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TCRS 2008-08: Department Of Labor Proposed Regulations On Investment Advice And Proposed Class Exemption From The ERISA Prohibited Transaction Rules

The Department of Labor (DOL) has released proposed regulations intended to implement the statutory prohibited transaction exemption added by the Pension Protection Act of 2006 (PPA), relating to the provision of investment advice by a fiduciary adviser to participants and beneficiaries in participant-directed individual account plans and beneficiaries in Individual Retirement Accounts (IRAs). If adopted, a fiduciary adviser would get relief from the prohibited transaction rules of ERISA section 406 and the parallel provisions of section 4975 of the Internal Revenue Code (Code) for investment-related transactions described in ERISA section 408(b)(14) if the investment advice is given under an "Eligible Investment Advice Arrangement" (EIAA) described in ERISA Section 408(g) and certain disclosure and other requirements are met.

The DOL also released a proposed class exemption from the prohibited transaction rules of ERISA and the Code for investment advice given in situations not covered by the PPA's statutory exemption.

Effective Date Of Proposed Regulations

These regulations are proposed to be effective 60 days after publication of the final regulations in the Federal Register. To be considered, written comments on the proposed regulations must be submitted to the DOL by October 6, 2008.

Background

Under the prohibited transaction rules of ERISA and the Code, a fiduciary is prohibited from rendering advice to participants and beneficiaries regarding investments that result in the payment of additional advisory and other fees to the fiduciary or its affiliates. Absent an exemption, this prohibition would have continued.

The PPA amended ERISA and the Code to add a statutory exemption from the prohibited transaction rules for investment advice provided through an EIAA. This statutory exemption was designed to permit a broader array of investment advice providers to offer their services to participants and beneficiaries in participant-directed individual account plans and IRAs. On December 4, 2006, pursuant to the requirements of the PPA, the DOL published a Request For Information regarding the feasibility of computer model investment advice programs for IRAs. A public hearing was held to gather information regarding computer model programs. In February, 2007, the DOL issued Field Assistance Bulletin 2007-01 addressing certain issues presented by the PPA's new statutory exemption, but did not invalidate prior DOL guidance relating to investment advice.

On August 22, 2008, the DOL proposed these regulations providing general guidance on the statutory exemption requirements for investment advice. The DOL also proposed a prohibited transaction class exemption that would allow investment advisers to provide individualized advice in addition to the investment arrangements covered by the statutory exemption.

ERISA Section 408(b)(14) Transactions

If these proposed regulations are adopted, the following investment-related transactions would be exempt from the prohibited transaction rules of ERISA section 406 provided the requirements of the proposed regulations are met:

- The provision of investment advice to participants or beneficiaries with respect to a security or other property available as an investment under the plan;
- the acquisition, holding or sale of a security or other property available as an investment under the plan pursuant to the investment advice; and
- the direct or indirect receipt of compensation by a fiduciary adviser or its affiliate in connection with the provision of investment advice or the acquisition, holding or sale of such security or property pursuant to the investment advice.

Eligible Investment Advice Arrangement

The centerpiece of the proposed regulations is the concept of an EIAA. An arrangement is an EIAA if it meets the requirements of a level-fee arrangement or a computer model, or both.

• **Level-Fee Arrangement**

Under the proposed regulations, an arrangement is provided under a level-fee arrangement if:

- it is based on generally accepted investment theories that consider historic returns of various asset classes over defined periods of time;
- it considers information furnished by a participant or beneficiary relating to age, life expectancy, retirement age, risk tolerance, other assets or sources of income and investment preferences;
- any fees or other compensation (including salary, bonuses, awards, promotions, commissions or other things of value) received, directly or indirectly, by an employee, agent, or registered representative that provides investment advice on behalf of a fiduciary adviser does not vary on the basis of any investment option selected;
- any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or in connection with the sale, holding or acquisition of any security or other property for purposes of the investment of plan assets do not vary on the basis of any investment option selected; and
- the additional requirements of Items 1) through 5) below are met.

With respect to the first two requirements above, the proposed regulations do not preclude a fiduciary adviser from using generally accepted investment theories that take into account other considerations nor from taking into account additional information provided by the participant or beneficiary.

According to the proposed regulations, the compensation requirement relating to an employee, agent or registered representative is designed to safeguard against a firm's creation of incentives for individuals to recommend certain investment products.

• **Computer Model**

The proposed regulations provide that an arrangement is an EIAA, if the only advice provided under the arrangement is advice generated by a computer model, the advice occurs solely at the direction of the participant or beneficiary, and the design and operation and certification requirements as well as the additional requirements of Items 1) through 5) below are met.

○ **Design and Operation**

The computer model must be designed and operated to:

- take into account the requirement described in the first bullet under the Level-Fee Arrangement;
- utilize information described in the second bullet under the Level-Fee Arrangement;
- utilize appropriate objective criteria to provide asset allocation portfolios comprised of investment options available under the plan;
- avoid investment recommendations that inappropriately favor investment options offered by the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser, or investment options that may generate greater income for such adviser or person; and
- take into account all designated investment options under the plan (except brokerage windows, self-directed brokerage accounts or similar arrangements) without giving inappropriate weight to any particular investment option. Qualifying employer securities do not have to be taken into account.

○ **Certification**

Before using a particular computer model, the fiduciary adviser is required to obtain a written certification that meets the requirements below, from an eligible investment expert (defined in the proposed regulations) that the computer model meets the design and operation requirements described above. In certain situations, if changes to a previously certified computer model are made, a new certification may be required.

- A certification by an eligible investment expert shall:
 - be provided in writing;
 - contain the following information :
 - identification of the methodology or methodologies applied in determining whether the computer model meets the design and operation requirements described above;
 - an explanation of how the applied methodology or methodologies demonstrated that the computer model met such design and operation requirements;
 - a description of any limitations imposed on the selection or application of methodologies for determining if the computer model meets the design and operation requirements;
 - a representation that the methodology or methodologies were applied by persons with the education, technical training or experience necessary to analyze and determine if the computer model meets the design and operation requirements; and
 - a statement that the eligible investment expert has determined the computer model meets the design and operation requirements.
 - be signed by the eligible investment expert.

The proposed regulations state that the selection of an eligible investment expert is a fiduciary act.

- **Additional Requirements**

The following requirements (Items 1) through 5)) must also be met by an investment advice arrangement:

- 1) **Investment Advice Arrangement Must Be Authorized**

The plan fiduciary (or IRA beneficiary, in the case of an IRA), other than the person offering the arrangement, or any person providing designated investment options under the plan or any of their affiliates, must expressly authorize the investment advice arrangement.

- 2) **Annual Audit**

- the plan fiduciary, at least annually, must engage the services of an independent auditor who will conduct an audit of the investment advice arrangement for compliance with the regulations and, within 60 days after completion of the audit, issue a written report to the fiduciary adviser and to each fiduciary authorizing the arrangement;
- with respect to an IRA arrangement, within 30 days following receipt of the audit report, the fiduciary adviser must furnish a copy of the audit report to the IRA beneficiary or post the report onto its website, provided the participant or beneficiary is given information regarding the purpose of the report and how and where to locate the report that applies to his/her account;
- the auditor is required to review sufficient relevant information to formulate an opinion as to whether the arrangement and the advice given comply with the various requirements; and
- if noncompliance items are identified in the audit report, the fiduciary adviser forwards to the DOL a copy of the report.

The proposed regulations consider an auditor independent if it does not have a material affiliation or material contractual relationship with the person offering the investment advice arrangement to the plan or any designated investment options under the plan.

- 3) **Disclosure Requirements**

The proposed regulations require the fiduciary adviser to provide, without charge, to a participant or beneficiary before the initial provision of investment advice in connection with any security or other property offered as an investment option, a written notification containing the following information:

- the role of any party having a material affiliation or material contractual relationship with the fiduciary adviser in the development of advice programs and selection of investment options;
- the past performance and historical rates of return of the designated investment options, to the extent this information is not otherwise provided;

- all fees or other compensation relating to the advice that the fiduciary adviser or any of its affiliates is to receive (including compensation to a third party) in connection with the advice or the sale, acquisition or holding of the security or other property;
- any material affiliation or material contractual relationship of the fiduciary adviser or its affiliates in the security or property;
- the manner and under what circumstances, any participant or beneficiary information will be used or disclosed;
- the types of services to be provided by the fiduciary adviser in connection with the advice. If a computer model (described above) is used, any limitations on the ability of a computer model to consider an investment option consisting primarily of qualifying employer securities;
- that the adviser is acting as a fiduciary of the plan in connection with the provision of advice; and
- that a recipient of the advice may separately arrange for the provision of advice by another adviser that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property.

Notification Requirements

The required notification must:

- be written in a clear and concise manner calculated to be understood by the average participant;
- be sufficiently accurate and comprehensive; and
- upon request, provide accurate information to the recipient of the advice. The proposed regulations include a model disclosure form that may be used for this purpose. Use of the model disclosure form is voluntary. The proposed regulations provide that use of an appropriately completed disclosure form would be deemed to satisfy the content and form requirements of the notification.

Electronic Media

Notification may be provided in writing, or electronically, as long as the DOL's requirements for the use of electronic media are met.

Maintenance Of Information

The fiduciary adviser, at all times during the term of the advice arrangement, must:

- maintain the disclosure information in accurate form and in the manner described under the Notification Requirements, above;
- provide once a year, without charge, accurate information to the recipient of the advice; and
- provide, without charge, accurate information to the recipient of the advice concerning any material change to the required information at a time reasonably contemporaneous to the change in the information.

4) Other Conditions

- the fiduciary adviser provides disclosure in connection with the sale, acquisition or holding of security or other property ("transaction") in accordance with securities laws;
- the transaction occurs solely at the direction of the recipient of the advice;
- compensation received by the fiduciary adviser and its affiliates in connection with the transaction is reasonable; and
- the terms of the transaction are at least as favorable to the plan as an arm's length transaction would be.

5) Maintenance of Records

The fiduciary adviser must maintain, for a period of at least 6 years (certain exceptions apply), any records necessary to determine whether the requirements have been met.

Proposed Class Exemption

The DOL's proposed class exemption is intended to supplement the proposed regulations described earlier in this summary by furthering the availability of individualized investment advice to participants and beneficiaries in participant-directed individual account plans and beneficiaries in IRAs under circumstances not covered in the statutory exemption or the proposed regulations. The proposed class exemption, if granted, would first provide relief for individualized investment advice following the furnishing of recommendations generated by a computer model, or in the case of IRAs where modeling is not feasible, the furnishing of certain investment education materials; and second, apply the fee-leveling limits solely to the compensation received by the employee, agent or registered representative providing advice on behalf of the fiduciary adviser as distinguished from the compensation received by the fiduciary adviser on whose behalf the employee, agent or registered representative is providing such advice.

Scope Of Proposed Class Exemption

If the proposed exemption is made final and the conditions of the exemption are met, the prohibited transaction rules of ERISA sections 406(a) and 406(b) and the resulting sanctions under Code section 4975 would not apply to the following investment-related transactions:

- the provision of investment advice by a fiduciary adviser to a participant or beneficiary in a participant-directed individual account plan and individual retirement account (and certain similar plans);
- the acquisition, holding, or sale of a security or other property pursuant to the investment advice; and
- except as otherwise provided under the exemption, the direct or indirect receipt of fees or other compensation by a fiduciary adviser (or any employee, agent, registered adviser or any of their affiliates) in connection with the provision of advice or in connection with an acquisition, holding or sale of a security or other property pursuant to the investment advice.

The proposed class exemption requirements significantly mirror the requirements of the statutory exemption and the proposed regulations. For the sake of brevity, this summary references those same or similar requirements and notes where the requirements differ.

Effective Date Of Proposed Class Exemption

The DOL is proposing an effective date which is 90 days after publication of the final exemption in the Federal Register.

Conditions For Class Exemption

- The advice arrangement must be authorized in advance by a plan fiduciary similar to that required by the proposed regulations;
- The requirements described in the first 2 bullets under the Level-Fee Arrangement described above must be met; and
- The fiduciary adviser must provide advice in accordance with 1) or 2) below, or both.
 - 1) Before providing other investment advice covered by this proposed class exemption, participants and beneficiaries must be furnished investment recommendations generated by a computer model that meets the design and operation and the certification requirements discussed earlier in this summary; or that meets the design and operation requirements and is designed and maintained by a person independent of the fiduciary adviser or any of its affiliates using methodologies and parameters determined solely by the independent person.

In the case of an IRA with respect to which the types and number of investment choices precludes the use of a computer model, participants and beneficiaries must be furnished investment education materials (based on the design and operation requirements of a computer model described above, such as graphs, pie charts, case studies, worksheets or interactive software that produce asset allocation models, taking into account age or time horizon and risk profile of the IRA beneficiary, to the extent known).

The education materials must reflect the requirements of a computer model described earlier in this summary, in other words, models must be based on generally accepted investment theories and historic returns of different asset classes, must not be biased in favor of investments offered by a fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary

adviser, and all material facts and assumptions such as retirement ages, life expectancies income levels, financial resources, replacement ratios, inflation rates and rates of return, accompany the models.

Except for advice generated solely by use of a computer model described above, the investment advice arrangement must not recommend investment options that generate additional income for the fiduciary adviser or any agent, registered representative or their affiliates than other options of the same asset class, as required under the proposed regulations, unless the fiduciary adviser prudently concludes it is in the best interest of the participant or beneficiary and the fiduciary adviser explains the basis of that conclusion. This means that the fiduciary adviser could give advice that would differ from the computer model and that advice would still be covered under the class exemption, so long as the fiduciary adviser explains how the advice differs from the computer model, and where additional fees apply, justify such fees.

Within 30 days of the advice, the employee, agent or registered representative providing advice on behalf of a fiduciary adviser is required to document the basis of any investment option recommended to a participant or beneficiary, including an explanation as to how that recommendation relates to the earlier advice provided and the basis for concluding that the recommendation is in the best interest of the participant or beneficiary. The 6-year documentation retention requirement, described under Item 5 above, applies.

- 2) Any fees or other compensation (including salary, bonuses, awards promotions, commissions or any other thing of value) received, directly or indirectly, by an agent or registered representative providing advice on behalf of the fiduciary adviser (as distinguished from compensation received by the fiduciary adviser on whose behalf such employee, agent or registered representative is providing such advice) do not vary depending on the basis of any investment option selected by the participant or beneficiary.

The fiduciary adviser is required to provide, without charge to the participant or beneficiary, the written notification, described in Item 3 above, upon the initial provision of investment advice covered by the class exemption, and at least annually, thereafter.

The fiduciary adviser must also meet the disclosure requirements of the proposed regulations, described in Item 3 above, including the form and content of the notification, the use of the model disclosure form, maintenance of information, and the use of electronic media.

The fiduciary adviser must provide appropriate disclosure in connection with the sale, acquisition, or holding of the security or other property in accordance with all applicable securities laws and must adopt and follow written policies and procedures that are designed to assure compliance with all the conditions of the class exemption.

The annual audit requirements of the proposed regulations described above must also be met with respect to investment advice covered by the class exemption.

The class exemption, like the proposed regulations, expands the definition of an IRA to include an individual retirement account or annuity, an Archer MSA, a HSA, a Coverdell education savings account, a trust, plan, account, or annuity which at any time, has been determined to be part of any of the foregoing accounts or arrangements.

Noncompliance With The Terms Of The Exemption

The class exemption would not apply to a specific investment advice if the conditions of the exemption are not satisfied, or if there is a pattern or practice of noncompliance, with any of the conditions of the class exemption, for any investment advice provided by the fiduciary during such period of noncompliance.

This Summary is designed to provide an overview of the Department of Labor's proposed regulations regarding investment advice and proposed class exemption from the prohibited transaction rules of ERISA and the Code and is not intended to be comprehensive. The Transamerica Center for Retirement Studies® ("The Center") is a non-profit corporation and private operating foundation. The Center may be funded by contributions from Transamerica Life Insurance Company and its affiliates or other unaffiliated third-parties. For more information about The Center, please refer to www.transamericacenter.org. The Center and its representatives cannot give ERISA, tax or legal advice. This material is provided for informational purposes only and should not be construed as ERISA, tax or legal advice. Interested parties must consult and rely solely upon their own independent advisors regarding their particular situation and the concepts presented here. Although care has been taken in preparing this material and presenting it accurately, The Center disclaims any express or implied warranty as to the accuracy of any material contained herein and any liability with respect to it.