



Department of Labor Releases Final Investment Advice Regulations

The Pension Protection Act of 2006 (PPA) addressed many retirement plan issues, including investment providers' ability to give investment advice to retirement plan participants, IRA owners, and their beneficiaries. Congress has long held that retirement savers have not had adequate access to professional investment advice. The reason for this stems from the prohibited transaction rules. These rules define a plan fiduciary, in part, as a person who provides investment advice to a plan for a fee and prohibit these plan fiduciaries from receiving certain compensation for providing investment advice. This prohibition has caused uncertainty about what fees may properly be received by such fiduciaries and has reduced the investment advice that many are willing to provide.

PPA gave relief from this general prohibition through a statutory exemption. PPA also directed the Department of Labor (DOL) to issue regulations implementing and providing guidance on these provisions of PPA. Final regulations were issued in 2009, but were subsequently delayed and withdrawn before taking effect. The DOL issued new proposed regulations in February of 2010 and subsequently received more than seventy public comments from individual investment advisers, investment firms, and special interest groups. After considering the comments, the DOL has now issued its long-awaited final regulations.

The final regulations make moderate changes to the proposed regulations. Many of these changes involve details of the fee-leveling arrangements and computer models (described below) as well as clarifying definitions for purposes of the regulation. The final regulations also add language stating that simplified employee pension (SEP) plans and simple retirement accounts (SIMPLE IRAs) will be considered IRAs for purposes of the final regulations. Following is a summary of the rules that are imposed by the regulations.

Final Regulations

The regulations provide prohibited transaction relief for fiduciaries that give investment advice to an advice recipient when the choice of investments could result in a fee (or additional compensation such as bonuses, tips, or gifts) paid to the fiduciary. This relief is available if the advice is provided by a "fiduciary adviser" under an "eligible investment advice arrangement."

The definition of a "fiduciary adviser" is substantially unchanged from the proposed regulations and is generally an entity that is a fiduciary of the plan because it provides investment advice *and* that is a registered investment adviser, bank or similar financial institution, insurance company, registered broker-dealer, an affiliate of one of these entities or an employee, agent, or registered representative of one of these entities, or an affiliate of theirs. A person who develops or markets a computer model or markets an investment advice program used in an eligible investment advice arrangement is also considered a fiduciary adviser. But a fiduciary adviser may elect to be the sole fiduciary adviser treated as a fiduciary of a plan as a result of developing or marketing a computer model or marketing an investment advice program used in an eligible investment advice arrangement. In general, the fiduciary adviser's election must be a signed, written election, must identify the arrangement and person offering the arrangement subject to the election, and must identify the person electing to be the sole fiduciary adviser. A copy of the election must be furnished to the person who authorized use of the model or program.

The definition of an "eligible investment advice arrangement" is also unchanged from the proposed regulations and is an arrangement that

- 1) meets the fee-leveling requirements of the new regulations,
- 2) uses an acceptable investment advice computer model as described in the regulations, or
- 3) uses both a fee-leveling arrangement and computer modeling.

Fee-Leveling Arrangement Requirements

The requirements for a fee-leveling arrangement are essentially unchanged from the proposed regulations. The DOL has clarified that the compensation received cannot *vary* based on the investor's selection, while the proposed regulations specified that compensation could not be *based on* the investor's selection. This change was due to concern that the phrase "based on" could be interpreted to include virtually any compensation received when an investment was selected, even if the adviser was paid the same flat fee for all investment options. Changing the phrase by adding the word "vary" clarifies that this requirement is intended to address the situations where an adviser would receive greater compensation if an investor chose one investment over another.

Additionally, certain compensation or bonus arrangements that are based on an organization's profitability may, under certain circumstances, be permitted. These types of arrangements would only be permitted when the investment option components are either excluded from consideration or are a negligible portion of the calculation used to determine the compensation or bonus paid. These types of arrangements will be subject to an independent auditor's review and report to qualify for relief from the prohibited transaction rules.

When a fiduciary adviser provides investment advice using a fee-leveling arrangement, the advice generally must

- 1) be based on generally accepted investment theories that consider historic returns of different asset classes over defined time periods;
- 2) take into account investment management fees and other fees associated with the recommended investments;
- 3) consider (to the extent furnished) investor-specific information that the fiduciary adviser is required to request (e.g., age, life expectancy, risk tolerance, other assets); and
- 4) not cause the fiduciary adviser, or any affiliate of the adviser, to receive from any source—directly or indirectly—compensation or fees that vary based on the investor's selection of any particular investment option. Compensation includes commissions, salary, bonuses, awards, promotions, or anything of value.

Computer Model Requirements

The final requirements also change the requirements for computer models. The final regulations add a requirement that all factors used in estimating future returns must be appropriately weighted and the advice must take into account both employer securities and target date ("life stage") funds, which a computer model could have excluded under the proposed regulations. The final regulations also clarify that a computer model could exclude specific investment types at the direction of the investor.

The requirement that a computer model avoid investment recommendations that "inappropriately distinguish between investments in an asset class based on factors that cannot be confidently expected to continue in the future" was the subject of many comments. There was concern that the vague language contained in the regulation, combined with the uncertainty inherent in almost all investments, would result in virtually all historical performance data needing to be disregarded and that information on fees and expenses would be disproportionately weighted. This provision is clarified to reflect the DOL's position that it is appropriate for a computer model to take into account multiple factors, including fees, expenses *and* historical performance, attaching weights to each factor based on facts and circumstances (see item 6, below).

If investment advice is provided through a computer model, that computer model generally must

- 1) apply generally accepted investment theories that consider historic returns of different asset classes over defined periods of time;
- 2) take into account investment management fees and other fees associated with the recommended investments;
- 3) request information from the advice recipient—and use any data provided—that relates to age, life expectancy, risk tolerance, other assets, and additional information that could affect investment selection;
- 4) use objective criteria to create asset allocation portfolios using plan investment options;
- 5) avoid investment recommendations that inappropriately
 - a) favor investment options offered by the fiduciary adviser, or
 - b) favor investment options that may generate greater income for the fiduciary adviser;
- 6) appropriately weight all of the factors used in estimating future returns of investment options; and

- 7) take into account “all designated investment options” available under the plan. The regulations exclude self-directed brokerage accounts (and similar arrangements) from the definition of “designated investment options,” and the computer model generally need not make recommendations relating to annuity options or any option that the advice recipient specifically asks to be excluded from consideration. The final regulations remove the exemption for making recommendations relating to qualifying employer securities and target date (or “life stage”) funds.

Before using the computer model, the fiduciary adviser must obtain a written, signed certification from an “eligible investment expert” that the model meets the regulations’ requirements. This expert must be a person who is sufficiently independent from the arrangement and—as determined by the fiduciary adviser—has the appropriate educational background, technical training, or experience necessary to analyze, determine, and certify whether a computer model meets the requirements of the regulations. Among other things, the certification must include the methodologies applied in making the determination along with an explanation of the methodologies.

Plan Fiduciary Authorization

A plan fiduciary, other than the person (or affiliate) offering the arrangement or providing the investment options under the plan, must expressly authorize an eligible investment advice arrangement. In return, the fiduciary adviser must provide, in writing, a notice to the plan that the fiduciary adviser intends to comply with these regulations, that the adviser will be audited annually, and that the auditor will provide a copy of the audit to the plan fiduciary.

Annual Audit

Each year, an independent auditor with “appropriate technical training or experience and proficiency” must audit the investment advice arrangement for compliance with the regulations. The final regulations have added a more detailed list of what must be included in the auditor’s report, as well as a requirement that the fiduciary adviser let the plan know that the adviser intends to comply with the regulations.

- 1) The auditor must have no material relationship with the entity or person offering the advice arrangement or with any of the plan’s designated investment options and must not have a role in the development of the advice arrangement or certification of the computer model used, if applicable.
- 2) Within 60 days of the audit, the auditor must provide a written report to the fiduciary adviser and to each fiduciary that authorized the investment advice arrangement.
- 3) For IRAs, if the investment advice arrangement fails to meet the requirements in the regulations, the fiduciary adviser must provide a copy, either written or electronic, to the DOL within 30 days.
- 4) For IRAs, the fiduciary adviser (likely the IRA trustee, custodian, or issuer) must within 30 days of receipt of the report furnish a copy of the report to the IRA owner or make it available on the entity’s website.

Disclosure

Before giving investment advice, the fiduciary adviser must provide a notice that is written clearly, accurately, and comprehensively enough to give advice recipients the information required by the regulations, including

- 1) the role of any party with a material relationship with the fiduciary adviser in developing the investment advice program or in selecting the investment options available under the plan;
- 2) the past performance and historical rates of return of the designated investments (unless otherwise provided);
- 3) all fees or other compensation that the fiduciary adviser or its affiliates will receive in connection with
 - a) giving investment advice,
 - b) the sale, acquisition, or holding of an investment, or
 - c) any rollover or other distribution;
- 4) any material relationship of the fiduciary adviser in relation to the investment; and
- 5) how any advice recipient information might be used or disclosed, the types of investment advice services available, and notice that the investment adviser is acting as a fiduciary of the plan by providing the advice and that investment advice may be obtained from another adviser who has no affiliation with—and receives no compensation from—the investment provider.

The fiduciary adviser must, while providing advice, maintain accurate, up-to-date information (consistent with the regulations) and provide it to advice recipients without charge at least annually and at a time “reasonably contemporaneous” with any changes. This free information must also be given when a recipient requests it and whenever there is a material change.

The regulations include a model notice that can be used to meet these disclosure requirements.

Other Conditions

- 1) The fiduciary adviser must provide appropriate disclosures in connection with the sale, acquisition, or holding of investments under all applicable securities laws (e.g., a prospectus or other investment information required under securities law). Fiduciary advisers cannot qualify for the prohibited transaction exemption if they violate securities law by failing to provide required disclosures.
- 2) Such sale, acquisition, or holding of investments must be at the sole direction of the advice recipient.
- 3) Compensation received by the fiduciary adviser must be reasonable.
- 4) The terms of any transaction must be as favorable to the plan as an arm’s length transaction would be.

Record Retention

For a period of at least six years, the fiduciary adviser must maintain records adequate to determine whether the requirements of the regulations have been met. Loss or destruction of such records before the expiration of the six-year period will not result in presumption of a prohibited transaction if the loss is due to circumstances beyond the control of the fiduciary adviser.

Effective Date

The effective date of this regulation is December 27, 2011.