Exemptions	Level Fee	Computer Model
	<p>Incentive compensation or bonuses to such employee, agent or registered representative reflecting the overall success of the fiduciary adviser, as opposed to the selection of particular investment options, may be permissible, depending on the details.</p>	<p>Clarification: DOL suggested that almost any form of cash or noncash remuneration that takes into account the investments selected by the participant may be problematic, but that compensation or bonus determinations based on the overall profitability of the organization may be acceptable if participant advice and investment options are excluded from or are a negligible element of that determination.</p>
<p>Investment advice</p>	<p>Level fee advice must be based on/computer model must be designed and operated to apply and utilize generally accepted investment theories that take into account historic returns of different asset classes over defined time periods.</p> <p>Revision: As noted above, the final regulation permits a computer model to take into account the historical performance of particular investments, but adds that the model must “appropriately weight” the factors used in estimating future returns of investment options.</p> <p>Must take into account:</p> <ul style="list-style-type: none"> ▪ Fees and expenses attendant to the recommended investments; and ▪ Information, to the extent furnished by participant, relating to age, time horizons, risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences. <p>Revision: Fiduciary advisers must request this information from participants, but are not precluded from providing advice to the extent that information is not forthcoming. A direction from the participant to use previously provided information is acceptable.</p> <p>May also take into account additional investment/participant information.</p>	
<p>Additional investment advice requirements for computer model</p>	<p>Revision: A company stock fund or target date/asset allocation fund may no longer be excluded from the model.</p>	<p>Must be designed and operated to utilize “appropriate objective criteria” in providing asset allocation portfolios composed of plan investment options, and to avoid recommendations that “inappropriately” favor options:</p> <ul style="list-style-type: none"> ▪ Offered by fiduciary adviser, or person with material affiliation/contractual relationship with fiduciary adviser; or ▪ That may generate greater income for fiduciary adviser, or person with material affiliation/contractual relationship with fiduciary adviser. <p>Plan may offer only proprietary options.</p> <p>Must take into account all “designated investment options” available under the plan without giving “inappropriate” weight to any option. May exclude from recommendations:</p>

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	<p>Clarification: The model must, however, take into account the participant's existing investment in the in-plan annuity in formulating its advice.</p> <p>Revision: This is a new exception.</p>	<ul style="list-style-type: none"> ▪ An option that is an in-plan annuity option if that limitation is disclosed to participants and the participant receives a general description of that option contemporaneously with the advice; or ▪ An option that the participant requests not be included.
<p>Certification of computer model</p>	<p>Revision: DOL added that the eligible investment expert must not have developed the computer model. DOL did not provide any additional guidance with respect to the credentials necessary to serve as an eligible investment expert, but confirmed that position neither entails ERISA fiduciary status nor is subject to the ERISA bonding requirement.</p>	<p>Prior to utilization of the model, the fiduciary adviser obtains a certification from an "eligible investment expert" with the technical training/experience and proficiency to analyze and certify compliance of the model with the foregoing conditions. The eligible investment expert may not have a material affiliation/contractual relationship with:</p> <ul style="list-style-type: none"> ▪ The fiduciary adviser; ▪ Any person with a material affiliation/contractual relationship with the fiduciary adviser; or ▪ Any employee, agent or registered representative of the foregoing. <p>Also, the eligible investment expert must not have developed the computer model. No other academic or other credentials are specified.</p> <p>Written certification must include:</p> <ul style="list-style-type: none"> ▪ Identification of the methodology used to determine compliance; ▪ Explanation of how that methodology demonstrated compliance; ▪ Description of any limitations imposed by any person on the selection or application of the methodology; ▪ Representation that the methodology was applied by person(s) with educational background, technical training or experience necessary to analyze and determine compliance; ▪ Certification that the model complies; and ▪ Signature of the eligible investment expert. <p>No particular methodology is specified.</p> <p>New certification must be obtained before any modification to the model that may affect compliance is utilized.</p> <p>Selection of eligible investment expert is an ERISA fiduciary function for which the fiduciary adviser is responsible.</p>
<p>Authorization</p>	<p>Investment advice arrangement must be "expressly" authorized in advance by a plan fiduciary or IRA beneficiary other than:</p> <ul style="list-style-type: none"> ▪ The person offering the advice arrangement; ▪ Any person providing a designated investment option. The plan sponsor is not treated as such a person solely because employer securities are an investment option under the plan; or 	

Statutory Exemptions	Level Fee	Computer Model
	<ul style="list-style-type: none"> ▪ Affiliates of the foregoing. For this purpose, an IRA beneficiary is not treated as an affiliate solely by reason of being an employee of the foregoing (i.e., employees of the fiduciary adviser can authorize advice arrangements for their own IRAs). <p>Clarification: For SIMPLE and SEP plans, DOL intends the participant will provide the authorization.</p> <p>The fiduciary adviser must provide the authorizing fiduciary with a notice that</p> <ul style="list-style-type: none"> ▪ The fiduciary adviser is relying on the exemption; ▪ The advice arrangement will be audited annually for compliance with the exemption; and ▪ The auditor will furnish the authorizing fiduciary with a copy of its audit report within 60 days of completion. <p>The form content and timing of the authorization is not otherwise specified.</p> <p>Revision: The notice is a new requirement.</p> <p>Plan sponsor of a fiduciary adviser's plan may provide authorization for that plan if the same advice arrangement is offered to unaffiliated plans in the ordinary course of business.</p> <p>Clarification: With respect to the fiduciary adviser's own plan, DOL warned that the exemptions do not provide relief for the selection of the fiduciary adviser or advice arrangement, and suggested that the advice may need to be provided without cost (other than reimbursement of direct costs) to the plan or participants.</p>	
<p>Annual independent audit</p>	<p>Fiduciary adviser at least annually must engage an independent auditor with appropriate technical training/experience and proficiency to conduct compliance audit.</p> <ul style="list-style-type: none"> ▪ Auditor must so represent in writing to the fiduciary adviser. ▪ Auditor is independent if it has no material affiliation/contractual relationship with a person offering the advice arrangement or any designated investment option. <p>It appears allowable for the auditor to be providing audit or other services to the fiduciary adviser or the plan if those services do not rise to the level of a material contractual relationship.</p> <p>Revision: DOL specified that the auditor must not have participated in the development of the advice arrangement or certified the computer model, but provided no additional guidance as to the qualifications of the auditor.</p> <p>Auditor is to review sufficient information to formulate an opinion whether the advice arrangement, as well as the advice provided pursuant to the arrangement, was in compliance with the regulation. Sampling techniques reasonably determined by the auditor are permissible. Audit of every investment advice arrangement or all the advice provided under the exemption is not required. Otherwise, the scope and methodology for the audit is left to the auditor.</p> <p>Clarification: DOL suggested that an examination only of compliance with internal controls and policies would be insufficient.</p> <p>Auditor must issue a written report:</p> <ul style="list-style-type: none"> ▪ To the fiduciary adviser and each authorizing plan fiduciary within 60 days of completion of the audit; and ▪ Within 30 days of receipt, the fiduciary adviser must furnish the report to or post the report on its Web site for IRA beneficiaries. If the report identifies noncompliance, the fiduciary adviser must submit a copy to DOL within 30 days of receipt (applies only if the exemption is being relied on for IRAs). 	

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	<p>The report must:</p> <ul style="list-style-type: none"> ▪ Identify the fiduciary adviser and type of advice arrangement (level fee or computer model), and ▪ State the date of the most recent computer model certification (if applicable). <p>Otherwise, the form, content and manner of delivering the report is not otherwise specified.</p> <div style="border: 1px solid black; padding: 5px;"> <p>Revision: DOL added these content requirements.</p> </div> <p>Selection of the auditor is an ERISA fiduciary function for which the fiduciary adviser is responsible.</p> <div style="border: 1px solid black; padding: 5px;"> <p>Clarification: The auditor does not become an ERISA fiduciary, however.</p> </div>	
<p>Disclosure to participants</p>	<p>Prior to the initial investment advice and at the other times discussed below, the fiduciary adviser must provide to participants without charge a written notification (which may be in electronic form in accordance with existing DOL rules) describing:</p> <ul style="list-style-type: none"> ▪ The role of any party with a material affiliation/contractual relationship with the fiduciary adviser in the development of the advice program and the selection of investment options available under the plan; ▪ Past performance and historical rates of return of designated investment options, if not otherwise provided; ▪ All fees or other compensation (including any from third parties) to be received by the fiduciary adviser or an affiliate in connection with the advice or investment activity or any rollover of plan assets or investment of plan distributions; ▪ Any material affiliation/contractual relationship of the fiduciary adviser or affiliates in the security or other property; ▪ The manner and circumstances in which participant information provided under the arrangement will be used; ▪ The types of services provided by the fiduciary adviser in connection with the investment advice; ▪ That the adviser is acting as a fiduciary to the plan in providing the advice; ▪ That the recipient of the advice may separately arrange for advice from another adviser that may not have a material affiliation with, or receive fees or compensation in connection with, the security or property; and ▪ If the exemption is being relied on for IRAs, the purpose of the audit report and how and where to locate it. <p>Notification must be written in a clear and conspicuous manner calculated to be understood by the average participant, must be sufficiently accurate and comprehensive to reasonably apprise participants of requisite information, and may be provided in written or specified electronic form (including in disclosure materials prepared for other purposes provided that the foregoing disclosures are not compromised).</p> <p>A model form of disclosure is provided but not required.</p> <div style="border: 1px solid black; padding: 5px;"> <p>Clarification: DOL confirmed that securities or other disclosures may be used to provide the requisite participant disclosure so long as the quality of the disclosure is not compromised.</p> </div> <p>During the term of the advice arrangement, the fiduciary adviser must:</p> <ul style="list-style-type: none"> ▪ Maintain the required information in accurate form; and ▪ Provide, without charge, accurate information to the participant at least annually or on request or reasonably contemporaneously on any material change. 	

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<p>Other conditions</p>	<ul style="list-style-type: none"> ▪ The fiduciary adviser must provide appropriate disclosure in connection with investment activity in accordance with applicable securities laws. ▪ The investment activity occurs solely at the direction of the recipient of the advice. <div style="border: 1px solid black; padding: 5px; margin: 5px 0;"> <p>Clarification: A pre-authorization to maintain a particular asset allocation by periodic rebalancing is permissible where the circumstances of and particular investments involved in the rebalancing are known to and approved by the participant in advance. A change in the particular investments at the discretion of the fiduciary adviser would be outside that direction, however.</p> </div> <ul style="list-style-type: none"> ▪ The compensation to the fiduciary adviser or affiliates in connection with investment activity is reasonable. ▪ The terms of investment activity is at least as favorable to the plan as an arm's-length transaction. 	
<p>Recordkeeping</p>	<p>The fiduciary adviser must maintain records necessary to determine whether the applicable requirements of the regulation have been met for 6 years after the provision of advice pursuant to the arrangement, unless the records are lost or destroyed due to circumstances beyond the fiduciary's control.</p>	
<p>Definitions</p>		
<p>Fiduciary adviser</p>	<p>A fiduciary to the plan by reason of providing ERISA § 3(21)(A)(ii) investment advice to a participant and who is:</p> <ul style="list-style-type: none"> ▪ An investment adviser registered under the Investment Advisers Act or the laws of the state in which it maintains its principal office and place of business; ▪ A bank or similar financial institution or savings association as defined in certain statutes if the advice is provided through a trust department or similar financial institution or savings association that is subject to periodic examination and review by federal or state banking authorities; ▪ An insurance company qualified to do business under the laws of a state; ▪ A registered broker-dealer; or ▪ An affiliate of any of the foregoing. <p>Includes employees, agents (a term intended broadly to encompass persons acting for the fiduciary adviser) or registered representatives of any of the above entities who:</p> <ul style="list-style-type: none"> ▪ Provide advice in such capacity; and ▪ Satisfy applicable requirements of insurance, banking or securities law. <p>For a computer model program, any person who develops the computer model, or markets the computer model or investment advice program, is treated as an ERISA fiduciary and a fiduciary adviser, subject to an election to designate one such person as the sole fiduciary adviser treated as a fiduciary for this reason.</p>	
<p>Registered representative</p>	<p>Includes investment adviser representatives (IARs).</p>	
<p>Affiliate</p>	<p>Adapted from Investment Company Act § 2(a)(3); differs from the usual ERISA PTE "affiliate" definition.</p>	
<p>Material affiliation with another person</p>	<ul style="list-style-type: none"> ▪ Any affiliate of such other person. ▪ Any person directly or indirectly owning, controlling, or holding 5% or more of the interests of such other person. ▪ Any person 5% or more of whose interests are directly or indirectly owned, controlled or held by such other person; or <p>"Interest" means:</p> <ul style="list-style-type: none"> ▪ In a corporation, the combined voting power of all stock classes entitled to vote or the total value of the shares of all classes of stock; or 	

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	<ul style="list-style-type: none"> ▪ If a partnership, the capital interest or the profits interest; or ▪ If a trust or unincorporated enterprise, the beneficial interest. 	
Material contractual relationship	Payments made by one person to the other person pursuant to written contracts or agreements between the persons exceed 10% of the gross revenue on an annual basis of such other person. <div style="border: 1px solid black; padding: 5px; margin-top: 10px;"> <p>Clarification: The gross revenue test is not limited to amounts paid pursuant to agreements that have been reduced to writing.</p> </div>	
Designated investment option	Any option designated by the plan into which participants may direct investments, other than brokerage windows, self-directed brokerage accounts and similar arrangements.	