

August 26, 2008

## DOL Issues Proposals Under PPA Investment Advice Provisions

On August 22, 2008, the U.S. Department of Labor (“DOL”) published proposals to implement the “eligible investment advice arrangement” exemption enacted in section 601 of the Pension Protection Act of 2006 (“PPA”). The proposals were reflected in three documents:

- A mandated [report to Congress](#) finding that there are “computer model” investment advice arrangements available to IRA’s that satisfy the requirements of the PPA;
- A [proposed regulation](#) elaborating the statutory “level fee” and “computer model” exemption applicable for both ERISA plans and, in light of the conclusions reached in the report to Congress, IRAs. This exemption conditionally allows “fiduciary advisers” to provide investment advice to plan participants and IRA beneficiaries that might bear on the economic results of (i) affiliates of the adviser, so long as the compensation to the adviser does not vary with the participant’s investment choices; or (ii) the adviser itself, so long as the advice is provided by a computer model meeting certain requirements; and
- A proposed [ERISA class exemption](#) supplementing the statutory exemptions by permitting “off-model advice” and additional organizational structures for “level fee” arrangements.

Comments on the proposals are due by October 6, 2008.

### Report to Congress

DOL concluded that there are computer model programs available to IRA’s that (i) utilize relevant information about the IRA beneficiary; (ii) take into account the “full range of investments, including equities and bonds,” in recommending options for the IRA investment portfolio; and (iii) allow the IRA beneficiary sufficient flexibility in obtaining advice to evaluate and select investment options. In reaching that conclusion, DOL read the PPA to require that the computer model take into account “all of the generally recognized asset classes that are necessary for an account beneficiary to construct a diversified investment portfolio,” and need not consider the “full universe” of every investment legally available to IRA’s (which commentators asserted, without contradiction, was not feasible).

### Proposed Regulation

The proposed regulation is summarized in the chart starting on page 4. The proposal largely follows the language of the statute and the positions taken by DOL in FAB 2007-71. In addition, DOL was responsive to some but not all of the advance commentary it received pursuant to its December 2006 request for information or otherwise. Among other notable aspects of the proposal:

- The proposal does not further elucidate the exemption provided by the statute for plan sponsors and certain other fiduciaries.
- The proposal does not speak to the circumstances in which investment activity is deemed to occur “solely at the direction” of the participant or IRA beneficiary – a predicate of the exemption.
- An advice arrangement may rely on a combination of the level fee and computer model approaches.

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- For level fee arrangements, the proposal adds a requirement that the advice be based on generally accepted investment theories that take account of historic returns of different asset classes over defined time periods. (The statute imposes this condition on computer models.)
- For both level fee and computer model arrangements, the proposal requires the investment advice to take account of information furnished by the participant relating to age, life expectancy (about which participants may not always be reliably informed), retirement age, risk tolerance, other assets or sources of income (which not all advice programs are currently designed to reflect), and investment preferences.
- The proposal makes it clear that the computer model exemption is available for plans that offer only investment options proprietary to the investment adviser.
- The rules for a computer model contemplate the development of asset allocation portfolios from available investment options – a concept that, at least for IRAs, might benefit from further clarification in the final regulation.
- The certification required for computer models can apply across similar applications of a model for multiple plans and IRAs; i.e., a separate certification is not required for the advice arrangement as applied to each plan or IRA.
- A number of important requirements for compliance with the regulation – such as the manner in which a computer model is to satisfy certain specifications, the qualifications of the independent expert that certifies a computer model, the methodology utilized in that certification, and the scope and methodology for the annual audit – are addressed in this advance guidance only generally, and are left for advisers to determine in connection with their programs and for the regulators and courts to judge after the fact.
- DOL undertook to balance the potential burdens of the annual audit requirement:
  - The audit is to address all the adviser’s investment advice programs with ERISA plans and IRAs, and all the advice provided under those programs; but
  - The auditor is to be selected by the fiduciary adviser, is allowed to have other engagements with the fiduciary adviser subject to certain limitations, and may rely on sampling techniques.
- The delivery of securities law disclosures required by reason of the participant’s investment choices – a condition to qualify for this exemptive relief – is framed as a responsibility of the fiduciary adviser; in practice, other parties often are responsible for delivering those disclosures.
- For a variety of purposes, the regulation introduces the concept of a “material affiliation” or “material contractual relationship” among certain parties. While this threatens a return to a variation of the “party in interest” tree, it may be that the circumstances in which these concepts apply are sufficiently focused that the rules will be workable.
- Since the exemption extends to all the advice provided under the advice programs, the usual ERISA recordkeeping requirement under this exemption may warrant particular attention.
- This guidance reiterates that the SunAmerica approach remains available under ERISA for investment advice arrangements.

The regulation would take effect 60 days after publication in final form.

## Proposed Class Exemption

DOL proposes to resolve two important issues arising under the statutory exemption through the issuance of a class exemption.

The proposed class exemption would significantly expand the scope of the level fee relief by limiting the level fee requirement to the individual adviser, and not applying it to the fiduciary adviser employing the individual adviser. This would be helpful to financial service business structures where the investment advice function and the investment product manufacturing function must be integrated in a single corporate entity.

The proposed class exemption also would allow a fiduciary adviser to provide individualized investment advice following the furnishing of recommendations generated by a computer model or (with respect to IRAs where the fiduciary adviser determines that computer modeling is not feasible in light of the number and types of investment choices available) certain investment education. Additional conditions would apply to such “off-model” advice – i.e., advice that is not provided by a computer model that either has been certified or is developed and maintained by an independent party (in which case the certification requirement does not apply):

- The investment advice may not recommend investment options that may generate greater income than other options of the same asset class for the fiduciary adviser or certain other persons, unless the fiduciary adviser prudently concludes that the recommendation is in the best interest of the participant, and explains that conclusion and its basis to the participant; and
- The advice is documented within 30 days, including (as applicable) how the advice relates to recommendations generated by computer model and how advice that would generate such greater income is in the participant’s best interest.

Otherwise, the proposed class exemption generally incorporates the conditions applicable to the statutory exemptions. In addition, the fiduciary adviser must adopt and follow written compliance policies and procedures, and the auditor is to examine the adviser’s observation of those policies and procedures.

The class exemption would be unavailable not only with respect to particular investment advice where the conditions for relief were not satisfied, but also for otherwise compliant advice during a period where there was a pattern or practice of noncompliance with *any* of the conditions of the exemption.

The proposed class exemption would take effect 90 days after publication in final form.



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Statutory Exemptions	Level Fee	Computer Model
<b>Scope</b>		
<b>Plans covered</b>	ERISA plans and IRAs (including Archer MSAs, HSAs and Coverdell educational savings accounts) that: <ul style="list-style-type: none"> <li>▪ Are individual account plans, and</li> <li>▪ Permit participants<sup>1</sup> to direct investments of assets in their individual accounts.</li> </ul>	
<b>Transactions exempted (per ERISA §408(b)(14) and IRC §4975(d)(17))</b>	<ul style="list-style-type: none"> <li>▪ Provision of investment advice to a participant with respect to a security or other property available as plan investment.</li> <li>▪ Acquisition, holding or sale of a security or other property pursuant to the investment advice.<sup>2</sup></li> <li>▪ Direct/indirect receipt of fees or other compensation by the “fiduciary adviser”<sup>3</sup> or an “affiliate” (or their employees, agents or “registered representatives”) in connection with the investment advice or investment activity pursuant to the advice.</li> </ul>	
<b>Scope of exemption</b>	From ERISA §406 and IRC §4975. No apparent limitation on the scope of §406(b) relief.	
<b>Conditions</b>		
<b>Fiduciary adviser</b>	Advice is provided by a fiduciary adviser pursuant to level fee or computer model arrangement.	
<b>Level fee</b>	Fees or other compensation for investment advice or investment activity received <ul style="list-style-type: none"> <li>▪ Directly or indirectly by an employee, agent or registered representative who provides advice on behalf of fiduciary adviser; or</li> <li>▪ By the fiduciary adviser</li> </ul> may not vary depending on the investment option selected by participant. <p>Level fee requirement does not extend to affiliates of the fiduciary adviser.</p> <p>Incentive compensation to such employee, agent or registered representative reflecting the overall success of the fiduciary adviser, as opposed to the selection of particular investment options, is permissible.</p>	

<sup>1</sup> References to participants generally include beneficiaries as well.

<sup>2</sup> For convenience, this summary refers to these transactions as “investment activity.”

<sup>3</sup> See “Definitions” below, for a summary of this and selected other defined terms used in the proposed regulation.

Statutory Exemptions	Level Fee	Computer Model
<b>Investment advice</b>	Must be based on (level fee)/designed and operated to apply/utilize (computer model):	<ul style="list-style-type: none"> <li>▪ Generally accepted investment theories that take account of historic returns of different asset classes over defined time periods; and</li> <li>▪ Information furnished by participant relating to age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and investment preferences.</li> </ul> <p>May take account of additional investment/participant information.</p>
<b>Additional investment advice requirements for computer model</b>		<p>Must be designed and operated to utilize “appropriate objective criteria” in providing asset allocation portfolios comprised of plan investment options, and to avoid recommendations that “inappropriately” favor options:</p> <ul style="list-style-type: none"> <li>▪ Offered by fiduciary adviser, or person with material affiliation/contractual relationship with fiduciary adviser; or</li> <li>▪ That may generate greater income for fiduciary adviser, or person with material affiliation/contractual relationship with fiduciary adviser.</li> </ul> <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 an option primarily invested in qualifying employer securities if that limitation is disclosed to participants.</p>
<b>Certification of computer model</b>		<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"> <li>▪ The fiduciary adviser;</li> <li>▪ Any person with a material affiliation/contractual relationship with the fiduciary adviser; or</li> <li>▪ Any employee, agent or registered representative of the foregoing.</li> </ul> <p>No other academic or other credentials are specified.</p> <p>Written certification must include:</p> <ul style="list-style-type: none"> <li>▪ Identification of the methodology used to determine compliance;</li> <li>▪ Explanation of how that methodology demonstrated compliance;</li> <li>▪ Description of any limitations imposed by any person on the selection or application of the methodology;</li> <li>▪ Representation that the methodology was applied by person(s) with educational background, technical training or experience necessary to analyze and determine compliance;</li> </ul>

Statutory Exemptions	Level Fee	Computer Model
		<ul style="list-style-type: none"> <li>▪ Certification that the model complies; and</li> <li>▪ Signature of the eligible investment expert.</li> </ul> <p>No particular methodology is specified.</p> <p>New certification must be obtained before any model modification 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>
<b>Authorization</b>	<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"> <li>▪ The person offering the advice arrangement;</li> <li>▪ Any person providing a designated investment option; or</li> <li>▪ 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 arrangement for their own IRAs).</li> </ul> <p>The form and timing of the authorization is not otherwise specified.</p>	
<b>Annual independent audit</b>	<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"> <li>▪ Auditor must so represent in writing to the fiduciary adviser.</li> <li>▪ Auditor is independent if it has no material affiliation/contractual relationship with a person offering the advice arrangement or any designated investment option. 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.</li> </ul> <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>Auditor must issue a written report:</p> <ul style="list-style-type: none"> <li>▪ To the fiduciary adviser and each authorizing plan fiduciary within 60 days of completion of the audit; and</li> <li>▪ Within 30 days of receipt, the fiduciary adviser must furnish the report to or post the report on its website 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).</li> </ul> <p>The form and manner of delivering the report is not otherwise specified.</p>	

<p><b>Disclosure to participants</b></p>	<p>Prior to the initial investment advice and at the other times discussed below, the fiduciary adviser must provide to participants a written notification (which may be in electronic form in accordance with existing DOL rules) describing:</p> <ul style="list-style-type: none"> <li>▪ 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;</li> <li>▪ Past performance and historical rates of return of designated investment options, if not otherwise provided;</li> <li>▪ 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;</li> <li>▪ Any material affiliation/contractual relationship of the fiduciary adviser or affiliates in the security or other property;</li> <li>▪ The manner and circumstances in which participant information provided under the arrangement will be used;</li> <li>▪ The types of services provided by the fiduciary adviser in connection with the investment advice, including any limitations on the ability of a computer model to consider options primarily invested in employer securities;</li> <li>▪ That the adviser is acting as a fiduciary to the plan in providing the advice;</li> <li>▪ 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</li> <li>▪ If the exemption is being relied on for IRAs, the purpose of the audit report and how and where to locate it.</li> </ul> <p>Notification must be written in a clear and conspicuous manner calculated to be understood by average participant and must be sufficiently accurate and comprehensive to reasonably apprise participants of requisite information.</p> <p>A model form of disclosure is provided but not required.</p> <p>During the term of the advice arrangement, the fiduciary adviser must:</p> <ul style="list-style-type: none"> <li>▪ Maintain the required information in accurate form; and</li> <li>▪ Provide, without charge, accurate information to the participant at least annually or on request or reasonably contemporaneously on any material change.</li> </ul>
<p><b>Other conditions</b></p>	<ul style="list-style-type: none"> <li>▪ The fiduciary adviser must provide appropriate disclosure in connection with investment activity in accordance with applicable securities laws.</li> <li>▪ The investment activity occurs solely at the direction of the recipient of the advice.</li> <li>▪ The compensation to the fiduciary adviser or affiliates in connection with investment activity is reasonable.</li> <li>▪ The terms of investment activity is at least as favorable to the plan as an arms-length transaction.</li> </ul>
<p><b>Recordkeeping</b></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>

<b>Definitions</b>	
<b>Fiduciary adviser</b>	<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"> <li>▪ 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;</li> <li>▪ 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 is subject to periodic examination and review by federal or state banking authorities;</li> <li>▪ An insurance company qualified to do business under the laws of a state;</li> <li>▪ A registered broker-dealer; or</li> <li>▪ An affiliate of any of the foregoing.</li> </ul> <p>Includes employees, agents or registered representatives of any of the above entities who:</p> <ul style="list-style-type: none"> <li>▪ Provide advice in such capacity; and</li> <li>▪ Satisfy applicable requirements of insurance, banking or securities law.</li> </ul> <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>
<b>Registered representative</b>	Includes investment adviser representatives (IARs).
<b>Affiliate</b>	Adapted from Investment Company Act §2(a)(3); differs from the usual ERISA PTE “affiliate” definition.
<b>Material affiliation with another person</b>	<ul style="list-style-type: none"> <li>▪ Any affiliate of such other person.</li> <li>▪ Any person directly or indirectly owning, controlling, or holding 5% or more of the interests of such other person.</li> <li>▪ Any person 5% or more of whose interests are directly or indirectly owned, controlled or held by such other person.</li> </ul> <p>“Interest” means:</p> <ul style="list-style-type: none"> <li>▪ 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;</li> <li>▪ If a partnership, the capital interest or the profits interest; or</li> <li>▪ If a trust or unincorporated enterprise, the beneficial interest.</li> </ul>
<b>Material contractual relationship</b>	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.
<b>Designated investment option</b>	Any option designated by the plan into which participants may direct investments, other than brokerage windows, self-directed brokerage accounts and similar arrangements.