

**DEPARTMENT OF LABOR****Employee Benefits Security Administration****29 CFR Part 2550**

RIN 1210-AB35

**Investment Advice—Participants and Beneficiaries****AGENCY:** Employee Benefits Security Administration, Labor.**ACTION:** Final rule.

**SUMMARY:** This document contains a final rule under the Employee Retirement Income Security Act, and parallel provisions of the Internal Revenue Code of 1986, relating to the provision of investment advice to participants and beneficiaries in individual account plans, such as 401(k) plans, and beneficiaries of individual retirement accounts (and certain similar plans). The final rule affects sponsors, fiduciaries, participants and beneficiaries of participant-directed individual account plans, as well as providers of investment and investment advice related services to such plans.

**DATES:** The final rule is effective on December 27, 2011.

**FOR FURTHER INFORMATION CONTACT:** Fred Wong, Office of Regulations and Interpretations, Employee Benefits Security Administration (EBSA), (202) 693-8500. This is not a toll-free number.

**SUPPLEMENTARY INFORMATION:****A. Background**

Section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 (ERISA) and section 4975(e)(3)(B) of the Internal Revenue Code of 1986 (Code) include within the definition of “fiduciary” a person that renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of a plan, or has any authority or responsibility to do so.<sup>1</sup> The prohibited transaction provisions of ERISA and the Code prohibit a fiduciary from dealing with the assets of the plan in his own interest or for his own account and from receiving any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.<sup>2</sup> These statutory provisions have been interpreted as prohibiting a fiduciary from using the authority, control or responsibility that makes it a

fiduciary to cause itself, or a party in which it has an interest that may affect its best judgment as a fiduciary, to receive additional fees.<sup>3</sup> As a result, in the absence of a statutory or administrative exemption, fiduciaries are prohibited from rendering investment advice to plan participants regarding investments that result in the payment of additional advisory and other fees to the fiduciaries or their affiliates. Section 4975 of the Code applies similarly to the rendering of investment advice to an individual retirement account (IRA) beneficiary.

With the growth of participant-directed individual account plans, there has been an increasing recognition of the importance of investment advice to participants and beneficiaries in such plans. Over the past several years, the Department of Labor (Department) has issued various forms of guidance concerning when a person would be a fiduciary by reason of rendering investment advice, and when such investment advice might result in prohibited transactions.<sup>4</sup> Responding to the need to afford participants and beneficiaries greater access to professional investment advice, Congress amended the prohibited transaction provisions of ERISA and the Code, as part of the Pension Protection Act of 2006 (PPA),<sup>5</sup> to permit a broader array of investment advice providers to offer their services to participants and beneficiaries responsible for investment of assets in their individual accounts and, accordingly, for the adequacy of their retirement savings.

Specifically, section 601 of the PPA added a statutory prohibited transaction exemption under sections 408(b)(14) and 408(g) of ERISA, with parallel provisions at Code sections 4975(d)(17) and 4975(f)(8).<sup>6</sup> Section 408(b)(14) sets forth the investment advice-related transactions that will be exempt from the prohibitions of ERISA section 406 if the requirements of section 408(g) are met. The transactions described in section 408(b)(14) are: the provision of investment advice to the participant or

beneficiary 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 affiliate in connection with the provision of investment advice or the acquisition, holding or sale of a security or other property available as an investment under the plan pursuant to the investment advice. As described more fully below, the requirements in section 408(g) are met only if advice is provided by a fiduciary adviser under an “eligible investment advice arrangement.” Section 408(g) provides for two general types of eligible arrangements: one based on compliance with a “fee-leveling” requirement (imposing limitation on fees and compensation of the fiduciary adviser); the other, based on compliance with a “computer model” requirement (requiring use of a certified computer model). Both types of arrangements also must meet several other requirements.

On February 2, 2007, the Department issued Field Assistance Bulletin (FAB) 2007-01 addressing certain issues presented by the new statutory exemption. This Bulletin affirmed that the enactment of sections 408(b)(14) and 408(g) did not invalidate or otherwise affect prior guidance of the Department relating to investment advice and that such guidance continues to represent the views of the Department.<sup>7</sup> The Bulletin also confirmed the applicability of the principles set forth in section 408(g)(10) [Exemption for plan sponsor and certain other fiduciaries]<sup>8</sup> to plan

<sup>7</sup> In this regard, the Department cited the following: August 3, 2006 Floor Statement of Senate Health, Education, Labor and Pensions Committee Chairman Enzi (who chaired the Conference Committee drafting legislation forming the basis of H.R. 4) regarding investment advice to participants in which he states, “It was the goal and objective of the Members of the Conference to keep this advisory opinion [AO 2001-09A, SunAmerica Advisory Opinion] intact as well as other pre-existing advisory opinions granted by the Department. This legislation does not alter the current or future status of the plans and their many participants operating under these advisory opinions. Rather, the legislation builds upon these advisory opinions and provides alternative means for providing investment advice which is protective of the interests of plan participants and IRA owners.” 152 Cong. Rec. S8,752 (daily ed. Aug. 3, 2006) (statement of Sen. Enzi).

<sup>8</sup> Section 408(g)(10) addresses the responsibility and liability of plan sponsors and other fiduciaries in the context of investment advice provided pursuant to the statutory exemption. Subject to certain requirements, section 408(g)(10) provides that a plan sponsor or other person who is a plan fiduciary, other than a fiduciary adviser, is not treated as failing to meet the fiduciary requirements

<sup>1</sup> See also 29 CFR 2510.3-21(c) and 26 CFR 54.4975-9(c).

<sup>2</sup> ERISA section 406(b)(1) and (3) and Code section 4975(c)(1)(E) and (F).

<sup>3</sup> 29 CFR 2550.408b-2(e).

<sup>4</sup> See Interpretative Bulletin relating to participant investment education, 29 CFR 2509.96-1 (Interpretive Bulletin 96-1); Advisory Opinion (AO) 2005-10A (May 11, 2005); AO 2001-09A (December 14, 2001); and AO 97-15A (May 22, 1997).

<sup>5</sup> Public Law 109-280, 120 Stat. 780 (Aug. 17, 2006).

<sup>6</sup> Under Reorganization Plan No. 4 of 1978 (43 FR 47713, Oct. 17, 1978), 5 U.S.C. App. 1, 92 Stat. 3790, the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this notice to specific sections of ERISA should be taken as referring also to the corresponding sections of the Code.

sponsors and fiduciaries who offer investment advice arrangements with respect to which relief under the statutory exemption is not required. Finally, the Bulletin addressed the scope of the fee-leveling requirement under the statutory exemption.

On January 21, 2009, the Department published in the **Federal Register** final rules implementing section 408(b)(14) and 408(g) of ERISA, and the parallel provisions in the Code.<sup>9</sup> The final rules also included an administrative class exemption, adopted pursuant to ERISA section 408(a), granting additional prohibited transaction relief. The effective and applicability dates of the final rules, originally set for March 23, 2009, subsequently were delayed to allow the Department to solicit and review comments from interested persons on legal and policy issues raised under the final rules.<sup>10</sup> Based on a consideration of the concerns raised by commenters as to whether the conditions of the class exemption would be adequate to mitigate advisers' conflicts, the Department decided to withdraw the final rule. Notice of the withdrawal of the final rule was published in the **Federal Register** on November 20, 2009 (74 FR 60156).

On March 2, 2010, the Department published in the **Federal Register** new proposed regulations that, upon adoption, implement the statutory prohibited transaction exemption under ERISA sections 408(b)(14) and 408(g), and the parallel provisions in the Code (75 FR 9360). In response to the proposal, the Department received 74 comment letters.<sup>11</sup>

Set forth below is an overview of the final rule and an overview of the major

of ERISA solely by reason of the provision of investment advice as permitted by the statutory exemption. This provision does not exempt a plan sponsor or a plan fiduciary from fiduciary responsibility under ERISA for the prudent selection and periodic review of the selected fiduciary adviser.

<sup>9</sup>In connection with the development of the January 2009 final rules, the Department published two requests for information from the public (see 71 FR 70429 (Dec. 4, 2006) and 72 FR 70427; comments found at <http://www.dol.gov/ebsa/regs/cmt-investmentadvice.html> and <http://www.dol.gov/ebsa/regs/cmt-investmentadviceIRA.html>); published proposed regulations and class exemption with solicitation of public comment (see 73 FR 49896 (Aug. 22, 2008) and 73 FR 49924; comments found at <http://www.dol.gov/ebsa/regs/cmt-investment-advice.html> and <http://www.dol.gov/ebsa/regs/cmt-investmentadviceexemption.html>); and held public hearings on October 21, 2008 (see 73 FR 60657 (Oct. 21, 2008) and 73 FR 60720) and July 31, 2007 (see 72 FR 34043 (June 20, 2007)).

<sup>10</sup>74 FR 59092 (Nov. 17, 2009); 74 FR 23951 (May 22, 2009); 74 FR 11847 (Mar. 20, 2009). Comments can be found at: <http://www.dol.gov/ebsa/regs/cmt-investmentadvicefinalrule.html>.

<sup>11</sup>Comments can be found at: <http://www.dol.gov/ebsa/regs/cmt-1210-AB35.html>.

comments received on the proposed rule.

## B. Overview of Final § 2550.408g–1 and Public Comments

### 1. General

In general, § 2550.408g–1 tracks the requirements under section 408(g) of ERISA that must be satisfied in order for the investment advice-related transactions described in section 408(b)(14) to be exempt from the prohibitions of section 406. Paragraph (a) describes the general scope of the statutory exemption and regulation. Paragraph (b) sets forth the requirements that must be satisfied for an arrangement to qualify as an “eligible investment advice arrangement” and for the exemption to apply. Paragraph (c) defines certain terms used in the regulation. Paragraph (d) sets forth the record retention requirement applicable to an eligible investment advice arrangement. Paragraph (e) describes the implications of noncompliance on the prohibited transaction relief under the statutory exemption.

The provisions in paragraph (a) of the final rule have not been changed from the proposal. Paragraph (a)(1) describes the general scope of the final rule, referencing the statutory exemption under sections 408(b)(14) and 408(g)(1) of ERISA, and under sections 4975(d)(17) and 4975(f)(8) of the Code, for certain transactions in connection with the provision of investment advice, as set forth in paragraph (b) of the final rule. It further provides that the requirements and conditions of the final rule apply solely for the relief described in the final rule, and that no inferences should be drawn with respect to the requirements applicable to the provision of investment advice not addressed by the rule.

Several comment letters raised issues with respect to the general scope of the proposal. Although a number of commenters supported the Department's decision with respect to the withdrawal of the class exemption, others requested its re-proposal. The latter group argued that increasing the availability of investment advice to plan participants and beneficiaries requires broader prohibited transaction relief than provided under the proposed regulation. Other commenters argued that plan sponsors also would benefit from increased access to investment advice, and suggested extending exemptive relief to advice provided to plan sponsors, either through the final rule or by an administrative class exemption. Another commenter requested that the final rule provide relief for management

of managed accounts. These comments are beyond the scope of the proposal, which was limited to implementation of the statutory exemption for the provision of investment advice to plan participants and beneficiaries, and have not been adopted by the Department.

Two commenters observed that paragraph (a)(1) indicates that the requirements contained in the final rule should not be read as applicable to arrangements for which prohibited transaction relief is not necessary. They requested clarification that a plan sponsor's selection and monitoring responsibilities do not differ for advice provided pursuant to the regulation compared to arrangements for which prohibited transaction relief is not necessary. In response, we note that, as stated in FAB 2007–1, it is the Department's view that, except for section 408(g)(10)(A)(i) to (iii), the same fiduciary duties and responsibilities apply to the selection and monitoring of an investment adviser regardless of whether the arrangement for investment advice services is one to which the regulation applies. As further explained in that Bulletin, a plan sponsor or other fiduciary that prudently selects and monitors an investment advice provider will not be liable for the advice furnished by such provider to the plan's participants and beneficiaries, whether or not that advice is provided pursuant to the statutory exemption under section 408(b)(14).

Paragraph (a)(2) provides that nothing contained in ERISA section 408(g)(1), Code section 4975(f)(8), or the final rule imposes an obligation on a plan fiduciary or any other party to offer, provide or otherwise make available any investment advice to a participant or beneficiary. Paragraph (a)(3) provides that nothing contained in those same provisions of ERISA and the Code, or the final rule invalidates or otherwise affects prior regulations, exemptions, interpretive or other guidance issued by the Department pertaining to the provision of investment advice and the circumstances under which such advice may or may not constitute a prohibited transaction under section 406 of ERISA or section 4975 of the Code.

Several commenters suggested that, rather than merely affirming the continued applicability of pre-PPA guidance in paragraph (a)(3),<sup>12</sup> the Department should reconsider its past guidance in light of the safeguards contained in the statutory exemption and the proposed rule. Such an undertaking is beyond the scope of the

<sup>12</sup>See also Field Assistance Bulletin 2007–1 (Feb. 2, 2007).

current proposal, and the Department has not adopted this suggestion.

Other commenters requested a general clarification of how the final rule applies in the context of IRAs. In particular, a commenter asked if paragraph (a)(3) indicates that prior ERISA regulations are now applicable to IRAs. Code section 4975(c), similar to ERISA section 406, generally prohibits a plan fiduciary from rendering investment advice that results in the payment of additional advisory and other fees to the fiduciaries or their affiliates. A fiduciary who participates in a prohibited transaction is subject to excise taxes under Code section 4975(a) and (b).<sup>13</sup> The application of the Code section 4975 prohibited transaction provisions to IRAs pre-dates the enactment of the PPA.<sup>14</sup> The statutory exemption implemented by this rule merely provides limited conditional relief from the application of those Code provisions. Except for the relief afforded by the statutory exemption, the final rule does not change the manner or extent to which Code section 4975 applies to an IRA.<sup>15</sup> Nor does the final rule make ERISA's fiduciary responsibility provisions applicable to an IRA that is not covered by ERISA.

Commenters also asked questions relating to the prohibited transaction implications of making recommendations to plan participants to roll-over plan benefits into an IRA. The Department has taken the position that merely advising a plan participant to take an otherwise permissible plan distribution, even when that advice is combined with a recommendation as to how the distribution should be invested, does not constitute "investment advice" within the meaning of 29 CFR 2510-3.21(c).<sup>16</sup> The Department, however, has invited public comment on the issue as part of its review of the definition of "fiduciary" with regard to persons providing investment advice to plans or plan participants and beneficiaries under 29 CFR 2510.3-21(c).<sup>17</sup> The Department has not completed its review of those comments and,

accordingly, is not addressing the issue as part of this final rule.

## 2. Statutory Exemption

### a. General

Paragraph (b) of the final rule describes the requirements that must be satisfied in order for the investment advice-related transactions described in section 408(b)(14) to be exempt from the prohibitions of section 406. These requirements generally track the requirements in section 408(g)(1) of ERISA.

Paragraph (b)(1) of the final rule sets forth the general scope of the statutory exemption and regulation as providing relief from the prohibitions of section 406 of ERISA for transactions described in section 408(b)(14) of ERISA in connection with the provision of investment advice to a participant or a beneficiary if the investment advice is provided by a fiduciary adviser under an "eligible investment advice arrangement." The transactions described in section 408(b)(14) include the provision of investment advice to a participant or beneficiary 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 advice; and the direct or indirect receipt of fees or other compensation by the fiduciary adviser or an affiliate in connection with the provision of the advice or in connection with the acquisition, holding or sale of the security or other property. Paragraph (b)(1) also notes that the Code contains parallel provisions at section 4975(d)(17) and (f)(8).

A commenter asked whether relief would be provided for extensions of credit intrinsic to investments made pursuant to investment advice rendered. It is the view of the Department that transactions in connection with the provision of investment advice described in section 3(21)(A)(ii) of ERISA include, for purposes of the statutory exemption, otherwise permissible routine transactions necessary for the efficient execution and settlement of trades of securities, such as extensions of short term credit in connection with settlements.

Commenters also requested clarification as to whether advice to a participant or beneficiary concerning the selection of an investment manager to manage some or all of the participant's or beneficiary's plan assets constitutes the provision of investment advice within the meaning of section 3(21)(A)(ii) of ERISA for purposes of the

statutory exemption. As previously stated in the context of adopting the 2009 final rule, the Department has long held the view that individualized recommendations of particular investment managers to plan fiduciaries constitutes the provision of investment advice within the meaning of section 3(21)(A)(ii) in the same manner as recommendations of particular securities or other property. The fiduciary nature of such advice does not change merely because the advice is being given to a plan participant or beneficiary.<sup>18</sup> The Department has reaffirmed this position in connection with proposed amendments to regulations at 29 CFR 2510.3-21(c).<sup>19</sup>

Paragraph (b)(2) provides that, for purposes of section 408(g)(1) of ERISA and section 4975(f)(8) of the Code, an "eligible investment advice arrangement" is an arrangement that meets either the requirements of paragraph (b)(3) [describing investment advice arrangements that use fee-leveling] or paragraph (b)(4) [describing investment advice arrangements that use computer modeling], or both.

### b. Arrangements Using Fee-Leveling

With respect to arrangements that use fee-leveling, paragraph (b)(3)(i)(A) requires that any investment advice must be based on generally accepted investment theories that take into account historic returns of different asset classes over defined periods of time, but also notes that generally accepted investment theories that take into account additional considerations are not precluded. Paragraph (b)(3)(i)(B) requires that investment advice must take into account investment management and other fees and expenses attendant to the recommended investments. These provisions have not been changed from the proposal.

Paragraph (b)(3)(i)(C) of the final rule requires that investment advice provided under a fee-leveling arrangement must take into account, to the extent furnished, information relating to age, time horizons (*e.g.*, life expectancy, retirement age), risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences of the participant or beneficiary. Despite a request for re-consideration by commenters, paragraph (b)(3)(i)(C) requires that a fiduciary adviser must request such information. These

<sup>13</sup> See Code section 4975(a), (b), and (e)(2)(A).

<sup>14</sup> Code section 4975(e)(1)(B). Public Law 93-406 section 2003(a), 88 Stat. 971.

<sup>15</sup> As indicated in footnote 6 above, pursuant to section 102 of Reorganization Plan No. 4 of 1978, the Secretary of Labor has authority to interpret certain provisions of Code section 4975.

<sup>16</sup> AO 2005-23A (Dec. 7, 2005). This opinion further states that where someone who is already a plan fiduciary responds to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from the plan, that fiduciary is exercising discretionary authority respecting management of the plan and must act prudently and solely in the interest of the participant.

<sup>17</sup> 75 FR 65263 (Oct. 22, 2010).

<sup>18</sup> 74 FR 3822, 3824 (Jan. 21, 2009). See also AO 84-04A (Jan. 4, 1984); AO 84-03A (Jan. 4, 1984); 29 CFR 2509.96-1(c).

<sup>19</sup> See footnote 17, above.

commenters noted that ERISA section 408(g)(3) does not contain a mandatory request for information, and that the Department similarly should avoid such a mandate. The Department believes that this information is sufficiently important to the provision of useful investment advice that fiduciary advisers should be required to make a request for the information. Accordingly, this requirement is retained in both the fee-leveling and computer modeling provisions of the final rule. We note that, as also reflected in paragraph (b)(3)(i)(C) of the final rule, investment advice need not take into account information requested, but not furnished by a participant or beneficiary, and a fiduciary adviser is not precluded from requesting and taking into account additional information that a plan or participant or beneficiary may provide. Furthermore, the Department does not believe that this provision, or paragraph (b)(4)(i)(D) applicable to arrangements using computer models, would preclude a fiduciary adviser or computer model, when making an information request, from also providing a participant or beneficiary with an opportunity to direct the use of information previously provided.

Paragraphs (b)(3)(i)(D) of the final rule sets forth the limitations on fees and compensation applicable to fee-leveling arrangements. As proposed, paragraph (b)(3)(i)(D) provided that no fiduciary adviser (including any employee, agent, or registered representative) that provides investment advice receives from any party (including an affiliate of the fiduciary adviser), directly or indirectly, any fee or other compensation (including commissions, salary, bonuses, awards, promotions, or other things of value) that is based in whole or in part on a participant's or beneficiary's selection of an investment option. Some commenters suggested that the fee and compensation limitation be expanded to include the affiliates of a fiduciary adviser. The Department has not adopted this suggestion. In FAB 2007-1, the Department concluded that the requirement in ERISA section 408(g)(2)(A)(i) that fees not vary depending on the basis of any investment option selected applies only to a fiduciary adviser, and does not extend to affiliates of the fiduciary adviser unless the affiliate also is a provider of investment advice. In reaching this conclusion, the Department explained that, consistent with its previous guidance, if the fees and compensation received by an affiliate of a fiduciary that provides

investment advice do not vary or are offset against those received by the fiduciary for the provision of investment advice, no prohibited transaction will result solely by reason of providing investment advice, and prohibited transaction relief, such as provided under sections 408(b)(14) and 408(g), is not necessary.<sup>20</sup>

Several commenters suggested that the Department revise the language in paragraph (b)(3)(i)(D) that refers to fees or compensation that is "based in whole or in part" on a participant's investment selection to conform to the statutory provision, and make clear that the regulation only proscribes fees or compensation that vary based on investment selections. As an example, a commenter explained that if commissions paid with respect to each plan investment option are the same, the commission could nonetheless be considered "based on" an investment selection because it is paid only if an investment is made, and therefore would appear to violate the proposal. Such a result, it is argued, is inconsistent with the section 408(g)(2)(A)(i), which only requires that "any fees (including any *commission* or other compensation) received by the fiduciary adviser \* \* \* do not vary depending on the basis of any investment option selected." (Emphasis added) Another commenter cautioned that the proposal could be misinterpreted as proscribing only those payments that a payor intends to act as an incentive, whereas the statutory provision appears to address receipt of any varying payment that has the effect of creating an incentive, without regard to the payor's intent.<sup>21</sup> This commenter also recommended that the proposal should be revised to conform to the statutory language.

The Department agrees with the observations of the commenters and, accordingly, has revised the provision in response to these comments. Paragraph (b)(3)(i)(D) of the final rule requires that no fiduciary adviser (including any employee, agent, or registered representative) that provides investment advice receives from any party (including an affiliate of the fiduciary adviser), directly or indirectly, any fee or other compensation

<sup>20</sup> See AO 97-15A and AO 2005-10A.

<sup>21</sup> The commenter focused on the Department's preamble explanation that, even though an affiliate of a fiduciary adviser would be permitted to receive fees that vary depending on investment options selected, any provision of financial or economic incentives by an affiliate (or any other party) to a fiduciary adviser or person employed by such fiduciary adviser to favor certain investments would be impermissible under the proposal. 75 FR 9361

(including commissions, salary, bonuses, awards, promotions, or other things of value) that varies depending on the basis of a participant's or beneficiary's selection of a particular investment option. Consistent with the statute, this provision proscribes the receipt of fees or compensation that vary based on investment options selected, and therefore could have the effect of creating an incentive for a fiduciary adviser, or any individual employed by the adviser, to favor certain investments.

A commenter expressed the view that by encompassing bonuses, awards, promotions, or other things of value, the fee-leveling requirement may be unnecessarily broad. Some commenters asked whether particular compensation arrangements or structures described in their comment letters would meet the fee-leveling requirement. Others similarly sought confirmation that bonuses, where it can be established that plan and IRA components are excluded from, or constitute a negligible portion of, the calculation, would not violate the fee-leveling requirement. The Department intends the fee-leveling requirement to be broadly applied in order to ensure the objectivity of the investment advice recommendations to plan participants and beneficiaries is not compromised by the advice provider's own financial interest in the outcome. For purposes of applying the provision, the Department would consider things of value to include trips, gifts and other things that, while having a value, are not given in the form of cash. Accordingly, almost every form of remuneration that takes into account the investments selected by participants and beneficiaries would likely violate the fee-leveling requirement of the final rule. On the other hand, a compensation or bonus arrangement that is based on the overall profitability of an organization may be permissible if the individual account plan and IRA investment advice and investment option components are excluded from, or constituted a negligible portion of, the calculation of the organization's profitability. The Department believes, however, that whether any particular salary, bonus, awards, promotions or commissions program meets or fails the fee-leveling requirement ultimately depends on the details of the program. In this regard, the Department notes that, under paragraph (b)(6), the details of such programs will be the subject of both a review and a report by an independent auditor as a condition for relief under the statutory exemption.

In addition to the foregoing, under paragraph (b)(3)(ii), fiduciary advisers utilizing investment advice

arrangements that employ fee-leveling must comply with the requirements of paragraphs (b)(5) [authorization by plan fiduciary], (b)(6) [audits], (b)(7) [disclosure to participants], (b)(8) [disclosure to authorizing fiduciary], (b)(9) [miscellaneous], and (d) [maintenance of records] of the final rule, each of which is discussed in more detail below.

#### c. Arrangements Using Computer Models

Paragraph (b)(4) addresses the requirements applicable to investment advice arrangements that rely on use of computer models under the statutory exemption. To qualify as an eligible investment advice arrangement, the only investment advice provided under the arrangement must be advice generated by a computer model described in paragraph (b)(4)(i) [computer model design and operation] and (ii) [computer model certification], and the arrangement must meet the requirements of paragraphs (b)(5) through (9) and paragraph (d), each of which is discussed in more detail below.

##### 1. Computer Model Design and Operation

In general, the computer model design and operation provisions in the proposal were based on section 408(g)(3)(B)(i)–(v) of ERISA. They also reflected comments received during development of the January 2009 final rule. However, the proposal also included a new provision, at paragraph (b)(4)(i)(E)(3), requiring that a computer model must be designed and operated to avoid investment recommendations that inappropriately 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. The Department added this provision to enhance the rule's protections against the potential that the adviser's conflicts might taint advice given under the exemption. To further explore the merits of enhancing the rule's protections by providing more specific computer model standards, the Department solicited comment on a number of questions involving computer models. These questions related to matters such as the identification and application of, and practices consistent with, generally accepted investment theories; use of historical data (such as past performance) of asset classes and plan investments; and criteria appropriate for consideration in developing asset allocation recommendations consisting of plan investments.

As in the proposal, paragraph (b)(4)(i)(A) of the final rule relates to the application of generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time. In response to the Department's solicitation, commenters indicated that generally accepted investment theories is a term defined by wide usage and acceptance by investment experts and academics, and is subject to change over time. Most did not believe, however, that the Department should specifically define or identify generally accepted investment theories, or prescribe particular practices or computer model parameters. These commenters explained that economic and investment theories and practices continuously evolve over time in response to changes and developments in academic and expert thinking, technology, and financial markets. Commenters cautioned that defining generally accepted theories and practices through the final rule would reflect a determination made at a particular point in time, and that such a determination might limit the ability of advisers to select and apply investment theories and methodologies they believe to be appropriate, and cause them to apply theories and methodologies that they otherwise might determine to be outdated. They also suggested that establishing a specific standard might inhibit innovation in participant-oriented investment advice. Commenters further noted that the proposal's computer model provisions, without modification, would be sufficient to protect against use of specious or highly unorthodox methods, or inappropriate consideration of factors such as recent performance of plan investment options. These commenters therefore suggested that specifying theories and practices is not necessary to protect participants, and furthermore may impede the development of advice that is in their best interests.

Other commenters suggested that more specific standards might be helpful. One commenter stated that lack of guidance on what constitutes a generally accepted investment theory may present difficulties in performing the rule's required computer model certifications. The commenter recommended that the Department revise the rule to include a process for determining whether a theory is generally accepted, which could include submission to a panel of experts for determination and publication of an

acceptable list of theories. Another commenter suggested that the final rule contain non-exclusive "safe harbor" computer model parameters. Another commenter requested clarification that a computer model must apply generally accepted investment theories that take into account the other considerations described in the regulation's computer model provisions (e.g., information about a participant's age and time horizon).

Virtually all commenters who addressed this issue indicated that use of historical performance data is required by generally accepted investment theories, but only in ways that recognize statistical uncertainty. Most noted that defining "historical" differently can have a tremendous impact on the resulting data and investment recommendations, and generally agreed that long-term performance information is preferable to short-term performance information. Some opined that historical performance data must reflect at least one market or economic cycle, but provided different timeframes (e.g., at least 5, 10, or 20 years) that they believe would meet this standard. Some also suggested that use of historical performance data should be limited to estimating future performance for an entire asset class, rather than as a predictor for individual investments within an asset class.

After careful consideration of all the comments on the issue, the Department does not believe it has a sufficient basis for determining appropriate changes to the generally accepted investment theory standard. While several commenters described theories and practices they believe to be generally accepted, there did not appear to be any consensus among them, with the exception of modern portfolio theory,<sup>22</sup> which the Department believes is already reflected in the rule's reference to investment theories that take into account the historic returns of different asset classes over defined periods of time. Moreover, the Department is concerned that attempting to provide further clarification or additional specificity in this area may have potentially significant unintended consequences—such as limiting advisers' ability to select, apply or make further innovations in participant-oriented investment advice—that could potentially lower the quality of

<sup>22</sup> This is consistent with a survey of literature on generally accepted investment theories prepared for the Department. See Deloitte Financial Advisory Services LLP, *Generally Accepted Investment Theories* (July 11, 2007) (unpublished, on file with the Department of Labor).

investment advice received by participants and reduce the economic benefit of the statutory exemption. The Department also is persuaded that, without additional specificity, the final rule's computer model requirements are sufficient to safeguard participants from inappropriate application of investment theories. As the party seeking prohibited transaction relief under the exemption, the fiduciary adviser has the burden of demonstrating satisfaction of all applicable requirements of the exemption. A fiduciary adviser relying on use of computer models therefore must be able to demonstrate that the computer model is designed and operated to apply generally-accepted investment theories. Furthermore, as with the other computer model requirements in paragraph (b)(4)(i), application of generally-accepted investment theories is subject to certification by an eligible investment expert under paragraph (b)(4)(ii). This provides significant additional procedural and substantive safeguards, as the expert must be independent of the fiduciary adviser as described in paragraph (b)(4)(iii), and must following its evaluation of a computer model prepare a written certification report. Paragraph (d) of the final rule, in turn, requires the fiduciary adviser to retain for a period of no less than 6 years any records necessary for determining whether the applicable requirements of the regulation have been met.

Accordingly, paragraph (b)(4)(i)(A) of the final rule has not been changed from the proposal. This provision requires that a computer model must be designed and operated to apply generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time, but also makes clear that the provision does not preclude a computer model from applying generally accepted investment theories that take into account additional considerations.

Paragraph (b)(4)(i)(B) of the final rule requires that a computer model must take into account investment management and other fees and expenses attendant to the recommended investments. No substantive comments were received on this provision, and it is being adopted unchanged from the proposal.

Paragraph (b)(4)(i)(C) of the final rule, as described below, reflects the requirement that was contained in paragraph (b)(4)(i)(E)(3) of the proposal.

Paragraph (b)(4)(i)(D) of the final rule, as with paragraph (b)(4)(i)(C) of the proposal, requires a computer model to request from a participant or beneficiary

and, to the extent furnished, utilize information relating to age, time horizons, risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences. The provision further makes clear, however, that a computer model is not precluded from requesting, and utilizing, other information from a participant or beneficiary. As discussed above in the description of paragraph (b)(3)(i)(C) (applicable to arrangements that use fee-leveling), the Department has not adopted commenter requests to remove the regulation's mandatory request for information from participants and beneficiaries. A few commenters also suggested that the Department revise the regulation to provide additional factors that must be considered in computer models, such as participant contribution rates and liquidity needs. Although paragraph (b)(4)(i)(D) has not been modified to reflect these factors, the Department notes that there is nothing in the final rule that expressly precludes a computer model from requesting and taking into account additional factors to the extent the model otherwise complies with the requirements of the regulation.

Paragraph (b)(4)(i)(D) of the proposal requires that a computer model must be designed and operated to utilize appropriate objective criteria to provide asset allocation portfolios comprised of investment options available under the plan. Paragraph (b)(4)(i)(E) of the proposal further requires that a computer model be designed and operated to avoid investment recommendations that inappropriately favor investment options offered by the fiduciary adviser or certain other persons, over other investment options, if any, available under the plan (paragraph (b)(4)(i)(E)(1)); inappropriately favor investment options that may generate greater income for the fiduciary adviser or certain other persons (paragraph (b)(4)(i)(E)(2)); or inappropriately 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 (paragraph (b)(4)(i)(E)(3)). With respect to paragraph (b)(4)(i)(E)(3), the Department explained that while some differences between investment options within a single asset class, such as differences in fees and expenses or management style, are likely to persist in the future and therefore to constitute appropriate criteria for asset allocation, other differences, such as differences in historical performance, are less likely to

persist and therefore less likely to constitute appropriate criteria for asset allocation; asset classes, in contrast, can more often be distinguished from one another on the basis of differences in their historical risk and return characteristics.

The Department did not receive any substantive comments with respect to paragraphs (b)(4)(i)(D), (b)(4)(i)(E)(1) and (2), and therefore is adopting these provisions as proposed, now at paragraphs (b)(4)(i)(E), (b)(4)(i)(F)(1) and (2) of the final rule. A number of commenters requested that the Department consider removing paragraph (b)(4)(i)(E)(3) of the proposal. Some opined that the test contained in that provision—which applies on an asset-class by asset-class basis—lacks sufficient clarity because it fails to define the essential term “asset class.” A commenter further noted that a rules-based definition of asset class, and the necessary confidence of future persistence, likely would be too vague or too restrictive. Some commenters also requested removal of this provision unless the Department clarifies that it would be acceptable for a computer model to take into account historical performance data. According to these commenters, the proposal's discussion of paragraph (b)(4)(i)(E)(3) and related computer model questions has been construed as strictly prohibiting, or strongly cautioning against, any consideration of historical performance data, even if considered in conjunction with other information. These commenters opined that a complete disregard of historical performance data would be inconsistent with generally accepted investment theories, as discussed above. Furthermore, some cautioned that, by limiting consideration to only those factors that can confidently be expected to persist in the future, a computer model might be limited to distinguishing between investment options solely on the basis of fees and expenses. A commenter noted that, other than fees, it could not identify any other factor with the necessary likelihood of persistence it believed would be required under the proposal. Although commenters generally agreed that fees are an important consideration, most recognized they should not be the only factor taken into account.

Several commenters indicated that, while the rule is limited to implementation of the statutory exemption for investment advice, any views the Department expresses with respect to investment theories and practices might be read as applying more generally to any fiduciary decision

relating to investments. Thus, a number of commenters expressed concern that the proposal, with its focus on historical performance data, superior past performance and fees, appeared to suggest that it would be impermissible under any circumstances for a plan fiduciary to pursue an active management style, or that a plan fiduciary would bear a very high burden of justification. Commenters also stated that the Department's proposal appeared to demonstrate a clear bias in favor of passive investment styles over active styles, which they believe to be premature because it is the subject of ongoing debate among investment experts.

Other commenters, however, questioned the utility of historical performance data beyond estimating future performance of an entire asset class. They further noted that, because the regulation permits a fiduciary adviser to provide investment recommendations to plan participants when the adviser has an interest in the investment options being recommended, there is the potential that the computer model might be designed to favor certain options by giving undue weight to historical performance data. They therefore stressed the importance of scrutinizing the use of historical performance data and supported the inclusion of paragraph (b)(4)(i)(E)(3) of the proposal.

Paragraph (b)(4)(i)(E)(3) of the proposal incorporated the generally-recognized premise that an investment option's historical performance on its own is not an adequate predictor of such investment option's future performance. The provision was not intended to prohibit a computer model from any consideration of an investment option's historical performance, as some commenters interpreted. Rather, as some commenters recognized, the provision is intended to ensure that in evaluating investment options for asset allocation, it would be appropriate and consistent with generally accepted investment theories for a computer model to take into account multiple factors, including historical performance, attaching weights to those factors based on surrounding facts and circumstances. As with the consideration of fees and expenses attendant to investment options, commenters generally recognized the importance of ensuring that historical performance of options is not given inappropriate weight. The Department is not persuaded by the comments received that the provision should be eliminated, however, to avoid further misinterpretation of the provision, the

requirement has been clarified and moved to paragraph (b)(4)(i)(C) of the final rule. This provision requires that a computer model must be designed and operated to appropriately weight the factors used in estimating future returns of investment options.

Paragraph (b)(4)(i)(G)(1) of the final rule, like paragraph (b)(4)(i)(F)(1) of the proposal, requires a computer model to take into account all "designated investment options" available under the plan without giving inappropriate weight to any investment option. The term "designated investment option" is defined in paragraph (c)(1) of the final rule to mean any investment option designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term "designated investment option" does not include "brokerage windows," "self-directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

As with paragraph (b)(4)(i)(F)(2) of the proposal, paragraph (b)(4)(i)(G)(2) of the final rule provides that a computer model will not be treated as failing to meet paragraph (b)(4)(i)(G)(1) merely because it does not make recommendations relating to the acquisition, holding or sale of certain types of investment options. Under the proposal, this exception applied to: qualifying employer securities; an investment that allocates the invested assets of a participant or beneficiary to achieve varying degrees of long-term appreciation and capital preservation through equity and fixed income exposures, based on a defined time horizon or level of risk of the participant or beneficiary; and an annuity option with respect to which a participant or beneficiary may allocate assets toward the purchase of a stream of retirement income payments guaranteed by an insurance company.

Several commenters suggested removal of one or more of these exceptions. Commenters noted that requiring computer models to be capable of providing recommendations with respect to employer securities could help participants avoid risks associated with overconcentrated investments in equity securities of a single company. As to asset allocation funds (e.g., lifecycle, or target date, funds), commenters noted that, if a computer model does not include recommendations on these popular investments, then interested participants would need to conduct their own research beyond the general

explanation required under the proposal.<sup>23</sup> With respect to in-plan annuity options, several commenters noted that these newly-developing options can help participants address longevity risk and improve retirement security, and that permitting their exclusion from computer model advice could result in low utilization by participants. A commenter also expressed confidence that, in the time since the Department's 2009 final rule, computer modeling technology has become sufficiently sophisticated to take in-plan annuity options into account.

The Department has decided to remove qualifying employer securities and asset allocations funds from the list of excepted options in paragraph (b)(4)(i)(G)(2). The Department believes that it is feasible to develop a computer model capable of addressing investments in qualifying employer securities, and that plan participants may significantly benefit from this advice. The Department also believes that participants who seek investment advice as they manage their plan investments would benefit from advice that takes into account asset allocation funds, if available under the plan. Based on recent experience in examining target date funds and similar investments, the Department believes it is feasible to design computer models with this capability.<sup>24</sup>

The Department, however, is less certain that computer models are able to give adequate consideration to in-plan annuity products, which permit a participant to allocate a portion of the assets in his or her plan account towards the purchase of an annuitized retirement benefit. In the absence of a better understanding of the computer modeling issues raised by in-plan annuities, the Department is hesitant to mandate their inclusion in a computer

<sup>23</sup> Under paragraph (b)(4)(i)(F)(2)(ii) of the proposal, the limitation for these types of funds was subject to the condition that the participant, contemporaneous with the provision of the computer-generated advice, would be furnished with a general description of the fund and how they operate.

<sup>24</sup> In 2009, the Department and the U.S. Securities and Exchange Commission (SEC) held a joint public hearing to examine issues related to the design and operation of target date funds and similar investments. See <http://www.dol.gov/ebsa/regs/cmt-targetdatefundshearing.html>. In 2010, the agencies jointly provided an Investor Bulletin to help investors and plan participants better understand the operations and risks of target date fund investments. See <http://www.dol.gov/ebsa/pdf/TDFInvestorbulletin.pdf>. The Department is in the process of developing regulations to address disclosures related to target date funds, 75 FR 73987 (Nov. 30, 2010), and also is currently developing guidance to assist plan sponsors in the selection and monitoring of target date funds for their plans.

model. The Department therefore is retaining the exception for in-plan annuity options. Thus, paragraph (b)(4)(i)(G)(2)(i) of the final rule provides that a computer model will not fail to satisfy paragraph (b)(4)(i)(G)(1) merely because it does not make recommendations relating to the acquisition, holding, or sale of an annuity option with respect to which a participant or beneficiary may allocate assets toward the purchase of a stream of retirement income payments guaranteed by an insurance company, provided that, contemporaneous with the provision of investment advice generated by the computer model, the participant or beneficiary is also furnished a general description of such options and how they operate. The Department notes, however, that even though paragraph (b)(4)(i)(G)(2)(i) permits a computer model to not make recommendations to allocate amounts to an in-plan annuity, amounts that a participant or beneficiary have already allocated to such an annuity must be taken into account by the computer model in developing the recommendation with respect to the investment of the participant's remaining available assets. The Department further notes that, while not mandated, there is nothing in the regulation that precludes a computer model from being designed to make recommendations to allocate amounts to an in-plan annuity, subject to the other conditions of the regulation being satisfied.

Also, the Department has added a new provision to reflect the interaction between paragraph (b)(4)(i)(G)(1) and paragraph (b)(4)(i)(C), which requires a computer model to request and, to the extent furnished, take into account a participant's investment preferences. This new provision, paragraph (b)(4)(i)(G)(2)(ii) of the final rule, provides that a computer model will not fail to satisfy paragraph (b)(4)(i)(G)(1) merely because it does not provide a recommendation with respect to an investment option that a participant or beneficiary requests to be excluded from consideration in such recommendations.

A commenter requested clarification as to whether an IRA with an unlimited universe of investment options would be treated similar to a brokerage window or self-directed brokerage account for purposes of this provision. Another commenter indicated that some IRAs permit beneficiaries to make investments in a limited universe of options, while also permitting them to hold other investments that are not offered by the IRA, and asked if

paragraph (b)(4)(i)(G)(1) would be violated if a computer model provides "buy" "hold" and "sell" recommendations with respect to the limited universe of options, while accommodating "hold" and "sell" recommendations for the investments not available through the IRA. While the Department believes that computer models should, with few exceptions, be required to model all investment options available under a plan or through an IRA, the Department does not believe that it is reasonable to expect that all computer models be capable of modeling the universe of investment options, rather than just those investment alternatives designated as available investments through the IRA. Accordingly, it is the view of the Department that a computer model would not fail to meet the requirements of paragraph (b)(4)(i)(G)(1) merely because it limits buy recommendations only to those investment options that can be bought through the plan or IRA, even if the model is capable of modeling hold and sell recommendations with respect to investments not available through the plan or IRA, provided, of course, that the plan participant or beneficiary or IRA beneficiary is fully informed of the model's limitations in advance of the recommendations, thereby enabling the recipient of advice to assess the usefulness of the recommendations.

## 2. Computer Model Certification

Paragraph (b)(4)(ii) of the final rule, like the proposal, requires that, prior to utilization of the computer model, the fiduciary adviser must obtain a written certification that the computer model meets the requirements of paragraph (b)(4)(i), discussed above. If the model is subsequently modified in a manner that may affect its ability to meet the requirements of paragraph (b)(4)(i), the fiduciary adviser, prior to utilization of the modified model, must obtain a new certification. The required certification must be made by an "eligible investment expert," within the meaning of paragraph (b)(4)(iii), and must be made in accordance with the requirements of paragraph (b)(4)(iv).

Paragraph (b)(4)(iii) of the final rule, like the proposal, defines an "eligible investment expert" to mean a person that, through employees or otherwise, has the appropriate technical training or experience and proficiency to analyze, determine and certify, in a manner consistent with paragraph (b)(4)(iv), whether a computer model meets the requirements of paragraph (b)(4)(i). Consistent with section 408(g)(3)(C)(iii) of ERISA, paragraph (b)(4)(iii) further

limits this definition by excluding certain parties that would not have sufficient independence from an arrangement to certify a computer model for compliance with the regulation. The proposal provided that the term "eligible investment expert" does not include any person that has any material affiliation or material contractual relationship with the fiduciary adviser, with a person with a material affiliation or material contractual relationship with the fiduciary adviser, or with any employee, agent, or registered representative of the foregoing.

Several commenters asked for additional guidance on the credentials necessary to serve as an "eligible investment expert." The Department previously attempted to define with greater specificity the qualifications of the eligible investment expert. It received public comments on this issue in response to a specific request for information published in 2006 and to similar proposed rules published in 2008.<sup>25</sup> At that time, it concluded that it could not define a specific set of academic or other credentials for an eligible investment expert. The Department continues to believe it would be very difficult to do so, and the comments received with respect to this most recent proposal did not provide significant additional information for consideration. As a result, no changes have been made to this aspect of the final rule. The Department notes, however, that as provided in paragraph (b)(4)(v) of the final rule, the fiduciary adviser's selection of the eligible investment expert is a fiduciary act governed by section 404(a)(1) of ERISA. Therefore, a fiduciary adviser must act prudently in its selection. Moreover, as the party seeking prohibited transaction relief under the exemption, the fiduciary adviser has the burden of demonstrating that all applicable requirements of the exemption are satisfied with respect to its arrangement.

Commenters raised general questions as to whether the provision of certain types of services for a fiduciary adviser would disqualify a person from acting as the "eligible investment expert" required under paragraph (b)(4) or as the independent auditor required under paragraph (b)(6).<sup>26</sup> With respect to the eligible investment expert, the Department believes that the 10% gross revenue test in the definition of the term "material contractual relationship,"

<sup>25</sup> See footnote 9, above.

<sup>26</sup> The Department's response as it relates to the independent auditor is contained in the discussion of the audit provisions, below.



which contemplates that there may be instances in which a person might be performing other services for a fiduciary adviser or affiliates, generally is sufficient to minimize any influence on the part of the fiduciary adviser by virtue of service relationships that might compromise the independence of the person in performing the certification under the regulation. However, the Department does not believe that a person who develops a computer model should be considered sufficiently independent to conduct a certification of the same model.<sup>27</sup> The exclusionary language of paragraph (b)(4)(iii) of the final rule has been modified accordingly, and provides that the term “eligible investment expert” does not include any person that: Has any material affiliation or material contractual relationship with the fiduciary adviser, with a person with a material affiliation or material contractual relationship with the fiduciary adviser, or with any employee, agent, or registered representative of the foregoing; or develops the computer model utilized by the fiduciary adviser to satisfy paragraph (b)(4).

One commenter asked whether the eligible investment expert must be bonded for purposes of section 412 of ERISA. In the view of the Department, an eligible investment expert, in performing the computer model certification described in the final rule, would neither be acting as a fiduciary under ERISA, nor be “handling” plan assets such that the bonding requirements would be applicable to the eligible investment expert.

Paragraph (b)(4)(iv) of the final rule provides that a certification by an eligible investment expert shall be in writing and contain the following: An identification of the methodology or methodologies applied in determining whether the computer model meets the requirements of paragraph (b)(4)(i) of the final rule; an explanation of how the applied methodology or methodologies demonstrated that the computer model met the requirements of paragraph (b)(4)(i); and a description of any limitations that were imposed by any person on the eligible investment expert’s selection or application of methodologies for determining whether the computer model meets the requirements of paragraph (b)(4)(i). In addition, the certification is required to

contain a representation that the methodology or methodologies were applied by a person or persons with the educational background, technical training or experience necessary to analyze and determine whether the computer model meets the requirements of paragraph (b)(4)(i); and a statement certifying that the eligible investment expert has determined that the computer model meets the requirements of paragraph (b)(4)(i). Finally the certification must be signed by the eligible investment expert. The Department received no comments on this provision and, accordingly, has adopted the provision as proposed.

Paragraph (b)(4)(v) of the final rule provides that the selection of an eligible investment expert as required by the regulation is a fiduciary act governed by section 404(a)(1) of ERISA. A commenter recommended that the eligible investment expert should be treated as a fiduciary under ERISA. The Department does not believe it would be appropriate, as part of this final rule, without further notice and comment to adopt such a potentially significant change. Accordingly, the Department has not adopted this recommendation.

#### d. Authorization by a Plan Fiduciary

Paragraph (b)(5)(i) of the final rule requires that, except as provided in paragraph (b)(5)(ii), the arrangement pursuant to which investment advice is provided to participants and beneficiaries must be expressly authorized by a plan fiduciary (or, in the case of an IRA, the IRA beneficiary) other than: The person offering the arrangement; any person providing designated investment options under the plan; or any affiliate of either. For purposes of this authorization, an IRA beneficiary will not be treated as an affiliate of a person solely by reason of being an employee of such person. Therefore, an IRA beneficiary is not precluded from providing the authorization required under paragraph (b)(5)(i) merely because the IRA beneficiary is an employee of the fiduciary adviser. Paragraph (b)(5)(iii) provides that a plan sponsor is not treated as a person providing a designated investment option under the plan merely because one of the designated investment options of the plan is an option that permits investment in securities of the plan sponsor or an affiliate. Therefore, a plan sponsor-fiduciary is not precluded from providing the authorization required by paragraph (b)(5)(i) merely because the plan includes qualifying employer securities as a designated investment option.

Paragraph (b)(5)(ii) addresses authorization in connection with the adviser’s own plan. This provision accommodates a fiduciary adviser’s provision of investment advice to its own employees (or employees of an affiliate) pursuant to an arrangement under the final rule, provided that the fiduciary adviser or affiliate offers the same arrangement to participants and beneficiaries of unaffiliated plans in the ordinary course of its business. The Department notes, however, that the statutory exemption does not provide relief for the selection of the fiduciary adviser or the arrangement pursuant to which advice will be provided. Accordingly, a plan fiduciary must nonetheless be prudent in its selection and may not, in contravention of ERISA section 406(b), use its position to benefit itself or a person in which such fiduciary has an interest that may affect the exercise of such fiduciary’s best judgment as a fiduciary. In this regard, the Department has indicated that if a fiduciary provides services to a plan without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services) the provision of such services does not, in and of itself, constitute an act described in section 406(b).<sup>28</sup>

One commenter asked whether paragraph (b)(5) requires authorization by the employer or the IRA beneficiary with respect to an employer-sponsored SIMPLE IRA, Savings Incentive Match Plan for Employees (SIMPLE) IRA plans and Simplified Employee Pension (SEP) plans are relatively uncomplicated IRA-based retirement savings vehicles that allow contributions to be made on a tax-favored basis to individual retirement accounts and individual retirement annuities (IRAs) owned by the employees. Although generally a SEP or SIMPLE IRA is a plan subject to Title I of ERISA, many of the rules applicable to other ERISA-covered employer sponsored pension plans do not apply to SIMPLE IRA and SEP plans.<sup>29</sup> For example, SIMPLE IRA and SEP plans are subject to minimal reporting and disclosure requirements.<sup>30</sup> Many employers that sponsor these IRA-based plans that are intended to be

<sup>28</sup> See 29 CFR 2550.408b-2(e)(3).

<sup>29</sup> See ERISA sections 101(h) (application of reporting requirements) and 404(c)(2) (application of fiduciary responsibility requirements). The Department treats SEP and SIMPLE IRA plans differently from other ERISA-covered pension plans in other contexts. See 29 CFR 2550.404a-5 (disclosures to participants in participant-directed individual account plans) and 2550.408b-2(c)(1) (disclosures to fiduciaries of pension plans).

<sup>30</sup> 29 CFR 2520.104-48 and 2520.104-49.

<sup>27</sup> For example, a person who develops a computer model used under the exemption generally is treated as a fiduciary adviser under paragraph (c)(2)(ii) of the final rule. However, the fiduciary election described in Sec. 2550.408g-2 permits another person to be treated as fiduciary adviser.

uncomplicated to establish and administer may not be willing to assume the duty to authorize an investment advice provider under the regulation, even one selected by an IRA beneficiary. This could limit access to fiduciary investment advice under the regulation for the participants and beneficiaries of such IRA-based plans. Under these circumstances, the Department has defined the term "IRA" in this regulation to include a "simplified employee pension" described in section 408(k) of the Code, and a "simple retirement account" described in section 408(p) of the Code. Thus, SIMPLE IRA plans and SEP plans would be treated like IRAs under the requirements of the final regulation, and the required authorization would be given by the participant or beneficiary to whom the account belongs and who receives the advice. The Department is interested in continuing to receive public input on the operation of the regulation in the context of SIMPLE IRA plans and SEP plans, especially the experience of participants and beneficiaries and, to the extent public input suggests that changes in this context are necessary, the Department may consider further adjustments to the regulation in the future.

#### e. Annual Audit

Paragraph (b)(6) of the final rule sets forth the annual audit requirements for the statutory exemption.<sup>31</sup> Paragraph (b)(6)(i), like the proposal, provides that the fiduciary adviser shall, at least annually, engage an independent auditor, who has appropriate technical training or experience and proficiency, and so represents in writing to the fiduciary adviser, to conduct an audit of the adviser's investment advice arrangements for compliance with the requirements of the regulation and, within 60 days following completion of the audit, to issue a written report to the fiduciary adviser and, except with respect to an arrangement with an IRA, to each fiduciary who authorized the use of the investment advice arrangement. The written report must set forth the specific findings of the auditor regarding compliance of the arrangement with the requirements of the regulation (paragraph (b)(6)(i)(B)(4)). However, as discussed below, because of the importance of the annual audit in helping an authorizing fiduciary monitor compliance of the arrangement, paragraph (b)(6)(i)(B) of the final rule, unlike the proposal, also enumerates certain basic information about the

audited arrangement that must be included in the audit report. Specifically, the report must identify the fiduciary adviser and the type of arrangement (*i.e.*, fee leveling, computer models, or both) (paragraphs (b)(6)(i)(B)(1) and (2)). Further, if the arrangement uses computer models, or both computer models and fee leveling, the report must also indicate the date of the most recent computer model certification, and identify the eligible investment expert that provided the certification (paragraph (b)(6)(i)(B)(3)). The Department believes that this basic information will benefit the authorizing fiduciary or IRA beneficiary in understanding the arrangement without imposing a significant burden on the auditor, which ordinarily will have such information.

Given the significant number of reports that an auditor would be required to send if the written report was required to be furnished to all IRA beneficiaries, the Department framed an alternative requirement for investment advice arrangements with IRAs. This alternative is set forth in paragraph (b)(6)(ii) of the proposal and the final rule. Under this provision, the fiduciary adviser must, within 30 days following receipt of the report from the auditor as required under paragraph (b)(6)(i)(B), furnish a copy of the report to the IRA beneficiary or make such report available on its Web site, provided that such beneficiaries are provided information, along with other required participant disclosures (see paragraph (b)(7) of the final rule), concerning the purpose of the report, and how and where to locate the report applicable to their account. The Department believes that making reports available on a Web site in this manner to IRA beneficiaries satisfies the requirement of section 104(d)(1) of the Electronic Signatures in Global and National Commerce Act (E-SIGN)<sup>32</sup> that any exemption from the consumer consent requirements of section 101(c) of E-SIGN must be necessary to eliminate a substantial burden on electronic commerce and will not increase the material risk of harm to consumers. The Department solicited comments on this finding in connection with the prior proposal, and received no comments in response.<sup>33</sup>

Obtaining consent from each IRA holder or participant before publication on the Web site would be a tremendous burden on the plan or IRA provider. This element, along with the broad availability of Internet access and the lack of any direct consequences to any

particular participant for a failure to review the audit for the participants and beneficiaries, supports these findings.

As with the proposal, paragraph (b)(6)(ii) of the final rule also provides with respect to an arrangement with an IRA that, if the report of the auditor identifies noncompliance with the requirements of the regulation, then the fiduciary adviser must send a copy of the report to the Department. The final rule, like the proposal, requires that the fiduciary adviser submit the report to the Department within 30 days following receipt of the report from the auditor. This report will enable the Department to monitor compliance with the statutory exemption.

Some commenters expressed concern with the requirement in paragraph (b)(6)(ii)(B) that the fiduciary adviser must send a copy of the auditor's report to the Department if that report identifies instances of noncompliance. They recommended that reports only be required to be filed with the Department when there is "material" noncompliance. Other commenters recommended that fiduciary advisers be afforded a period within which to self-correct prior to the reporting of noncompliance. This filing requirement will enable the Department to monitor compliance with the exemption in those instances where there is no authorizing ERISA plan fiduciary to carry out that function. While it recognizes that not every instance of noncompliance would, itself, affect the quality of the advice provided to an IRA beneficiary, the Department believes that, given the overall significance of the audit as a protection for advice recipients, all reports that identify noncompliance in this area should be furnished to the Department for review, thereby giving it the opportunity to evaluate the significance of the noncompliance, the function that an authorizing plan fiduciary would carry out for its plan. Accordingly, the Department is adopting the filing requirement as proposed without substantive change. We note, however, that language has been added to paragraph (b)(6)(ii)(B) to provide a means for electronic submission to the Department.

A commenter suggested that plan participants should be informed of audit results. The Department does not believe it is appropriate as part of the final rule, without further notice and comment, to adopt such a requirement, which could involve a significant number of audit reports being furnished to plan participants. The Department believes that the furnishing of the audit report to the authorizing plan fiduciary, who must act prudently and solely in

<sup>31</sup> The audit provisions are set forth in section 408(g)(6) of ERISA.

<sup>32</sup> 15 U.S.C. 7004(d)(1) (2000).

<sup>33</sup> See 74 FR 3829 (Jan. 21, 2009).

the interest of plan participants, is sufficient to protect the interests of participants and beneficiaries. The fiduciary should examine the audit report furnished and, if noncompliance is identified, take appropriate steps. Because of the importance of the audit report, the Department has included a new provision, at paragraph (b)(8), which requires that the fiduciary adviser provide the authorizing fiduciary with written notification that the fiduciary adviser intends to comply with the statutory exemption and the regulations and that the fiduciary adviser's investment advice arrangement will be audited annually by an independent auditor for compliance, and that the auditor will furnish the authorizing fiduciary with a copy of that auditor's findings within 60 days of its completion of the audit. This disclosure serves to place the authorizing fiduciary on notice that an audit will be conducted annually and that a report of that audit will be furnished. The Department would expect the authorizing fiduciary to take reasonable steps if the report is not furnished in a timely manner, such as making inquiries with the auditor, the fiduciary adviser, or both.

With regard to the person who conducts the audit, one commenter recommended that the auditor should be treated as a fiduciary. Others asked if the audit must be conducted by a certified public accountant. Another requested that the final rule provide additional guidance with respect to necessary credentials to conduct an audit, such as minimum standards of experience, education, or professional certification or licensing. As with the requirements for an "eligible investment expert," the Department does not believe there is necessarily one set of credentials, such as being a certified public accountant, auditor, or lawyer, that qualifies an individual to conduct the required audits. In addition to any licenses, certifications or other evidence of professional or technical training, a fiduciary adviser will want to consider the relevance of that training to the required audit, as well as the individual's or organization's experience and proficiency in conducting similar types of audits. In this regard, because the selection of an auditor is a fiduciary act (see paragraph (b)(6)(v)), a fiduciary adviser's selection must be carried out in a manner consistent with the prudence requirements of section 404(a)(1), taking into account the nature and scope of the audit and the expertise and experience necessary to conduct such an audit.

Paragraph (b)(6)(iii) describes the circumstances under which an auditor will be considered independent for purposes of paragraph (b)(6). As proposed, this paragraph required that the auditor 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. The terms "material affiliation" and "material contractual relationship" are defined in paragraphs (c)(6) and (7) of the final rule, respectively. Some commenters asked whether an auditor's provision of certain services (e.g., computer model certification required under the regulation) would disqualify the auditor. The Department believes that the 10% gross revenue test in the definition of the term "material contractual relationship," which contemplates that there may be instances in which an auditor might be performing other services for a fiduciary adviser or affiliates, generally is sufficient to minimize any influence on the part of the fiduciary adviser by virtue of service relationships that would serve to compromise the independence of the auditor. However, if an auditor participates in the development of a fiduciary adviser's investment advice arrangement, then the auditor would appear to be in a position of auditing its own work for compliance with the exemption. The Department does not believe such an auditor is sufficiently independent for purposes of the regulation. Similarly, in the case of an investment advice arrangement that uses computer modeling, because an auditor would be in the position of determining whether the person who certifies a computer model, as required by paragraph (b)(4)(ii), has any relationship that would preclude it from acting as an "eligible investment expert" as defined in paragraph (b)(4)(iii), the Department does not believe an auditor may also act as the computer model certifier. Paragraph (b)(6)(iii) has been modified accordingly.

With regard to the scope of the audit, paragraph (b)(6)(iv) of the final rule provides that the auditor shall review sufficient relevant information to formulate an opinion as to whether the investment advice arrangements, and the advice provided pursuant thereto, offered by the fiduciary adviser during the audit period were in compliance with the regulation. Paragraph (b)(6)(iv) further provides that it is not intended to preclude an auditor from using information obtained by sampling, as

reasonably determined appropriate by the auditor, investment advice arrangements, and the advice pursuant thereto, during the audit period. The final rule, like the proposal, does not require an audit of every investment advice arrangement at the plan or fiduciary adviser-level or of all the advice that is provided under the exemption. In general, the final rule appropriately leaves to the auditor the determination of how to conduct its review, including the extent to which it can rely on representative samples for determining compliance with the exemption.

A number of comments requested clarification with respect to the conduct and scope of the audit. Several commenters asked whether each plan, IRA, and participant and beneficiary must be included. A commenter also asked whether the audit could be performed by only reviewing documentation of compliance with the fiduciary adviser's internal compliance policies and procedures. As discussed above, the audit provisions of the final rule require that the auditor review sufficient information to formulate an opinion as to whether the investment advice arrangements, and the advice provided pursuant thereto, are in compliance with the final rule. Accordingly, the methods used to conduct the audit are to be determined by the auditor. The Department does note, however, that nothing in these provisions precludes the auditor from using sampling, as determined reasonably appropriate by the auditor, of investment advice arrangements and investment advice. The Department expects that the sample used by an auditor will depend on the facts and circumstances encountered. For example, an auditor may initially believe that the most appropriate way to make the required findings is to construct a sample that represents a subset of all advice arrangements of a fiduciary adviser, and advice provided. In testing the sample, however, the auditor should look for, and may find, patterns of compliance failures that indicate that certain areas are more prone to compliance failures than others. If such patterns appear, the auditor may need to expand the sample to more accurately assess the extent and causes of noncompliance. While the Department believes that internal policies and procedures, if reasonably designed and followed, can be helpful to a fiduciary adviser to ensure compliance with the requirements of the regulation, the Department does not believe it would be appropriate for an

auditor to limit, in any way, the conduct of its audit to an examination of compliance with those policies and procedures.

Another commenter appeared to suggest development of audit alternatives for fiduciary advisers that are regulated and subject to periodic examination by other agencies. This commenter, however, did not include sufficient information for further consideration. The Department notes, moreover, that section 408(g)(6) of ERISA requires an annual audit for compliance with the exemption.

Paragraph (b)(6)(v) of the final rule, like the proposal, provides that for purposes of the statutory exemption, the selection of an auditor is a fiduciary act governed by section 404(a)(1) of ERISA. In response to a question from a commenter, the Department notes that, in its view, the performance of an audit under the final rule would not, by itself, cause an auditor to be a fiduciary under ERISA.

#### f. Disclosure to Participants

As in the proposal, paragraph (b)(7) of the final rule sets forth a number of requirements involving disclosures to participants and beneficiaries that are based on, and generally track, the disclosure requirements contained in section 408(g)(6).

Paragraph (b)(7)(i) generally requires that the fiduciary adviser provide to participants and beneficiaries without charge, prior to the initial provision of investment advice with regard to any security or other property offered as an investment option, a written notification describing: the role of any party that has a material affiliation or material contractual relationship with the fiduciary adviser in the development of the investment advice program and in the selection of investment options available under the plan; the past performance and historical rates of return of the designated investment options available under the plan, to the extent that such information is not otherwise provided; all fees or other compensation relating to the advice that the fiduciary adviser or any affiliate thereof is to receive (including compensation provided by any third party) in connection with the provision of the advice, the sale, acquisition, or holding of the security or other property pursuant to such advice, or any rollover or other distribution of plan assets or the investment of distributed assets in any security or other property pursuant to such advice; and any material affiliation or material contractual relationship of the fiduciary adviser or

affiliates thereof in the security or other property.

The notification to participants and beneficiaries also is required to explain: the manner, and under what circumstances, any participant or beneficiary information provided under the arrangement will be used or disclosed; the types of services provided by the fiduciary adviser in connection with the provision of investment advice by the fiduciary adviser; that the adviser is acting as a fiduciary of the plan in connection with the provision of the 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. Because the computer model exception for qualifying employer securities has been removed from paragraph (b)(4)(i)(G)(2), explained above, the language in paragraph (b)(7)(i)(F) of the proposal that required the notification to include any limitations with respect to a computer model's ability to take into account qualifying employer securities also has been removed.

Paragraph (b)(7)(ii)(A) of the final rule requires that the notification furnished to participants and beneficiaries must be written in a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant and must be sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of the information required to be provided in the notification.

Paragraph (b)(7)(ii)(B) of the final rule references the availability of a model disclosure form in the appendix to the final rule. As with the proposal, the model disclosure form may be used for purposes of satisfying the requirements set forth in paragraph (b)(7)(i)(C), as well as the requirements of paragraph (b)(7)(ii)(A) of the final rule. The final rule, like the proposal, makes clear, however, that the use of the model disclosure form is not mandatory.

The Department received a number of comments related to the contents and timing of the disclosures required under paragraph (b)(7). One commenter suggested that the final rule require the disclosure be provided at least 14 days before the initial provision of investment advice, and further require that each advice session be accompanied by a summary disclosure that includes a subset of the information required under the proposal (e.g., fees or other compensation that may be received, and that the adviser is acting

as a fiduciary). Another commenter recommended disclosure of each investment option's profitability to the fiduciary advisers or their affiliates, suggesting that this would enable participants to better understand the advisers' financial interests. In contrast, another commenter stated that requiring disclosure of "all" fees or other compensation could overwhelm participants and beneficiaries with information, and that the Department should instead adopt a materiality standard for such disclosure. Another commenter suggested removal of the past return information disclosure, arguing that participants may focus on investments with the highest returns without considering or understanding the associated risks. Another commenter suggested that the provision should require disclosure of historical rates of return at the asset class level, rather than the individual investment level. Others also indicated the practical difficulties in providing the proposal's disclosures for plans with numerous investment options, and requested that the Department consider more limited disclosures.

After consideration of the comments received, the Department believes that the statutory disclosure framework, reflected in both the proposal and final rule, strikes the appropriate balance in terms of ensuring participants and beneficiaries have the information to assess the potential for conflicts of interest and compensation of the fiduciary adviser.

Some commenters requested that the Department clarify that the required disclosures may be combined with other disclosures the adviser is required to furnish under securities or other laws. It is the view of the Department that nothing in the final rule forecloses the use of other materials for making the disclosures required by the final rule, so long as the understandability and clarity of the disclosures is not compromised by virtue of their inclusion in such other materials and the requirements of paragraph (b)(7)(ii)(A) are satisfied.

Like the proposal, paragraph (b)(7)(iii) of the final rule provides that the required notifications may, in accordance with 29 CFR 2520.104b-1, be furnished in either written or electronic form. Some commenters requested more flexibility for electronic disclosures than is permitted under 29 CFR 2520.104b-1. Others, however, suggested more limited use of electronic disclosures. Because the Department currently is reviewing issues related to use of electronic media to furnish information to participants and beneficiaries, this provision has not

been changed from the proposal in response to these comments.<sup>34</sup>

Paragraph (b)(7)(iv) of the final rule sets forth miscellaneous recordkeeping and furnishing responsibilities of the fiduciary adviser. Specifically, this paragraph requires that, at all times during the provision of advisory services to the participant or beneficiary pursuant to the arrangement, the fiduciary adviser must: Maintain the information required to be disclosed to participants and beneficiaries in accurate form; provide, without charge, accurate, up-to-date disclosures to the recipient of the advice no less frequently than annually; provide, without charge, accurate information to the recipient of the advice upon request of the recipient; and provide, without charge, to the recipient of the advice any material change to the required information at a time reasonably contemporaneous to the change in information. These provisions are being adopted in the final rule without substantive change from the proposal.

#### g. Disclosure to Authorizing Fiduciary

As discussed in more detail above in connection with the audit provision, paragraph (b)(8) of the final rule is a new provision that requires disclosure of certain information to the fiduciary that authorizes an investment advice arrangement. Under this provision, the fiduciary adviser must provide the authorizing fiduciary with a written notification that the fiduciary adviser intends to comply with the conditions of the statutory exemption for investment advice under section 408(b)(14) and (g) and this regulation. The notification also must inform the authorizing fiduciary that the fiduciary adviser's arrangement will be audited annually by an independent auditor for compliance with the requirements of the statutory exemption and this regulation, and that the auditor will furnish the authorizing fiduciary a copy of that auditor's findings within 60 days of its completion of the audit.

Because paragraph (b)(5) of the rule already requires authorization by an independent fiduciary, the Department does not believe the notification requirement in paragraph (b)(8) will impose a significant additional burden on fiduciary advisers.

#### h. Other Conditions

Paragraph (b)(9) of the final rule, like paragraph (b)(8) of the proposal, sets forth the additional requirements contained in section 408(g)(7) of ERISA that apply to the provision of

investment advice under the statutory exemption. These requirements are as follows: 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 (paragraph (b)(9)(i)); any sale, acquisition, or holding of a security or other property occurs solely at the direction of the recipient of the advice (paragraph (b)(9)(ii)); the compensation received by the fiduciary adviser and affiliates thereof in connection with the sale, acquisition, or holding of the security or other property is reasonable (paragraph (b)(9)(iii)); and the terms of the sale, acquisition, or holding of the security or other property are at least as favorable to the plan as an arm's length transaction would be (paragraph (b)(9)(iv)). This provision is unchanged from the corresponding provision of the proposal.

A commenter described a situation where an IRA owner or participant gives standing instructions to rebalance his or her portfolio on a pre-determined basis (which the commenter referred to as "ministerial rebalancing") and another situation where changes to a portfolio are permitted when a model changes and the client receives advance notice (which the commenter referred to as "re-optimization" or "re-allocation"), and asked whether these were consistent with the requirement in paragraph (b)(9)(ii) that any sale, acquisition or holding of a security or other property occurs solely at the direction of the recipient of the advice.

In general, it is the view of the Department that a pre-authorization for a fiduciary adviser to maintain a particular asset allocation structure for a participant's portfolio by periodic rebalancing of investments would not violate the "solely at the direction" requirement in paragraph (b)(9)(ii), provided that such maintenance does not involve the exercise of discretion on the part of the fiduciary adviser, that is, when a participant is informed of and approves, at the time of the authorization, the specific circumstances under which a rebalancing of his or her portfolio will take place and the particular investments that will be utilized for such rebalancing. If, on the other hand, the particular investments that might be utilized for purposes of rebalancing a participant's account are not known and the fiduciary adviser is given the discretion to select the required investments, it is the view of the Department that, in order to avoid violating paragraph (b)(9)(ii), the

participant must be afforded advance notice of the fiduciary adviser's intended investments and a reasonable opportunity, generally at least 30 days, to object to the investments. With respect to a different asset allocation structure, the Department believes that the participant or beneficiary must make an affirmative direction for its implementation.

#### i. Definitions

Paragraph (c) sets forth definitions of terms used in the final rule.

Paragraph (c)(1) defines the term "designated investment option." The term "designated investment option" means any investment option designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term "designated investment option" shall not include "brokerage windows," "self-directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan. The Department has added a cross-reference to clarify that the term "designated investment option" has the same meaning as "designated investment alternative" as defined in 29 CFR 2550.404a-5 (relating to certain disclosures to participants).

Paragraph (c)(2) defines the term "fiduciary adviser," as it appears in section 408(g)(11)(A) of ERISA. A commenter suggested that paragraph (c)(2)(ii), which treats a person who develops the computer model or markets the investment advice program or computer model utilized in satisfaction of paragraph (b)(4) as a fiduciary adviser, is overly broad, and could result in higher costs overall and fewer parties willing to provide these functions. In response, the Department notes that such fiduciary status is conferred by statute at section 408(g)(11)(A). However, the Department further notes that Sec. 2550.408g-2, discussed in more detail below, permits one such fiduciary to elect to be treated as a fiduciary with respect to the plan.

Paragraph (c)(3) defines the term "registered representative" as set forth in ERISA section 408(g)(11)(C), which states that a registered representative of another entity means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(18)) (substituting the entity for the broker or dealer referred to in such section) or a person described in section 202(a)(17) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(17)) (substituting the entity for the

<sup>34</sup> See 76 FR 19285 (Apr. 7, 2011).

investment adviser referred to in such section).

Paragraph (c)(4), consistent with section 601(b)(3)(A)(i) of the PPA, generally defines the term “Individual Retirement Account” or “IRA” for purposes of the final rule to mean plans described in paragraphs (B) through (F) of section 4975(e)(1) of the Code, as well as a trust, plan, account, or annuity which, at any time, has been determined by the Secretary of the Treasury to be described in such paragraphs. However, as explained above, paragraphs (c)(4)(vii) and (c)(4)(viii) have been added to make clear that for purposes of the regulation, the term “IRA” includes a “simplified employee pension” described in section 408(k) of the Code, and a “simple retirement account” described in section 408(p) of the Code.

Like the proposal, paragraph (c)(5) of the final rule defines the term “affiliate.” Under this provision, an “affiliate” of another person means: Any person directly or indirectly owning, controlling, or holding with power to vote, 5 percent or more of the outstanding voting securities of such other person (paragraph (c)(5)(i)); any person 5 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person (paragraph (c)(5)(ii)); any person directly or indirectly controlling, controlled by, or under common control with, such other person (paragraph (c)(5)(iii)); and any officer, director, partner, copartner, or employee of such other person (paragraph (c)(5)(iv)). Consistent with ERISA section 408(g)(11)(B), this definition is based on the definition of an “affiliated person” of an entity as contained in section 2(a)(3) of the Investment Company Act of 1940 (ICA) (15 U.S.C. sec. 80a–2(a)(3)), except that it does not reflect clauses (E) and (F) thereof. The Department has determined that including provisions similar to clauses (E) and (F) is unnecessary, because these clauses appear to focus on persons who exercise control over the management of an investment company.<sup>35</sup> These persons would be treated as affiliates under paragraph (c)(5)(iii) of the final rule because they would be persons directly or indirectly controlling,

controlled by, or under common control with, such other person.

A number of commenters presented factual questions on the definition of “affiliate” in paragraph (c)(5). These have not been addressed here because of their inherently factual nature.

One comment requested that the Department instead adopt the definition of “affiliate” that applies under 29 CFR 2510.3–21. For purposes of that regulation, an “affiliate” of a person includes: Any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such person; any officer, director, partner, employee or relative (as defined in ERISA section 3(15)) of such person; and any corporation or partnership of which such person is an officer, director or partner.<sup>36</sup> Because section 408(g)(11)(B) of ERISA defines the term “affiliate” for purposes of the statutory exemption specifically by reference to the definition in section 2(a)(3) of the ICA, the Department has not adopted this comment.

In a variety of places, the final rule refers to persons with “material affiliations” or “material contractual relationships,” which are defined in paragraphs (c)(6) and (c)(7), respectively. Paragraph (c)(6)(i) of the final rule describes a person with a “material affiliation” with another person as: Any affiliate of the other person; any person directly or indirectly owning, controlling, or holding, 5 percent or more of the interests of such other person; and any person 5 percent or more of whose interests are directly or indirectly owned, controlled, or held, by such other person. Paragraph (c)(6)(ii) provides that, for these purposes, an “interest” means with respect to an entity: The combined voting power of all classes of stock entitled to vote or the total value of the shares of all classes of stock of the entity if the entity is a corporation; the capital interest or the profits interest of the entity if the entity is a partnership; or the beneficial interest of the entity if the entity is a trust or unincorporated enterprise.

Paragraph (c)(7) of the final rule provides that persons shall be treated as having a “material contractual relationship” if payments made by one person to the other person pursuant to written contracts or agreements between the persons exceed 10 percent of the gross revenue, on an annual basis, of such other person. The Department notes that this 10% gross revenue test is not limited to amounts paid pursuant to

contracts or arrangements that have been reduced to writing.<sup>37</sup>

Lastly, paragraph (c)(8) defines “control” to mean the power to exercise a controlling influence over the management or policies of a person other than an individual.

#### j. Retention of Records

As with the proposal, paragraph (d) of the final rule sets forth the record retention requirements applicable to an eligible investment advice arrangement. Consistent with section 408(g)(9) of ERISA, paragraph (d) provides that the fiduciary adviser must maintain, for a period of not less than 6 years after the provision of investment advice under the section any records necessary for determining whether the applicable requirements of the final rule have been met, noting that a transaction prohibited under section 406 of ERISA shall not be considered to have occurred solely because the records are lost or destroyed prior to the end of the 6-year period due to circumstances beyond the control of the fiduciary adviser.

#### k. Noncompliance

Paragraph (e) of the final rule, like the proposal, specifically addresses the consequences of noncompliance with the regulation. This provision makes clear that the prohibited transaction relief described in paragraph (b) of the regulation will not apply to any transaction with respect to which the applicable conditions of the final rule have not been satisfied. Further, in the case of a pattern or practice of noncompliance with any of the applicable conditions of the final rule, the relief will not apply to any transaction in connection with the provision of investment advice provided by the fiduciary adviser during the period over which the pattern or practice extended. With respect to what would constitute a “pattern or practice,” the Department believes that it is important to identify both individual violations and patterns of such violations. Isolated, unrelated, or accidental occurrences would not themselves constitute a pattern or practice. However, intentional, regular, deliberate practices involving more than isolated events or individuals, or institutionalized practices will almost always constitute a pattern or practice. In determining whether a pattern or practice exists, the Department will consider whether the noncompliance appears to be part of either written or unwritten policies or established

<sup>35</sup> ICA section 2(a)(3)(E) and (F) include in the definition of an affiliated person: If the other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and if such other person is an unincorporated investment company not having a board of directors, the depositor thereof. 15 U.S.C. 80a–2(a)(3)(E)–(F).

<sup>36</sup> 29 CFR 2510.3–21(e)(1).

<sup>37</sup> See 74 FR 3822 (Jan. 21, 2009) (explaining corresponding language in the 2009 final rule).

practices, whether there is evidence of similar noncompliance with respect to more than one plan or arrangement, and whether the noncompliance is within a fiduciary adviser's control.

This provision is being adopted without change from the proposal. The Department believes that one of the most significant deterrents to noncompliance with the conditions of the statutory exemption is the potentially significant excise taxes applicable to transactions that fail to satisfy its conditions, and that extending the potential for excise taxes to encompass a period over which a pattern or practice of noncompliance extends creates additional incentives on the part of fiduciary advisers that take advantage of the exemptive relief to be vigilant in assuring compliance.

#### l. Effective Date

The Department proposed that the regulation would be effective 60 days after the date of publication of the final rule. One commenter indicated that the 60 day effective date would not constitute sufficient time to comply with the final rule, and suggested the effective date should be extended to 180 days after publication of the final rule.

Given the importance of investment advice to participants and beneficiaries generally and given that the exemption implemented in the final rule will expand the opportunity for participant and beneficiaries to obtain affordable, quality investment advice, the Department believes that the final rule should be effective on the earliest possible date, and has not made the suggested change. Accordingly, the final rule contained in this document will be effective 60 days after the date of publication in the **Federal Register** and will apply to transactions described in paragraphs (b) of the final rule occurring on or after that date.

#### m. Miscellaneous

A number of commenters made suggestions beyond the scope of this regulation that they believed would additionally benefit participants and beneficiaries. These suggestions were not adopted by the Department.

#### C. Overview of Final § 2550.408g-2 and Public Comments

Section 408(g)(11)(A) of ERISA provides that, with respect to an arrangement that relies on use of a computer model to qualify as an "eligible investment advice arrangement" under the statutory exemption, a person who develops the computer model, or markets the investment advice program or computer

model, shall be treated as a fiduciary of a plan by reason of the provision of investment advice referred to in ERISA section 3(21)(A)(ii) to the plan participant or beneficiary. Such a person also shall be treated as a "fiduciary adviser" for purposes of ERISA sections 408(b)(14) and 408(g). The Secretary of Labor, however, may prescribe rules under which only one fiduciary adviser may elect to be treated as a fiduciary with respect to the plan. Section 4975(f)(8)(j)(i) of the Code contains a parallel provision to ERISA section 408(g)(11)(A) that applies for purposes of Code sections 4975(d)(17) and 4975(f)(8).

In conjunction with the proposed regulation implementing the statutory exemption for investment advice, the Department also proposed a rule, Sec. 2550.408g-2, governing the requirements for electing to be treated as a fiduciary and fiduciary adviser by reason of developing or marketing a computer model or an investment advice program used in an eligible investment advice arrangement. Section 2550.408g-2 sets forth requirements that must be satisfied in order for one such fiduciary adviser to elect to be treated as a fiduciary with respect to a plan under such an eligible investment advice arrangement. See paragraph (a) of Sec. 2550.408g-2.

Paragraph (b)(1) of Sec. 2550.408g-2 provides that, if an election meets the requirements of paragraph (b)(2), then the person identified in the election shall be the sole fiduciary adviser treated as a fiduciary by reason of developing or marketing a computer model, or marketing an investment advice program, used in an eligible investment advice arrangement. Paragraph (b)(2) requires that the election be in writing and that the writing identify the arrangement, and person offering the arrangement, with respect to which the election is to be effective. The writing also must identify the electing person. Under paragraph (b)(2)(ii), the electing person must: fall within any of paragraphs (c)(2)(i)(A) through (E) of Sec. 2550.408g-1; develop the computer model or market the computer model or investment advice program; and acknowledge that it elects to be treated as the only fiduciary, and fiduciary adviser, by reason of developing such computer model or marketing such computer model or investment advice program. Paragraph (b)(2) of Sec. 2550.408g-2 requires that the election be signed by the person acknowledging that it elects to be treated as the only fiduciary and fiduciary adviser; that a copy of the election be furnished to the person who

authorized use of the arrangement; and that the writing be retained in accordance with the record retention requirements of Sec. 2550.408g-1(d).

The Department notes that this election applies only for purposes of limiting fiduciary status that results from developing or marketing a computer model or investment advice program used under the statutory exemption. It would not, for example, permit a fiduciary adviser who actually renders investment advice to participants or beneficiaries to avoid fiduciary status.

The Department received no substantive comments on this regulation and, therefore, is adopting the regulation substantially as proposed. This regulation, like Sec. 2550.408g-1, will be effective 60 days after the date of publication of the final rule in the **Federal Register**.

#### D. Regulatory Impact Analysis

##### Regulatory Procedures

*Executive Order 12866 "Regulatory Planning and Review" and Executive Order 13563 "Improving Regulation and Regulatory Review"*

Executive Orders 12866 and 13563 direct agencies to assess all costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. Executive Order 12866 and 13563 require a comprehensive regulatory impact analysis be performed for any economically significant regulatory action, defined as an action that would result in an annual effect of \$100 million or more on the national economy or which would have other substantial impacts. In accordance with OMB Circular A-4, the Department has examined the economic and policy implications of this final rule and has concluded that the action's benefits justify its costs.

##### Summary of Impacts

The provisions of this final regulation reflect the Department's efforts to ensure that the advice provided pursuant to them will be affordable and of high quality. The results of this final regulation will depend on its impacts on the availability, cost, use, and quality of participant investment advice. The

Department anticipates that, as a result of these actions, quality, affordable expert investment advice will proliferate, producing significant net gains for participant-directed defined contribution (DC) plan participants and beneficiaries and beneficiaries of individual retirement accounts (IRAs) (collectively hereafter, “participants”). The improved investment results will

reflect reductions in investment errors such as poor trading strategies and inadequate diversification.

The Department estimates that this final rule will yield benefits of between \$7 billion and \$18 billion annually, at a cost of between \$2 billion and \$5 billion, thereby producing a net financial benefit of between \$5 billion and \$13 billion. The estimated costs of

the final regulation include costs of approximately \$745 million that are associated with the Paperwork Reduction Act information collection requests contained in the final rule. Table 1 below presents these average annual real benefits and costs given a ten year horizon with discount rates of 3 percent and 7 percent.

TABLE 1—ACCOUNTING STATEMENT

| Category                                     | Estimates  |              |               | Units       |               |                |
|--|--|--------------|---------------|-------------|---------------|----------------|
|  | Primary estimate   | Low estimate | High estimate | Year dollar | Discount rate | Period covered |
| <b>Benefits:</b>                             |  |              |               |             |               |                |
| Annualized .....                             | 13,200.0   | 7,000.0      | 18,300.0      | 2009        | 7%            | 2011–2020      |
| Monetized (\$millions/year) .....            | 13,200.0   | 7,000.0      | 18,300.0      | 2009        | 3%            | 2011–2020      |
| Annualized .....                             | 0.0  | 0.0          | 0.0           | .....       | 7%            |                |
| Quantified .....                             | 0.0  | 0.0          | 0.0           | .....       | 3%            |                |
| Qualitative .....                            | In addition to the quantified benefits, the Department anticipates that the regulation will improve aggregate investment results, reflecting reduced participants’ investment related expenses, and will improve the welfare of participants by better aligning participant investments and their risk tolerances. |              |               |             |               |                |
| Notes .....                                  | The regulation is anticipated to extend quality, expert investment advice to a significantly greater number of participants. This will improve aggregate investment results, reflecting reductions in investment errors (including poor trading strategies and inadequate diversification).                        |              |               |             |               |                |
| <b>Costs:</b>                                |  |              |               |             |               |                |
| Annualized .....                             | 3,700.0  | 1,900.0      | 5,100.0       | 2009        | 7%            | 2011–2020      |
| Monetized (\$millions/year) .....            | 3,700.0  | 1,900.0      | 5,100.0       | 2009        | 3%            | 2011–2020      |
| Annualized .....                             | 0.0  | 0.0          | 0.0           | .....       | 7%            |                |
| Quantified .....                             | 0.0  | 0.0          | 0.0           | .....       | 3%            |                |
| Qualitative .....                            |  |              |               |             |               |                |
| Notes .....                                  | The costs of this regulation are due to the direct cost of providing (or paying for) investment advice, including approximately \$745 million that are associated with the Paperwork Reduction Act information collection requests contained in this final rule.   |              |               |             |               |                |
| Transfers .....                              | Not applicable.  |              |               |             |               |                |
| <b>Effects:</b>                              |  |              |               |             |               |                |
| State, Local, and/or Tribal Government ..... | Not applicable.  |              |               |             |               |                |
| Small Business .....                         | Not applicable.  |              |               |             |               |                |
| Wages .....                                  | Not applicable.  |              |               |             |               |                |
| Growth .....                                 | The regulation may also have macroeconomic consequences, which are likely to be small but positive.  |              |               |             |               |                |

**Need for Regulatory Action**

With the growth of participant-directed retirement savings accounts, the retirement income security of America’s workers increasingly depends on their investment decisions. Unfortunately, there is evidence that many participants of these retirement accounts often make costly investment errors due to flawed information or reasoning. As more fully discussed in the Benefits section below, these participants may make financial mistakes which result in lower asset accumulation, and thus final retirement account balances, for these individuals and/or result in less than optimal levels

of compensated risk. Financial losses (including foregone earnings) from such mistakes likely amounted to more than \$114 billion in 2010.<sup>38</sup> These losses compound and grow larger as workers progress toward and into retirement.

Such mistakes and consequent losses historically can be attributed at least in part to provisions of the Employee Retirement Income Security Act of 1974 that effectively preclude a variety of arrangements whereby financial professionals might otherwise provide

retirement plan participants with expert investment advice. Specifically, these “prohibited transaction” provisions of section 406 of ERISA and section 4975 of the Internal Revenue Code prohibit fiduciaries from dealing with DC plan or IRA assets in ways that advance their own interests. The prohibited transaction provisions prohibit a fiduciary from dealing with the assets of a plan in his own interest or for his own account and from receiving any consideration for his own personal account from any party dealing with the plan in connection with a transaction

<sup>38</sup> See 74 FR No 164 (Aug. 22, 2008), 74 FR No 12 (Jan. 21, 2009), and 75 FR No 40 (Mar. 2, 2010) for background on the analysis contained in the Department’s Regulatory Impact Analysis.



involving the assets of the plan.<sup>39</sup> These statutory provisions have been interpreted as prohibiting a fiduciary from using the authority, control or responsibility that makes it a fiduciary to cause itself, or a party in which it has an interest that may affect its best judgment as a fiduciary, to receive additional fees.<sup>40</sup> As a result, in the absence of a statutory or administrative exemption, fiduciaries are prohibited from rendering investment advice to plan participants regarding investments that result in the payment of additional advisory and other fees to the fiduciaries or their affiliates. Section 4975 of the Code applies similarly to the rendering of investment advice to an individual retirement account (IRA) beneficiary.

Over the past several years, the Department has issued various forms of guidance concerning when a person would be a fiduciary by reason of rendering investment advice, and when such investment advice might result in prohibited transactions.<sup>41</sup> Responding to the need to afford participants and beneficiaries greater access to professional investment advice, Congress amended the prohibited transaction provisions of ERISA and the Code, as part of the Pension Protection Act of 2006 (PPA),<sup>42</sup> to permit a broader array of investment advice providers to offer their services to participants responsible for investment of assets in their individual accounts and, accordingly, for the adequacy of their retirement savings.

Specifically, section 601 of the PPA added a statutory prohibited transaction exemption under sections 408(b)(14) and 408(g) of ERISA, with parallel

provisions at Code sections 4975(d)(17) and 4975(f)(8).<sup>43</sup> Section 408(b)(14) sets forth the investment advice-related transactions that will be exempt from the prohibitions of ERISA section 406 if the requirements of section 408(g) are met.<sup>44</sup> These requirements are met only if advice is provided by a fiduciary adviser under an “eligible investment advice arrangement.” Section 408(g) provides for two general types of eligible arrangements: one based on compliance with a “fee-leveling” requirement (imposing limitation on fees and compensation of the fiduciary adviser); the other, based on compliance with a “computer model” requirement (requiring use of a certified computer model). Both types of arrangements also must meet several other requirements.

The Department’s final investment advice regulation is needed to provide additional guidance regarding the conditions set forth in the PPA statutory exemption for investment advice. The Department calibrated this final regulation to protect participants while promoting the affordability of investment advice arrangements operating pursuant to the PPA’s statutory exemptive relief. The Department expects that as a result of this regulatory action, high-quality, affordable investment advice will proliferate, producing significant net benefits for participants. For a further discussion of these benefits, see the Benefits section below.

**Benefits**

The Department believes this final regulation will provide important benefits to society by extending quality, expert investment advice to more

participants, leading them to make fewer investment mistakes. As noted below, prior to implementation of the PPA, investment mistakes cost participants approximately \$114 billion in 2010 for participants, the Department estimates.<sup>45</sup> The Department believes that participants, after having received such advice, may pay lower fees and expenses, engage in less excessive or poorly timed trading, more adequately diversify their portfolios and thereby assume less uncompensated risk, achieve a more optimal level of compensated risk, and/or pay less excess taxes. The Department estimates that advice available prior to the PPA reduced errors by \$15 billion annually (*i.e.*, investment errors would have been \$124 billion absent this advice). Increased use of investment advice under the PPA will incrementally reduce such mistakes by between \$7 billion and \$18 billion annually (roughly 6 percent to 16 percent of the \$114 billion in investment errors remaining after pre-PPA advice is given), the Department estimates. Thus, the cumulative benefit of the pre-PPA investment advice and the new investment advice under the PPA and this final rule ranges between \$22 billion and \$33 billion. The Department’s estimates of the magnitude of these investment errors and the resulting reductions from participants receiving investment advice are summarized in Table 2 below. The sections below describe in more detail the investment errors participants may make along with the method the Department used to calculate the baseline, benefit and impact estimates for this final regulation.

TABLE 2—LONG TERM INVESTMENT ERRORS AND IMPACT OF ADVICE  
[\$Billions, annual]

| Policy context                                | Remaining errors | Errors eliminated by advice |            |
|---|------------------|-----------------------------|------------|
|   |                  | Incremental                 | Cumulative |
| No advice .....                               | \$124            | \$0                         | \$0        |
| Existing/Pre-PPA advice only (Baseline) ..... | 114              | 15                          | 15         |
| New/PPA advice:                               |                  |                             |            |

<sup>39</sup> ERISA section 406(b)(1) and (3) and Code section 4975(c)(1)(E) and (F).

<sup>40</sup> 29 CFR 2550.408b-2(e).

<sup>41</sup> See Interpretative Bulletin relating to participant investment education, 29 CFR 2509.96-1 (Interpretive Bulletin 96-1); Advisory Opinion (AO) 2005-10A (May 11, 2005); AO 2001-09A (December 14, 2001); and AO 97-15A (May 22, 1997). In October 2010, the Department proposed amendments to the regulation, at 29 CFR 2510.3-21(c) that define when the provision of advice causes a person to be a fiduciary.

<sup>42</sup> Public Law 109-280, 120 Stat. 780 (Aug. 17, 2006).

<sup>43</sup> Under Reorganization Plan No. 4 of 1978 (43 FR 47713, Oct. 17, 1978), 5 U.S.C. App. 1, 92 Stat.

3790, the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this notice to specific sections of ERISA should be taken as referring also to the corresponding sections of the Code.

<sup>44</sup> The transactions described in section 408(b)(14) are: the provision of investment advice to the participant or beneficiary 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 affiliate

in connection with the provision of investment advice or the acquisition, holding or sale of a security or other property available as an investment under the plan pursuant to the investment advice.

<sup>45</sup> The Department bases these estimates upon the retirement assets in DC plans and Individual Retirement Accounts reported by the Federal Reserve Board’s Flow of Funds Accounts (Mar. 2011), at <http://www.federalreserve.gov/releases/z1/Current/>. This estimate is subject to wide uncertainty. See 74 FR No 164 (Aug. 22, 2008), 74 FR No 12 (Jan. 21, 2009), and 75 FR No 40 (Mar. 2, 2010) for the details of the Department’s Regulatory Impact Analysis.

TABLE 2—LONG TERM INVESTMENT ERRORS AND IMPACT OF ADVICE—Continued  
[\$Billions, annual]

| Policy context         | Remaining errors | Errors eliminated by advice |            |
|------------------------|------------------|-----------------------------|------------|
|                        |                  | Incremental                 | Cumulative |
| Low Estimate .....     | 96               | 7                           | 22         |
| Primary Estimate ..... | 101              | 13                          | 28         |
| High Estimates .....   | 107              | 18                          | 33         |

### Investment Mistakes

The Department believes that many participants make costly investment mistakes and therefore could benefit from receiving and following good advice. In theory, investors can optimize their investment mix over time to match their investment horizon and personal taste for risk and return. But in practice many investors do not optimize their investments, at least not in accordance with generally accepted financial theories.

Some investors fail to exhibit clear, fixed and rational preferences for risk and return. Some base their decisions on flawed information or reasoning. For example some investors appear to anchor decisions inappropriately to plan features or to mental accounts or frames, or to rely excessively on past performance measures or peer examples. Some investors suffer from overconfidence, myopia, or simple inertia.<sup>46</sup> Such informational and behavioral problems translate into at least five distinct types of investment mistakes.<sup>47</sup>

### Fees and Expenses

Two distinct types of inefficiency can result in higher than optimal consumer expenditures for a particular type of good. The first is prices that are higher than would be efficient. Efficient markets require vigorous competition. Sellers with market power can command inefficiently high prices, thereby capturing consumer surplus and imposing a “dead weight loss” of welfare on society. Efficient markets also require perfect information and

<sup>46</sup> See, e.g., Richard H. Thaler & Shlomo Benartzi, *The Behavioral Economics of Retirement Savings Behavior*, AARP Public Policy Institute White Paper 2007–02 (Jan. 2007); and Jeffrey R. Brown & Scott Weisbenner, *Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans*, Social Science Research Network Abstract 631886 (Dec. 2004).

<sup>47</sup> The Department notes that much of the research documenting investment mistakes does not account for whether advice was present or not. At least some of the mistakes may have been made despite good advice to the contrary; some may have been made pursuant to bad advice. There is evidence both that advice sometimes is not followed, and that advice is sometimes bad. These issues are explored more below.

rational, utility maximizing consumers. Imperfect information, search costs and consumers’ behavioral biases likewise can allow some sellers to command inefficiently high prices. The Department accordingly has considered whether such conditions might exist in the market for investment products and services bought by or on behalf of participants. The second type of inefficiency is suboptimal consumer choices among available products. Even if goods are priced competitively, welfare will be lost if consumers make poor purchasing decisions. Imperfect information, search costs and behavioral biases can compromise purchasing decisions, and the Department has considered whether participants’ purchases of investment products and services might be so compromised.

The Department believes that the research available at this time provides an insufficient basis to confidently determine whether or to what degree participants pay inefficiently high investment prices.<sup>48</sup> Market conditions that may lead to inefficiently high prices—namely imperfect information, search costs and investor behavioral biases—certainly exist in the retail IRA market and likely exist to some degree in particular segments of the DC plan market. The Department believes there is a strong possibility that at least some participants, especially IRA beneficiaries, pay inefficiently high investment prices. If so, the Department would expect that quality advice reduces that inefficiency. Such a reduction in inefficiencies would increase participants’ welfare by transferring economic surplus from producers of investment products and services to participants and thereby reducing societal dead weight loss. The Department additionally believes that even where investment prices are efficient participants often make bad investment decisions with respect to expenses—that is, participants buy investment products and services whose

<sup>48</sup> See 74 FR No 164 (Aug. 22, 2008), 74 FR No 12 (Jan. 21, 2009), and 75 FR No 40 (Mar. 2, 2010) for background on the analysis contained in the Department’s Regulatory Impact Analysis.

marginal cost exceed their associated marginal benefit.<sup>49</sup> The Department expects the PPA and this final regulation to reduce such investment errors, improving participant and societal welfare. However, at this time the Department has no basis on which to quantify such errors or improvements.

### Poor Trading Strategies

There is evidence that some participants trade excessively, while many more participants trade too little, failing even to rebalance. In DC plans, excessive participant trading often worsens performance, and participants in accounts that are automatically rebalanced generally fare best.<sup>50</sup> Among inferior strategies, it is likely that active trading aimed at timing the market generates more adverse results than failing to rebalance. Many mutual funds investors’ experience badly lags the performance of the funds they hold because they buy and sell shares too frequently and/or at the wrong times.<sup>51</sup> Investors often buy and sell in response to short-term past returns, and suffer as a result.<sup>52</sup> Good advice is likely to discourage market timing efforts and encourage rebalancing, thereby

<sup>49</sup> It is possible that the converse could sometimes occur: participants might fail to buy efficiently priced products and services whose marginal cost lags their associated marginal benefit. If so advice, by correcting this error, might lead to higher expenses, but would still improve overall societal welfare. The economic research suggests that participants are insensitive to fees rather than excessively sensitive to fees, thus the Department believes that the converse situation is likely to be rare.

<sup>50</sup> See, e.g., Takeshi Yamaguchi *et al.*, *Winners and Losers: 401(k) Trading and Portfolio Performance*, Michigan Retirement Research Center Working Paper WP2007–154 (June 2007).

<sup>51</sup> See, e.g., Dalbar Inc., *Quantitative Analysis of Investor Behavior 2007* (2007).

<sup>52</sup> See, e.g., Rene Fischer & Ralf Gerhardt, *Investment Mistakes of Individual Investors and the Impact of Financial Advice*, Science Research Network Abstract 1009196 (Aug. 2007); Julie Agnew & Pierluigi Balduzzi, *Transfer Activity in 401(k) Plans*, Social Science Research Network Abstract 342600 (June 2006); and George Cashman *et al.*, *Investor Behavior in the Mutual Fund Industry: Evidence from Gross Flows*, Social Science Research Network Abstract 966360 (Feb. 2007).

ameliorating adverse impacts from poor trading strategies.

#### *Inadequate Diversification*

Investors sometimes fail to diversify adequately and thereby assume uncompensated risk and suffer associated losses. For example, DC plan participants sometimes concentrate their assets excessively in stock of their employer.<sup>53</sup> Relative to full diversification,<sup>54</sup> employer stock investments can be costly for DC plan participants.<sup>55</sup> Other lapses in diversification may involve omission from portfolios asset classes such as

<sup>53</sup> See, e.g., Olivia S. Mitchell & Stephen P. Utkus, *The Role of Company Stock in Defined Contribution Plans*, National Bureau of Economic Research Working Paper W9250 (Oct. 2002); and Jeffrey R. Brown & Scott Weisbenner, *Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans*, Social Science Research Network Abstract 631886 (Dec. 2004).

<sup>54</sup> This comparison should be viewed as an outer bound. Full diversification of the same assets might not be feasible if companies are unwilling to alter the compensation mix in this way (see, e.g., Olivia S. Mitchell & Stephen P. Utkus, *The Role of Company Stock in Defined Contribution Plans*, National Bureau of Economic Research Working Paper W9250 (Oct. 2002)). The comparison also neglects some potential tax benefits of employer stock investments that might offset losses from reduced diversification (see, e.g., Mukesh Bajaj et al., *The NUA Benefit and Optimal Investment in Company Stock in 401(k) Accounts*, Social Science Research Network Abstract 965808 (Feb. 2007)). See also, Lisa K. Meulbroek, *Company Stock in Pension Plans: How Costly Is It?*, Social Science Research Network Abstract 303782 (Mar. 2002) and Krishna Ramaswamy, *Company Stock and Pension Plan Diversification*, in *The Pension Challenge: Risk Transfers and Retirement Income Security* 71, 71–88 (Olivia S. Mitchell & Kent Smetters eds., 2003). The economic literature provides some evidence that investing in employer stock increases participants' exposure to equity overall, which might increase average wealth (see, e.g., Jack L. Vanderhei, *The Role of Company Stock in 401(k) Plans*, Employee Benefit Research Institute T-133 Written Statement for the House Education and Workforce Committee, Subcommittee on Employer-Employee Relations, Hearing on Enron and Beyond: Enhancing Worker Retirement Security (Feb. 2002), at <http://www.ebri.org/pdf/publications/testimony/t133.pdf>).

<sup>55</sup> Following findings reported in Lisa K. Meulbroek, *Company Stock in Pension Plans: How Costly Is It?*, Social Science Research Network Abstract 303782 (Mar. 2002), this estimate reflects losses amounting to 14 percent of the employer stock's value, assuming 10 percent of DC plan assets are held in employer stock, the DC plan is one-half of total wealth, and the holding period is 10 years. For comparison, following findings reported in Krishna Ramaswamy, *Company Stock and Pension Plan Diversification*, in *The Pension Challenge: Risk Transfers and Retirement Income Security* 71, 71–88 (Olivia S. Mitchell & Kent Smetters eds., 2003), the annualized cost of an option to receive the higher of the return on a typical company stock or the return on a fully diversified equity portfolio over a three-year horizon would amount to approximately \$24 billion, the Department estimates. This measure probably exaggerates the loss to participants, however, insofar as it would preserve for the participant the potential upside of a company stock that outperforms the market.

overseas equity or debt, small cap stocks, or real estate. Such lapses may sometimes reflect limited investment menus supplied by DC plans.<sup>56</sup> Yet even where adequate choices are available and company stock is not a factor, investors sometimes fail to diversify adequately.<sup>57</sup> The Department believes that quality advice will address over concentration in employer stock and other failures to properly diversify.

#### *Inappropriate Risk*

Investors who avoid the foregoing mistakes might be said to invest efficiently, in the sense that the investor generally can expect the maximum possible return given their level risk. However, these participants may still be making a costly mistake: they may fail to calibrate the risk and return of their portfolio to match their own risk and return preferences. As a result, participant investments may be too risky or too safe for their own tastes. The Department currently lacks a sufficient basis on which to estimate the magnitude of such mistakes, but believes mistakes associated with inappropriate risk levels may be common and large. The characteristics of a diversified portfolio's risks and returns generally are determined by the portfolio's allocation across asset classes. As noted above, there is ample evidence that participants' asset allocation choices often are inconsistent with fixed or well behaved risk and return preferences. If participants' true preferences are in fact fixed or well behaved, then observed asset allocations, which often appear to shift in response to seemingly irrelevant factors (or fail to shift in response to relevant factors), certainly entail large welfare losses. The Department believes good advice might help participants calibrate their asset allocations to match their true preferences.

#### *Excess Taxes*

It is likely that many households pay excess taxes as a result of disconnects between their investments and current tax strategies. Households saving for

<sup>56</sup> See, e.g., Edwin J. Elton et al., *The Adequacy of Investment Choices Offered By 401(k) Plans*, Social Science Research Network Abstract 567122 (Mar. 2004), which finds that menus are frequently inadequate, and Ning Tang and Olivia S. Mitchell, *The Efficiency of Pension Plan Investment Menus: Investment Choices in Defined Contribution Pension Plans*, University of Michigan Retirement Research Center Working Paper WP 2008-176 (June 2008), at <http://www.mrrc.isr.umich.edu/publications/papers/pdf/wp176.pdf>, which finds that most menus are efficient.

<sup>57</sup> See, e.g., Laurent E. Calvet et al., *Down or Out: Assessing the Welfare Costs of Household Investment Mistakes*, Harvard Institute of Economic Research Discussion Paper No. 2107 (Feb. 2006).

retirement must decide not only what assets to hold, but also whether to locate these assets in taxable or tax-deferred accounts. For example, households may be able to maximize their expected after-tax wealth by first placing heavily taxed bonds in their tax-deferred account and then placing lightly taxed equities in their taxable account. However a significant number of households do not follow this practice.<sup>58</sup> What is not clear, however, is whether such households are in fact making investment mistakes. In practice, this simple asset location rule may fail to minimize taxes.<sup>59</sup> As a result the Department currently has no basis to estimate the magnitude of excess taxes that might derive from participants' investment mistakes. In any event, whether or to what extent investment advisers would be positioned to provide advice on tax efficiency is unclear.

#### *Baseline Estimates: Availability and Use of Advice by Participants*

Participants have always had the option of obtaining permissible investment advice services directly in the retail market. DC plan sponsors likewise have had the option of obtaining such services in the commercial market and making them available to plan participants and beneficiaries in connection with the plan.

Prior to the 2006 enactment of the PPA, a substantial fraction of DC plan sponsors made investment advice available to plan participants and beneficiaries. Today, as the PPA's implementation progresses, many more have begun providing or are gearing up to provide such advice. The Department bases its estimate for pre-PPA availability of advice to DC plan participants on reported plan

<sup>58</sup> See, e.g., Daniel B. Bergstresser & James M. Poterba, *Asset Allocation and Asset Location: Household Evidence from the Survey of Consumer Finances*, *Journal of Public Economics*, Volume 88 1893, 1893–1915 (2004).

<sup>59</sup> See, e.g., James M. Poterba et al., *Asset Location for Retirement Savers*, in *Public Policies and Private Pensions* 290, 290–331 (John B. Shoven et al. eds., 2004); John B. Shoven & Clemens Sialm, *Asset Location in Tax-Deferred and Conventional Savings Accounts*, *Journal of Public Economics*, Volume 88 (2003); James M. Poterba et al., *Asset Location for Retirement Savers*, in *Public Policies and Private Pensions* 290, 290–331 (John B. Shoven et al. eds., 2004); Gene Amromin, *Portfolio Allocation Choices in Taxable and Tax-Deferred Accounts: An Empirical Analysis of Tax-Efficiency*, Social Science Research Network Abstract 302824 (May 2002); Lorenzo Garlappi & Jennifer C. Huang, *Are Stocks Desirable in Tax-Deferred Accounts?*, *Journal of Public Economics*, Volume 90 2257, 2257– and Robert M. Dammon et al., *Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing*, *The Journal of Finance*, Volume LIX, Number 3 999, 999–1037 (2004).

experiences in 2006.<sup>60</sup> The Department assumes that approximately 40 percent of DC plan sponsors provided access to investment advice either on line, by phone, or in-person in 2006, as outlined in Table 3 below. The Department further assumes that approximately 25 percent of the participants that are offered advice use the offered advice, as outlined in Table 4 below. In-person advice seems to be offered by most plan sponsors. On-line advice and, to a lesser degree, telephone advice are favored more by large sponsors. Smaller plan sponsors appear to offer advice generally, and in-person advice in particular, more frequently than larger plan sponsors.

TABLE 3—AVAILABILITY OF ADVICE: DC PLANS OFFERING ADVICE

| Policy context             | Any advice (computer or live) |
|----------------------------|-------------------------------|
| Pre-PPA .....              | 40%                           |
| PPA—Low Estimate .....     | 56%                           |
| PPA—Primary Estimate ..... | 63%                           |
| PPA—High Estimate .....    | 69%                           |

Investment advice is also already used by a substantial fraction of IRA participants, the Department believes. A majority of IRA participants that invest in mutual funds purchase some or all of their funds via a professional financial adviser.<sup>61</sup> Overall in 2006, 60 percent of

U.S. workers and retirees said they use the advice of a financial professional when making retirement savings and investment decisions; 40 percent said the advice of a financial professional was more helpful to them than alternatives.<sup>62</sup> However, what is not clear from the survey was how recently the participant received the referenced advice: in the same survey just 29 percent of participants stated that in the past year they obtained investment advice from a professional financial adviser who was paid through fees or commissions.<sup>63</sup>

TABLE 4—USE OF ADVICE BY DC PLAN AND IRA PARTICIPANTS

| Policy context             | Share of participants advised |         |     |
|----------------------------|-------------------------------|---------|-----|
|                            | DC Plans                      |         | IRA |
|                            | Where offered                 | Overall |     |
| Pre-PPA .....              | 25%                           | 10%     | 33% |
| PPA—Low Estimate .....     | 25%                           | 14%     | 50% |
| PPA—Primary Estimate ..... | 25%                           | 16%     | 67% |
| PPA—High Estimates .....   | 25%                           | 17%     | 80% |

The effect of investment advice depends not merely on its availability but on its use by DC plan and IRA participants. Do the participants seek advice, and if so do they follow it? According to one survey, among DC plan participants offered investment advice, approximately one in four uses the offered advice. There is some evidence that historically in-person advice has achieved higher use rates

than on-line advice, with on-line advice appealing more to higher-income participants.<sup>64</sup> In another survey large fractions of workers say they would be very likely (19 percent) or somewhat likely (35 percent) to take advantage of advice provided by the company that manages their employer’s DC plan. Of these, two-thirds said they would implement only those recommendations that were in line with their own ideas;

21 percent said they would implement all of the recommendations they receive as long as they trusted the source.<sup>65</sup> In a subsequent survey, among those obtaining investment advice, 36 percent say they implemented “all” of the advice, 58 percent “some,” and just 5 percent “none.”<sup>66</sup>

The Department’s assumptions regarding use of advice are summarized in Tables 3 and 4 above.<sup>67</sup> The

<sup>60</sup> This assessment is based on the Department’s reading of Hewitt Associates LLC, *Survey Findings: Hot Topics in Retirement, 2007* (2007); Profit Sharing/401(k) Council of America, *50th Annual Survey of Profit Sharing and 401(k) Plans* (2007); and Deloitte Development LLC, *Annual 401(k) Benchmarking Survey, 2005/2006 Edition* (2006). In addition to investment advice, a majority of sponsors also provide one or more other types of support to participants’ investment decisions.

<sup>61</sup> Eighty-two percent of mutual fund shareholders who hold funds outside of DC plans purchase some or all of their funds from a professional financial adviser such as a full-service broker, independent financial planner, bank or savings institution representative, insurance agent, or accountant (see, e.g., Victoria Leonard-Chambers & Michael Bogdan, *Why Do Mutual Fund Investors Use Professional Financial Advisers?*, Investment Company Institute Research Fundamentals, Volume 16, Number 1 (April 2007)). As families owning IRAs outnumber those owning pooled investment vehicles outside of retirement accounts (see, e.g., Brian K. Bucks et al., *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, Federal Reserve Bulletin 92 A1, A1–A38 (2006)), it is reasonable to conclude that a large majority of IRA beneficiaries who invest in mutual funds purchase them via such professionals. However, the Department has no

basis to estimate the fraction of these beneficiaries that receive true investment advice from such professionals. It is possible that some make their purchase decisions without receiving any recommendation or material guidance from the professional making the sale.

<sup>62</sup> Alternatives including advice of peers, written plan materials, print media, television and radio, seminars, software, on-line information or advice, and retirement benefit statements were all less likely to be characterized as “most helpful.”

<sup>63</sup> See, e.g., Employee Benefit Research Institute, *2007 Retirement Confidence Survey, Wave XVII*, Posted Questionnaire (Jan. 2007).

<sup>64</sup> See, e.g., Profit Sharing/401(k) Council of America, *50th Annual Survey of Profit Sharing and 401(k) Plans* (2007); and Julie Agnew, *Personalized Retirement Advice and Managed Accounts: Who Uses Them and How Does Advice Affect Behavior in 401(k) Plans?*, Center for Retirement Research Working Paper 2006–9 (2006).

<sup>65</sup> See, e.g., Employee Benefit Research Institute, *2007 Retirement Confidence Survey, Wave XVII*, Posted Questionnaire (Jan. 2007). In practice this might translate into a high rate of compliance with recommendations, if recommendations turn out not to diverge too much from participants’ own ideas.

<sup>66</sup> See, e.g., Employee Benefit Research Institute, *2008 Retirement Confidence Survey, Wave XVIII*, Posted Questionnaire (Jan. 2008).

<sup>67</sup> The Department’s bases its assumptions on its reading of Employee Benefit Research Institute, *2007 Retirement Confidence Survey, Wave XVII*, Posted Questionnaire (Jan. 2007); Hewitt Associates LLC, *Survey Findings: Hot Topics in Retirement, 2007* (2007); Profit Sharing/401(k) Council of America, *50th Annual Survey of Profit Sharing and 401(k) Plans* (2007); and Deloitte Development LLC, *Annual 401(k) Benchmarking Survey, 2005/2006 Edition* (2006). There are a number of reasons to believe that use of advice will be higher among IRA beneficiaries than DC plan participants. The aforementioned survey reports, read together, generally support this conclusion. In addition, relative to IRA beneficiaries, DC participants may have less need for advice and/or easier access to alternative forms of support for their investment decisions. DC plan participants’ choice is usually confined to a limited menu selected by a plan fiduciary, and the menu may include one-stop alternatives such as target date funds that may mitigate the need for advice. Their plan or employer may provide general financial and investment education in the form of printed material or seminars. They often make initial investment decisions (sometimes by default) before contributing to the plan so the decisions’ impact

Department believes it is likely that in practice a large proportion of participants who receive advice will follow that advice either in whole or in part. This is especially likely if the advice turns out to be broadly in line with the participants' own thinking.

Nonetheless, some advice will not be followed, and as a result some investment errors will not be corrected. For purposes of this analysis, the Department has assumed that advised participants make investment errors at one-half the rate of unadvised

participants. The remaining errors reflect participant failures to follow advice. Additionally, for purposes of this analysis, the Department assumes that all permissible advice arrangements deliver advice of similar quality and effectiveness.

TABLE 5—NUMBER OF ENTITIES

|                                 | Pre-PPA | PPA          |                  |               |
|---------------------------------|---------|--------------|------------------|---------------|
|                                 |         | Low estimate | Primary estimate | High estimate |
| DC:                             |         |              |                  |               |
| Plans offering (000s) .....     | 238     | 335          | 372              | 410           |
| Participants offered (MM) ..... | 30      | 42           | 46               | 51            |
| Participants using (MM) .....   | 6       | 9            | 10               | 11            |
| IRA:                            |         |              |                  |               |
| IRAs using (MM) .....           | 17      | 25           | 34               | 41            |

*Impact—Benefit*

For purposes of this assessment, the Department estimates that as a result of the PPA and this final regulation the proportion of participants using advice will increase.<sup>68</sup> As stated above, the Department has assumed that advised participants make investment errors at one-half the rate of unadvised participants. The estimates provided in the Tables 3 to 5 show three possible impacts for the PPA and this final regulation to reflect the uncertainty surrounding the availability and use of advice as well as the percentage of errors eliminated by advice: “low” estimates assume that 14 percent of DC plan participants and half of IRA beneficiaries will utilize advice which eliminates 25 percent of investment errors, “primary” estimates assume that 16 percent of DC plan participants and two-thirds of IRA beneficiaries will utilize advice which eliminates half of investment errors, and “high” estimates assume that 17 percent of DC plan participants and 80 percent of IRA beneficiaries will utilize advice which eliminates 75 percent of investment errors.

As summarized in Tables 3 through 5 above, the PPA and this final regulation will increase the availability of investment advice and thereby increase the use of investment advice by participants. The PPA and this final regulation will reduce investment mistakes by between \$7 billion and \$18

billion annually, the Department estimates. Cumulatively, after implementation of this final regulation, use of existing and new investment advice by DC plan and IRA participants will eliminate between \$22 billion and \$33 billion worth of investment errors annually. The Department’s estimates of investment errors and reductions from investment advice are summarized in Table 2 above.

**Costs**

Compliance with the terms and condition of the final rule is a condition of relief from the prohibited transaction provisions of ERISA and the Code. Such exemptive relief would allow a fiduciary adviser to receive compensation from providers of recommended investments. As such, this final rule does not include any Federal mandates that will require expenditures by the private sector per se. Plan sponsors and participants are expected to take advantage of these new opportunities in the marketplace; therefore these plans and participants will shoulder the costs to reap the associated benefits.

Nevertheless, participant gains from investment advice must be weighed against the cost of that advice. This final rule is expected to make quality fiduciary advice available to participants at a lower direct price, because advisers will be able to rely on indirect revenue sources, subject to the

safeguards and conditions of the final rule, to compensate their efforts. It may also make such advice available at a lower total cost to participants.

The general prohibition against transactions wherein fiduciary advisers’ and participants’ interests may conflict carries costs. Faced with such bars advisers may forgo certain potential economies of scale in production and distribution of financial services that would derive from more vertical and horizontal integration.<sup>69</sup> If they choose instead to take advantage of these opportunities and relationships, they must incur costs to carefully monitor and calibrate their relationships and compensation arrangements to avoid a prohibited fiduciary conflict, or structure and monitor their arrangements to meet the conditions of an applicable prohibited transaction exemption.

On the other hand, absent adequate protections, conflicts themselves may be more costly to participants than a general prohibition against them. The safeguards and conditions included in this final regulation are calibrated to ensure that conflicts do not compromise the quality of fiduciary advice.

The Department therefore expects this final rule to produce cost savings by harnessing economies of scale and by reducing compliance burdens. The Department is unaware of any available empirical basis on which to determine

may seem small. Finally, the availability of advice in connection with the plan is intermediated by the plan sponsor and fiduciary. In contrast, IRA beneficiaries generally have wider choice and are more likely to be without employer-provided support for their decisions. Decision points may more often occur when account balances are large, such as when rolling a large DC plan balance into

an IRA or when retiring. Finally, the availability of advice to IRA beneficiaries is not intermediated by an employer—rather IRA beneficiaries interface directly with the retail market and will thereby be more directly affected by the exemptive relief provided by the PPA and this final regulation. For all of these reasons IRA beneficiaries may use advice more frequently than DC plan participants.

<sup>68</sup> See 74 FR No 164 (Aug. 22, 2008), 74 FR No 12 (Jan. 21, 2009), and 75 FR No 40 (Mar. 2, 2010) for background on the analysis contained in the Department’s Regulatory Impact Analysis.

<sup>69</sup> For example, an adviser employed by an asset manager can share the manager’s research instead of buying or producing such research independently.

whether or by how much costs might be reduced, however.

Different types of advice may come with different costs. For example, advice generated by an automated computer program may be less costly than advice provided by a personal adviser. For purposes of this analysis the Department assumed that in the context of a DC plan, computer generated advice costs 10 basis points

annually, while adviser provided advice costs 20 basis points. In connection with an IRA the corresponding assumptions are 15 and 30 basis points. These assumptions are reasonable in light of information available to the Department about the cost of various existing advice arrangements. On this basis the Department estimates the aggregate cost of advice under the final rule to be a range between \$1.9 billion and \$5.1

billion annually as summarized in Table 6 below. These costs include the costs, outlined in the Paperwork Reduction Act section below, associated with requirements to document and keep records, provide disclosures to participants, hire an independent auditor, and obtain certification of the model from an eligible investment expert.

TABLE 6—COST OF ADVICE

|   | Pre-PPA | PPA          |              |               |
|---|---------|--------------|--------------|---------------|
|   |         | Low estimate | Mid estimate | High estimate |
| <b>Incremental:</b>                                     |         |              |              |               |
| Advice cost (\$billions) .....                          | \$3.90  | \$1.90       | \$3.70       | \$5.10        |
| Advice cost rate (bps, average) .....                   | 22.4    | 22.6         | 23.0         | 23.1          |
| <b>Cumulative (combined with policies to the left):</b> |         |              |              |               |
| Advice cost (\$billions) .....                          | 3.90    | 5.80         | 7.60         | 9.00          |
| Advice cost rate (bps, average) .....                   | 22.4    | 22.4         | 22.7         | 22.8          |

**Regulatory Alternatives**

Executive Order 12866 requires an economically significant regulation to include an assessment of the costs and benefits of potentially effective and reasonably feasible alternatives to a planned regulation, and an explanation of why the planned regulatory action is preferable to the identified potential alternatives. In formulating this final regulation, the Department considered several alternative approaches regarding computer model design and operation, which are discussed below. For a more detailed discussion of these alternatives, see section B.2., above.

Paragraph (b)(4)(i)(A) of the March 2010 proposal requires a computer model to be designed and operated to apply generally accepted investment theories that take into account historical risks and returns of different asset class over defined periods of time. The Department solicited comments in the proposal regarding whether the Department should amend the rule to specify generally accepted investment theories and require their application or specify certain practices required by such theories. Most commenters indicated that they did not believe the Department should specifically define or identify generally accepted investment theories or prescribe particular practices or computer model parameters. They explained that economic and investment theories and practices continually evolve over time in response to changes and developments in academic and expert thinking, technology, and financial

markets. Some commenters explained that additional specificity would facilitate compliance determinations. Other commenters described theories and practices they believed to be generally accepted.

After carefully considering the comments, the Department decided not to change the provision in the final rule. The Department is concerned that attempting to provide additional specificity in this area, such as by prescribing an acceptable list of theories and practices, may result in significant unintended consequences. Specific requirements might limit advisers' ability to select or apply the most current or effective investment theories, and thereby impede beneficial innovations in investment advice and reduce the economic benefits of the statutory exemption. The Department also believes that the final rule's computer model requirements, taken together, are sufficient to safeguard against application of investment theories that are not generally accepted.

Paragraph (b)(4)(i)(F)(1) of the March 2010 proposal requires a computer model to take into account all "designated investment options" available under the plan without giving inappropriate weight to any investment option. The term "designated investment option" is defined to mean any investment option designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term "designated investment option" does not include "brokerage windows," "self-

directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

Under paragraph (b)(4)(i)(F)(2) of the proposal, a computer does not have to make recommendations relating to the acquisition, holding or sale of the following: qualifying employer securities; an investment that allocates the invested assets of a participant or beneficiary to achieve varying degrees of long-term appreciation and capital preservation through equity and fixed income exposures, based on a defined time horizon or level of risk of the participant or beneficiary; and an annuity option with respect to which a participant or beneficiary may allocate assets toward the purchase of a stream of retirement income payments guaranteed by an insurance company.

The Department considered retaining this provision in the corresponding provision of the final rule, paragraph (b)(4)(i)(G). However, the Department has decided to remove qualifying employer securities and asset allocations funds from the list of excepted options. Based on comments received in response to the proposal, the Department believes that it is feasible to develop a computer model capable of addressing investments in qualifying employer securities, and that plan participants will significantly benefit from this advice. For example, DC plan participants sometimes concentrate their assets excessively in stock of their

employer.<sup>70</sup> Participant investments in employer securities can undermine diversification and thereby cause participants to bear uncompensated risk. This uncompensated risk comes at a cost.<sup>71</sup> According to 2008 Department estimates, holding employer stock instead of a diversified portfolio of investments cost DC plan participants \$3 billion in risk-adjusted value annually.<sup>72</sup> Yet, participants often seem unaware of this uncompensated risk and falsely believe that they can gauge how their company stock will perform in the future.<sup>73</sup> Good investment advice can benefit participants by promoting appropriate diversification<sup>74</sup> and combat some of the false perceptions of participants concerning employer stock.<sup>75</sup>

<sup>70</sup> Mitchell, Olivia S., and Stephen P. Utkus. October 2002. "The Role of Company Stock in Defined Contribution Plans." NBER Working Paper No. W9250. Citing EBRI/ICI data, the authors find that, of those participants who are offered company stock through their 401(k), 48 percent of them hold over 20 percent of their 401(k) assets in company stock and approximately one third of them hold over 40 percent of their 401(k) assets in company stock. The authors acknowledge that there are potential productivity gains attributable to employee stock ownership. However, diversifying assets, on average, decreases wealth volatility. While not explicitly pointed out in this article, the volatility argument is particularly relevant when a participant holds a high concentration of one's own company stock because company financial distress will correspond directly with both lower job security and decreased financial returns.

<sup>71</sup> Meulbroek, Lisa. 2002. "Company Stock in Pension Plans: How Costly is it?" *Harvard Business School Working Paper* 02-058.

<sup>72</sup> This figure is based upon an estimate from Meulbroek (2002) where if 10 percent of DC plan assets are held in employer stock, the DC plan is one-half total wealth, and the holding period is 10 years, investors lose out on 14 percent of risk-adjusted value.

<sup>73</sup> Benartzi, Shlomo and Richard Thaler. 2007. "Heuristics and Biases in Retirement Savings Behavior" *The Journal of Economic Perspectives*, Vol. 21, Summer, pp. 81-104. Citing a Boston Research Group (2002) study of individuals (most of whom were highly aware of the Enron scandal), half of the respondents said their company stock carries less risk than a money market fund. Another study, that included the coauthors, found that only 33 percent of the respondents who own company stock realize that it is riskier than a "diversified fund with many stocks." Employees' investment decisions reflect a belief that strong past performance by their company means that they should invest more in employee stock. Yet, this seems to have little bearing on future performance.

<sup>74</sup> Mottola, Gary and Stephen Utkus. 2007. "Red, Yellow, and Green: A Taxonomy of 401(k) Choices" Pension Research Council Working Paper, PRC WP 2007-14. Examining Vanguard's database of 2.9 million participants, the authors found that 17.2 percent of participants had invested more than 20 percent of their assets in company stock. A subset of 12,000 participants adopted managed account services. The authors were able to compare this subset's behavior before and after adopting the services. Before adoption, 11 percent of the participants had over 20 percent of their portfolio in company stock; a year after adoption, only 2 percent of the participants did.

<sup>75</sup> Choi, James, David Laibson, and Brigitte Madrian. 2005. *Brookings Papers on Economic*

The Department also decided to remove asset allocation funds from the list of excepted options. Asset allocation funds generally are designed to maintain a particular asset allocation that takes into account the time horizon or risk tolerance of the participant. Some commenters to the Department's 2008 proposed rule opined that it served no purpose to include such funds in an investment advice model's unrelated, overlaying asset allocation analysis. However, the Department's subsequent consideration of asset allocation funds has demonstrated that: (1) The asset allocation and associated risk and return characteristics of different funds targeted at similar participants varies widely; (2) the risk and return preferences of participants vary widely with factors other than the time horizons that are the sole targeting factor for many asset allocation funds; (3) participants investing in asset allocation funds sometimes do not understand the funds' risk and return characteristics; and (4) as a result of the foregoing, the risk and return characteristics of the asset allocation funds participants invest in are sometimes poorly aligned with the participants' own risk and return preferences. Because investment advice models will take into account designated investment options' true risk and return characteristics as well as participant characteristics and circumstances beyond time horizons, the Department believes that participants will benefit from investment advice that considers any asset allocation funds that are available to them.

The Department notes that a provision added to the final rule, paragraph (b)(4)(i)(G)(2)(ii), provides that a computer model will not fail to satisfy the requirements of paragraph (b)(4)(i)(G)(1) merely because it does not provide a recommendation with respect to an investment option that a participant or beneficiary requests to be excluded from consideration in such recommendations. Therefore, participants may express a preference for asset allocation funds to be excluded from a recommendation. This would be relevant in situations where participants do not want to include asset allocation funds in computer model investment advice, because such products themselves rely on a fund manager to maintain a particular asset allocation taking into account their time horizons

*Activity*, Vol. 2005, No. 2, pp. 151-198. Participants view the offering of the employee stock as a recommendation to purchase the stock. Loyalty to one's company may also be a factor.

(retirement age, life expectancy) and risk tolerance.

The Department, however, has decided to retain the exception for in-plan annuity products. It might be challenging for a computer model that is designed to select the optimal asset allocation for a participant's investments to also incorporate an option about whether the participant should purchase an in-plan annuity and how much of the portfolio should be dedicated to such a product. Annuities differ from other investments across several dimensions. For example, one valuable benefit to a lifetime annuity is that it provides an insurance-like feature of a guaranteed income stream that will last as long as one lives. It is difficult to know, however, how that should be valued within the context of a computer model. Similarly, participants' preferences about annuities may vary depending on their preferences regarding bequests. Another factor participants must consider is that the annuity may lock them in, either by preventing them from pulling out their accumulated value and investing it elsewhere or by imposing a penalty for doing so. Typically other investment options offer more liquidity. All of these features of annuities mean that it might be difficult to design a computer model that could produce a recommendation for a participant regarding the optimal selection of assets and purchase of annuities.

As an additional approach to ensuring that investment advice is not tainted by conflicts of interest, paragraph (b)(4)(i)(E)(3) of the March 2010 proposal provides that a computer model must be designed and operated to avoid investment recommendations that inappropriately distinguish among investment options in a single asset class on the basis of a factor that cannot confidently be expected to persist in the future.

A number of commenters requested that the Department remove paragraph (b)(4)(i)(E)(3). Some opined that the test contained in that provision—which applies on an asset-class by asset-class basis—lacks sufficient clarity because it fails to define the essential term "asset class". Some commenters also requested removal of this provision unless the Department clarifies that it would be acceptable for a computer model to take into account historical performance data. According to these commenters, the proposal's discussion of paragraph (b)(4)(i)(E)(3) and related computer model questions has been construed as strictly prohibiting, or strongly cautioning against, any consideration of historical performance data, even if

considered in conjunction with other information. These commenters opined that a complete disregard of historical performance data would be inconsistent with generally accepted investment theories.

Additionally, some cautioned that, by limiting consideration to only those factors that can confidently be expected to persist in the future, a computer model might be limited to distinguishing between investment options solely on the basis of fees and expenses. A commenter noted that, other than fees, it could not identify any other factor with the necessary likelihood of persistence required under the proposal. Although commenters generally agreed that fees are an important consideration, most recognized they should not be the only factor taken into account.

A number of commenters expressed concern that this provision of the proposal, with its focus on historical performance data, superior past performance and fees, appeared to suggest that it would be impermissible under any circumstances for a plan fiduciary to pursue an active management style, or that a plan fiduciary would bear a very high burden of justification. Commenters also stated that the Department's proposal appeared to demonstrate a clear bias in favor of passive investment styles over active styles, which they believe to be premature because it is the subject of ongoing debate among investment experts.

Other commenters, however, questioned the utility of historical performance data beyond estimating future performance of an entire asset class. They further noted that, because the regulation permits a fiduciary adviser to provide investment recommendations to plan participants when the adviser has an interest in the investment options being recommended, there is the potential that the computer model might be designed to favor certain options by giving undue weight to historical performance data. They therefore stressed the importance of scrutinizing the use of historical performance data and supported the inclusion of paragraph (b)(4)(i)(E)(3).

As discussed above, the provision is not intended to prohibit a computer model from any consideration of an investment option's historical performance, as some commenters interpreted. Based on its review of relevant academic literature, the Department does not believe such a prohibition is warranted. Although the academic literature indicates that there is skill in the investment community,<sup>76</sup> there is considerable disagreement amongst academics as to how much persistent skill fund managers exhibit.<sup>77</sup>

Without further clarification, a fiduciary adviser might not consider any factors whose persistence is in doubt, such as historical performance, but instead would consider only factors that are essentially fixed, such as fees and expenses, solely because she is unwilling to risk noncompliance with

that provision. That is, fiduciary advisers might omit from consideration factors that would be beneficial to consider, even when there is a sound empirical basis to justify their consideration. The Department believes that the final rule should not discourage consideration of factors whose predictive properties can be demonstrated. Accordingly, the Department has clarified application of this provision at paragraph (b)(4)(i)(C).

**Uncertainty**

The Department is highly confident in its conclusion that investment errors are common and often large, producing large avoidable losses (including foregone earnings) for participants. It is also confident that participants can reduce errors substantially by obtaining and following good advice. While the precise magnitude of the errors and potential reductions therein are uncertain, there is ample evidence that that magnitude is large.

However, the Department is uncertain to what extent advice will reach participants and to what extent advice that does reach them will reduce errors. To illustrate that uncertainty, the Department conducted sensitivity tests of how its estimates of the reduction in investment errors attributable to the PPA and this final rule would change in response to alternative assumptions regarding the availability, use, and quality of advice. Table 7 the results of these tests.<sup>78</sup>

TABLE 7—UNCERTAINTY IN ESTIMATE OF INVESTMENT ERROR REDUCTION

| After PPA/Final Rule: |                                 | Impact of PPA | Impact of all advice | Remaining errors |
|-----------------------|---------------------------------|---------------|----------------------|------------------|
| Advice eliminates:    | Advice reaches:                 |               |                      |                  |
| 25% of errors .....   | 14% of DC and 50% of IRA .....  | \$7           | \$21                 | \$107            |
| 50% of errors * ..... | 16% of DC and 67% of IRA* ..... | 13            | 28                   | 101              |

<sup>76</sup> See e.g., Russ Wermers, "Mutual Fund Performance: An Empirical Decomposition Into Stock-Picking Talent, Style, Transaction Costs And Expenses," *The Journal of Finance* (Aug., 2000). This study finds that fund managers choose stocks that outperform their relevant benchmark by an average of 71 basis points per year. However, non-stock components, expense ratios, and transaction costs explain why the returns on these active funds are not as high on average as index funds.

<sup>77</sup> See e.g., Eugene Fama and Kenneth French, "Luck Versus Skill in the Cross Section of Mutual Fund Returns," *Journal of Finance* (Sept. 21, 2010), at <http://www.afajof.org/afa/forthcoming/6311.pdf>. This study finds that approximately 10 percent of managers demonstrate higher returns before fees than what random chance would generate. Yet, after fees are taken into account, this share declines to 1 percent.

See also Robert Kosowski, Allan Timmermann, Russ Wermers and Hal White, "Can Mutual Fund 'Stars' Really Pick Stocks? New Evidence from a Bootstrap Analysis," *The Journal of Finance*,

Volume LXI, Number 6 (Dec. 2006). The authors find a larger share of fund managers demonstrating significant skill. Fama and French believe this analysis suffers from some of the same selection biases that industry prospectuses do.

See also John Hughes, Jing Liu and Mingshan Zhang, "Overconfidence, Under-Reaction, and Warren Buffett's Investments," at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1635061](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1635061). This study finds that mimicking Warren Buffett's position, or that of other top performing investment managers, can generate additional returns. The fact that following another fund's lead can be a credible exercise may be an argument in favor of looking at prior returns of some funds. However, the fact that winning strategies do get mimicked is an argument made by some that success cannot be indefinitely sustained. Copycats potentially drive up the price of the underlying assets over time.

See e.g., Jonathan B. Berk, and Richard C. Green, "Mutual Fund Flows and Performance in Rational

Markets," *Journal of Political Economy*, Volume 112, pp. 1269–1295 (2004).

<sup>78</sup> The Department maintains the 2006 baseline numbers used in the 2008 Proposal (73 FR 49896 (Aug. 22, 2008), at <http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=21243&AgencyId=8&DocumentType=1>). The baseline assessment was based on the Department's reading of Hewitt Associates LLC, Survey Findings: Hot Topics in Retirement, 2007 (2007), at [http://www.hewittassociates.com/Lib/MBUtil/AssetRetrieval.aspx?guid=CE3EEF86-50E7-4EEC-8C32-82FD055690A6;ProfitSharing/401\(k\)CouncilofAmerica,50thAnnualSurveyofProfitSharingand401\(k\)Plans\(2007\);andDeloitteDevelopmentLLC,Annual401\(k\)BenchmarkingSurvey,2005/2006Edition\(2006\),athttp://www.google.com/url?sa=t&source=web&cd=5&ved=0CDUQFjAE&url=http%3A%2F%2Fwww.ifebp.org%2Fpdf%2Fresearch%2F2005-06Annual401kSurvey.pdf&ei=\\_76UTYSXMY6y0QHBjZmADA&usg=AFQjCNfUmmwPpFA\\_EoBDUGyB9uyjFCCQ](http://www.hewittassociates.com/Lib/MBUtil/AssetRetrieval.aspx?guid=CE3EEF86-50E7-4EEC-8C32-82FD055690A6;ProfitSharing/401(k)CouncilofAmerica,50thAnnualSurveyofProfitSharingand401(k)Plans(2007);andDeloitteDevelopmentLLC,Annual401(k)BenchmarkingSurvey,2005/2006Edition(2006),athttp://www.google.com/url?sa=t&source=web&cd=5&ved=0CDUQFjAE&url=http%3A%2F%2Fwww.ifebp.org%2Fpdf%2Fresearch%2F2005-06Annual401kSurvey.pdf&ei=_76UTYSXMY6y0QHBjZmADA&usg=AFQjCNfUmmwPpFA_EoBDUGyB9uyjFCCQ).



TABLE 7—UNCERTAINTY IN ESTIMATE OF INVESTMENT ERROR REDUCTION—Continued

| After PPA/Final Rule: |                                | Impact of PPA | Impact of all advice | Remaining errors |
|-----------------------|--------------------------------|---------------|----------------------|------------------|
| Advice eliminates:    | Advice reaches:                |               |                      |                  |
| 75% of errors .....   | 17% of DC and 80% of IRA ..... | 18            | 33                   | 96               |

Note: Primary estimates denoted.\*

The Department is uncertain about the mix of advice and other support arrangements that will compose the market, and about the relative effectiveness of alternative investment advice arrangements or other means of supporting participants' investment decisions. For example, to what extent will arrangements pursuant to this final rule displace alternative arrangements? Will advice arrangements operating pursuant to this final rule be more, less, or equally effective as alternative arrangements?

This analysis has assumed that all types of permissible advice arrangements are equally effective at reducing investment errors, and that none will increase errors (there will be no very bad advice). This assumption may not hold, however. The Department notes that if users of advice are fully informed and rational then more cost effective arrangements will dominate the market. This final rule establishes conditions to ensure that prospective users of advice available pursuant to it will have the opportunity to become fully informed.

The Department is uncertain about the potential magnitude of any transitional costs associated with this final rule. These might include costs associated with efforts of prospective fiduciary advisers to adapt their business practices to the applicable conditions. They might also include transaction costs associated with initial implementation of investment recommendations by newly advised participants.

Another source of uncertainty involves potential indirect downstream effects of this final rule. Investment advice may sometimes come packaged

with broader financial advice, which may include advice on how much to contribute to a DC plan. The Department currently has no basis to estimate the incidence of such broad advice or its effects, but notes that those effects could be large. The opening of large new markets to a variety of investment advice arrangements to which they were heretofore closed may affect the evolution of investment advice products and services and related technologies and their distribution channels and respective market shares. Other possible indirect effects that the Department currently lacks bases to estimate include financial market impacts of changes in investor behavior and related macroeconomic effects.

**Regulatory Flexibility Act**

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) (RFA) imposes certain requirements with respect to Federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. 551 *et seq.*) and are likely to have a significant economic impact on a substantial number of small entities. For purposes of analysis under the RFA, the Department proposes to continue its usual practice of considering a small entity to be an employee benefit plan with fewer than 100 participants.<sup>79</sup> The Department estimates that approximately 100,000 small plans, a significant number, will voluntarily begin offering investment advice to participants as a result of this final regulation.

The primary effect of this final regulation will be to reduce participants' investment errors. This is an effect on participants rather than on

plans. The impact on plans generally will be limited to increasing the means by which they may make advice available to participants, and this impact will be similar and proportionate for small and large plans. Therefore the Department certifies that the impact on small entities will not be significant. Pursuant to this certification the Department has refrained from preparing an Initial Regulatory Flexibility Analysis of this final regulation.

Notwithstanding this certification, the Department did separately consider the impact of this final regulation on participants in small plans.

As noted above, prior to implementation of the PPA smaller plan sponsors offered advice generally, and in-person advice in particular, more frequently than larger plan sponsors. The Department believes that exemptive relief provided by both the PPA and this final regulation will promote wider offering of advice by small and large plans sponsors alike. Accordingly the Department estimated the impacts on small plans assuming that they generally will be proportionate to those on large plans. However, because smaller plan sponsors are more likely to offer in-person advice, their average cost for advice and the proportion of participants using advice may both be higher. The Department estimates that the PPA and this final regulation will reduce small DC plan participant investment errors respectively by between \$169 million and \$299 million annually, at a cost of between \$38 million and \$67 million annually. The estimated impacts on small plans and their participants are summarized in Table 8 below.

TABLE 8—SMALL DC PLAN PARTICIPANT IMPACTS

|                                      | Pre-PPA | PPA          |                  |               |
|--------------------------------------|---------|--------------|------------------|---------------|
|                                      |         | Low estimate | Primary estimate | High estimate |
| Dollars advised (\$billions) .....   | \$50    | \$71         | \$79             | \$87          |
| Investment errors (\$billions) ..... | \$7.9   | \$7.7        | \$7.7            | \$7.6         |

<sup>79</sup>EBSA has consulted with the SBA Office of Advocacy concerning use of this participant count standard for RFA purposes. See 13 CFR 121.903(c).

TABLE 8—SMALL DC PLAN PARTICIPANT IMPACTS—Continued

|   | Pre-PPA | PPA          |                  |               |
|---|---------|--------------|------------------|---------------|
|   |         | Low estimate | Primary estimate | High estimate |
| <b>Incremental:</b>                                     |         |              |                  |               |
| Errors reduced by advice (\$millions) .....             | \$416   | \$169        | \$234            | \$299         |
| Advice cost (\$millions) .....                          | \$93    | \$38         | \$52             | \$67          |
| Advice cost rate (bps, average) .....                   | 18      | 18           | 18               | 18            |
| Error reduced per \$1 of advice, average .....          | \$4.49  | \$4.49       | \$4.49           | \$4.49        |
| <b>Cumulative (combined with policies to the left):</b> |         |              |                  |               |
| Errors reduced by advice (\$millions) .....             | \$416   | \$585        | \$650            | \$715         |
| Advice cost (\$millions) .....                          | \$93    | \$130        | \$145            | \$159         |
| Advice cost rate (bps, average) .....                   | 18      | 18           | 18               | 18            |
| Error reduced per \$1 of advice, average .....          | \$4.49  | \$4.49       | \$4.49           | \$4.49        |

### Congressional Review Act

This final rule is subject to the Congressional Review Act provisions of the Small Business Regulatory Enforcement Fairness Act of 1996 (5 U.S.C. 801 *et seq.*) and will be transmitted to the Congress and the Comptroller General for review.

### Unfunded Mandates Reform Act

For purposes of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104-4), as well as Executive Order 12875, the final rule does not include any Federal mandate that will result in expenditures by state, local, or tribal governments in the aggregate of more than \$100 million, adjusted for inflation, or increase expenditures by the private sector of more than \$100 million, adjusted for inflation. Compliance with the terms and condition of the final rule is a condition of relief from the prohibited transaction provisions of ERISA and the Code. Such exemptive relief would allow a fiduciary adviser to receive compensation from providers of recommended investments. As such, this final rule does not include any Federal mandates that will require expenditures by the private sector *per se*.

### Federalism Statement

Executive Order 13132 (August 4, 1999) outlines fundamental principles of federalism and requires the adherence to specific criteria by federal agencies in the process of their formulation and implementation of policies that have substantial direct effects on the States, the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. This final rule does not have federalism implications because it has no substantial direct effect on the States, on

the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Section 514 of ERISA provides, with certain exceptions specifically enumerated, that the provisions of Titles I and IV of ERISA supersede any and all laws of the States as they relate to any employee benefit plan covered under ERISA. The requirements implemented in the rule do not alter the fundamental provisions of the statute with respect to employee benefit plans, and as such would have no implications for the States or the relationship or distribution of power between the national government and the States.

### Paperwork Reduction Act

In accordance with the requirements of the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3506(c)(2)), the notice of proposed rulemaking (NPRM) solicited comments on the information collections included therein. The Department also submitted an information collection request (ICR) to OMB in accordance with 44 U.S.C. 3507(d), contemporaneously with the publication of the NPRM, for OMB's review. Although no public comments were received that specifically addressed the paperwork burden associated with the ICR, the Department welcomes public comments on its estimates and any suggestions for reducing the paperwork burdens.

In connection with the publication of this final rule, the Department submitted an ICR to OMB for a revised information collection. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. OMB approved the ICR on October 18, 2011 under OMB Control Number 1210-0134, which will expire on October 31,

2014. A copy of the ICR may be obtained by contacting the PRA addressee: G. Christopher Cosby, Office of Policy and Research, U.S. Department of Labor, Employee Benefits Security Administration, 200 Constitution Avenue, NW., Room N-5718, Washington, DC 20210. *Telephone:* (202) 693-8410; *Fax:* (202) 219-2745. These are not toll-free numbers. *E-mail:* [ebbsa.opr@dol.gov](mailto:ebbsa.opr@dol.gov). ICRs submitted to OMB also are available at [reginfo.gov](http://www.reginfo.gov/public/do/PRAMain) (<http://www.reginfo.gov/public/do/PRAMain>).

In order to use the statutory exemption to provide investment advice to participants, fiduciary advisers are required to make disclosures to participants, authorizing fiduciaries, and hire an independent auditor to conduct a compliance audit and issue an audit report every year. Fiduciary advisers who satisfy the conditions of the exemption based on the provision of computer model-generated investment advice are required to obtain certification of the model from an eligible investment expert. These paperwork requirements are designed to safeguard the interests of participants in connection with investment advice covered by the rule.

The Department calculated the estimated hour and cost burden of the ICRs under the final rule using the same methodology that was used in making such estimate in the March 2010 proposal.<sup>80</sup> The Department has made a minor increase to the estimated number of DC plan sponsors offering advice, the number of DC plan participants utilizing advice, and the labor hour rates used to estimate the hour burden based on more

<sup>80</sup> 75 FR 9360, 9364-65 (Mar. 2, 2010), at <http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=23559&AgencyId=8&DocumentType=1>.

current data.<sup>81</sup> The Department also has taken into account a new requirement in paragraph (b)(8) of the final rule, which requires fiduciary advisers to provide written notification to authorizing fiduciaries stating that it: (i) Intends to comply with the conditions of the statutory exemption under ERISA sections 408(b)(14) and 408(g) and these final regulations; (ii) will be audited annually by an independent auditor for compliance with the conditions of the exemption and regulations; and, (iii) that the auditor will furnish the authorizing fiduciary with a copy of the auditor's findings within 60 days of completion of the audit.<sup>82</sup> All other calculations remain the same as in the March 2010 proposed rule.

The Department made several specific basic assumptions in order to establish a reasonable estimate of the paperwork burden of this information collection:

- The Department assumes that 80% of disclosures<sup>83</sup> will be distributed electronically via means already in existence as a usual and customary business practice and the costs arising from electronic distribution will be negligible.

- The Department assumes that investment advisory firms will use existing in-house resources to prepare most disclosures and to maintain the recordkeeping systems. This assumption does not apply to the computer model certification, the audit or the computer program used to generate disclosures for IRA participants.

- The Department assumes a combination of personnel will perform the information collections with an hourly wage rate for 2011 of approximately \$111, including both wages and benefits, for a financial manager and approximately \$27 for clerical personnel.<sup>84</sup> Legal professional

time is similarly assumed to be almost \$124 per hour, and computer programming time is estimated at \$72 per hour.

The Department assigned an hour burden (with associated 'equivalent costs' derived from multiplying the hour burden by the estimated employee compensation) and a cost burden (the actual monetary expenses of the entity, i.e. material and postage costs and fees paid to outside entities) to this final regulation. The total costs of this final regulation are calculated by adding the mutually exclusive hour burden equivalent costs and the cost burden. These PRA costs are a subset of the overall costs of this final regulation. The Department estimates that the third-party disclosures, computer model certification, and audit requirements for the final statutory exemption will require approximately 5.2 million burden hours (with an associated equivalent cost of approximately \$602 million) and a cost burden of approximately \$580 million in the first year. In each subsequent year the total burden hours are estimated to be approximately 2.8 million hours (with an associated equivalent cost of approximately \$314 million) and the cost burden is estimated at approximately \$431 million.

These paperwork burden estimates are summarized as follows:

*Type of Review:* Revised Collection.

*Agency:* Employee Benefits Security Administration, Department of Labor.

*Titles:* Final Statutory Exemption for the Provision of Investment Advice to Participants and Beneficiaries of Participant-Directed Individual Account Plans and IRAs.

*OMB Control Number:* 1210-0134.

*Affected Public:* Business or other for-profit.

*Estimated Number of Respondents:* 16,000.

*Estimated Number of Annual Responses:* 20,684,000.

*Frequency of Response:* Initially, Annually, Upon Request, when a material change.

*Estimated Total Annual Hour Burden:* 5,179,000 hours in the first year; 2,849,000 hours in each subsequent year (with associated three year annualized hour burden of 3,626,000).

Employment Survey (May 2009) and the Bureau of Labor Statistics Employment Cost Index (October 2010). Clerical wage and benefits estimates are based on metropolitan wage rates for executive secretaries and administrative assistants. Financial manager wage and benefits estimates are based on metropolitan wage estimates for financial managers. Legal professional wage and benefits estimates are based on metropolitan wage rates for lawyers. Computer programmer wage and benefits estimates are based on metropolitan wage rates for professional computer programmers.

*Estimated Total Annual Cost Burden:* \$580,272,000 in the first year; \$430,973,000 for each subsequent year (with associated three year annualized cost burden of \$480,739,000).

#### List of Subjects in 29 CFR Part 2550

Employee benefit plans, Exemptions, Fiduciaries, Investments, Pensions, Prohibited transactions, Reporting and recordkeeping requirements, and Securities.

For the reasons set forth in the preamble, Chapter XXV, subchapter F, part 2550 of Title 29 of the Code of Federal Regulations is amended as follows:

#### PART 2550—RULES AND REGULATIONS FOR FIDUCIARY RESPONSIBILITY

■ 1. The authority citation for part 2550 is revised to read as follows:

**Authority:** 29 U.S.C. 1135; and Secretary of Labor's Order No. 6-2009, 74 FR 21524 (May 7, 2009). Secs. 2550.401b-1, 2550.408b-1, 2550.408b-19, 2550.408g-1, and 2550.408g-2 also issued under sec. 102, Reorganization Plan No. 4 of 1978, 5 U.S.C. App. Sec. 2550.401c-1 also issued under 29 U.S.C. 1101. Sections 2550.404c-1 and 2550.404c-5 also issued under 29 U.S.C. 1104. Sec. 2550.407c-3 also issued under 29 U.S.C. 1107. Sec. 2550.404a-2 also issued under 26 U.S.C. 401 note (sec. 657(c)(2), Pub. L. 107-16, 115 Stat. 38, 136 (2001)). Sec. 2550.408b-1 also issued under 29 U.S.C. 1108(b)(1). Sec. 2550.408b-19 also issued under sec. 611(g)(3), Public Law 109-280, 120 Stat. 780, 975 (2006).

■ 2. Add § 2550.408g-1 to read as follows:

#### § 2550.408g-1 Investment advice—participants and beneficiaries.

(a) *In general.* (1) This section provides relief from the prohibitions of section 406 of the Employee Retirement Income Security Act of 1974, as amended (ERISA or the Act), and section 4975 of the Internal Revenue Code of 1986, as amended (the Code), for certain transactions in connection with the provision of investment advice to participants and beneficiaries. This section, at paragraph (b), implements the statutory exemption set forth at sections 408(b)(14) and 408(g)(1) of ERISA and sections 4975(d)(17) and 4975(f)(8) of the Code. The requirements and conditions set forth in this section apply solely for the relief described in paragraph (b) of this section and, accordingly, no inferences should be drawn with respect to requirements applicable to the provision of investment advice not addressed by this section.

<sup>81</sup> The increase in the estimated number of DC plans offering advice and DC plan participants utilizing advice is due to updating the count to reflect 2008 Form 5500 data, the latest year for which Form 5500 data is available. The counts in the 2010 Proposed Rule were based on 2006 Form 5500 data.

<sup>82</sup> The Department estimates that no additional hour or cost burden will be associated with this disclosure, because it will be provided in the normal course of engaging in an eligible investment advice engagement.

<sup>83</sup> This estimate is derived from Current Population Survey October 2003 School Supplement probit equations applied to the February 2005 Contingent Worker Supplement. These equations show that approximately 81 percent of workers aged 19 to 65 had internet access either at home or at work in 2005. The Department further assumes that one percent of these participants will elect to receive paper documents instead of electronic, thus 20 percent of participants receive disclosures through paper media.

<sup>84</sup> Hourly wage estimates are based on data from the Bureau of Labor Statistics Occupational

(2) Nothing contained in ERISA section 408(g)(1), Code section 4975(f)(8), or this regulation imposes an obligation on a plan fiduciary or any other party to offer, provide or otherwise make available any investment advice to a participant or beneficiary.

(3) Nothing contained in ERISA section 408(g)(1), Code section 4975(f)(8), or this regulation invalidates or otherwise affects prior regulations, exemptions, interpretive or other guidance issued by the Department of Labor pertaining to the provision of investment advice and the circumstances under which such advice may or may not constitute a prohibited transaction under section 406 of ERISA or section 4975 of the Code.

(b) *Statutory exemption.* (1) *General.* Sections 408(b)(14) and 408(g)(1) of ERISA provide an exemption from the prohibitions of section 406 of ERISA for transactions described in section 408(b)(14) of ERISA in connection with the provision of investment advice to a participant or a beneficiary if the investment advice is provided by a fiduciary adviser under an “eligible investment advice arrangement.” Sections 4975(d)(17) and (f)(8) of the Code contain parallel provisions to ERISA sections 408(b)(14) and (g)(1).

(2) *Eligible investment advice.* For purposes of section 408(g)(1) of ERISA and section 4975(f)(8) of the Code, an “eligible investment advice arrangement” means an arrangement that meets either the requirements of paragraph (b)(3) of this section or paragraph (b)(4) of this section, or both.

(3) *Arrangements that use fee leveling.* For purposes of this section, an arrangement is an eligible investment advice arrangement if—

(i)(A) Any investment advice is based on generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time, although nothing herein shall preclude any investment advice from being based on generally accepted investment theories that take into account additional considerations;

(B) Any investment advice takes into account investment management and other fees and expenses attendant to the recommended investments;

(C) Any investment advice takes into account, to the extent furnished by a plan, participant or beneficiary, information relating to age, time horizons (e.g., life expectancy, retirement age), risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences of

the participant or beneficiary. A fiduciary adviser shall request such information, but nothing in this paragraph (b)(3)(i)(C) shall require that any investment advice take into account information requested, but not furnished by a participant or beneficiary, nor preclude requesting and taking into account additional information that a plan or participant or beneficiary may provide;

(D) No fiduciary adviser (including any employee, agent, or registered representative) that provides investment advice receives from any party (including an affiliate of the fiduciary adviser), directly or indirectly, any fee or other compensation (including commissions, salary, bonuses, awards, promotions, or other things of value) that varies depending on the basis of a participant's or beneficiary's selection of a particular investment option; and

(ii) The requirements of paragraphs (b)(5), (6), (7), (8) and (9) and paragraph (d) of this section are met.

(4) *Arrangements that use computer models.* For purposes of this section, an arrangement is an eligible investment advice arrangement if the only investment advice provided under the arrangement is advice that is generated by a computer model described in paragraphs (b)(4)(i) and (ii) of this section under an investment advice program and with respect to which the requirements of paragraphs (b)(5), (6), (7), (8) and (9) and paragraph (d) are met.

(i) A computer model shall be designed and operated to—

(A) Apply generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time, although nothing herein shall preclude a computer model from applying generally accepted investment theories that take into account additional considerations;

(B) Take into account investment management and other fees and expenses attendant to the recommended investments;

(C) Appropriately weight the factors used in estimating future returns of investment options;

(D) Request from a participant or beneficiary and, to the extent furnished, utilize information relating to age, time horizons (e.g., life expectancy, retirement age), risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences; provided, however, that nothing herein shall preclude a computer model from requesting and taking into account

additional information that a plan or a participant or beneficiary may provide;

(E) Utilize appropriate objective criteria to provide asset allocation portfolios comprised of investment options available under the plan;

(F) Avoid investment recommendations that:

(1) Inappropriately favor investment options offered by the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser over other investment options, if any, available under the plan; or

(2) Inappropriately favor investment options that may generate greater income for the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser; and

(G)(1) Except as provided in paragraph (b)(4)(i)(G)(2) of this section, take into account all designated investment options, within the meaning of paragraph (c)(1) of this section, available under the plan without giving inappropriate weight to any investment option.

(2) A computer model shall not be treated as failing to meet the requirements of this paragraph merely because it does not make recommendations relating to the acquisition, holding or sale of an investment option that:

(i) Constitutes an annuity option with respect to which a participant or beneficiary may allocate assets toward the purchase of a stream of retirement income payments guaranteed by an insurance company, provided that, contemporaneous with the provision of investment advice generated by the computer model, the participant or beneficiary is also furnished a general description of such options and how they operate; or

(ii) The participant or beneficiary requests to be excluded from consideration in such recommendations.

(iii) Prior to utilization of the computer model, the fiduciary adviser shall obtain a written certification, meeting the requirements of paragraph (b)(4)(iv) of this section, from an eligible investment expert, within the meaning of paragraph (b)(4)(iii) of this section, that the computer model meets the requirements of paragraph (b)(4)(i) of this section. If, following certification, a computer model is modified in a manner that may affect its ability to meet the requirements of paragraph (b)(4)(i), the fiduciary adviser shall, prior to utilization of the modified model, obtain a new certification from an eligible investment expert that the

computer model, as modified, meets the requirements of paragraph (b)(4)(i).

(iii) The term “eligible investment expert” means a person that, through employees or otherwise, has the appropriate technical training or experience and proficiency to analyze, determine and certify, in a manner consistent with paragraph (b)(4)(iv) of this section, whether a computer model meets the requirements of paragraph (b)(4)(i) of this section; except that the term “eligible investment expert” does not include any person that: Has any material affiliation or material contractual relationship with the fiduciary adviser, with a person with a material affiliation or material contractual relationship with the fiduciary adviser, or with any employee, agent, or registered representative of the foregoing; or develops a computer model utilized by the fiduciary adviser to satisfy this paragraph (b)(4).

(iv) A certification by an eligible investment expert shall—

(A) Be in writing;

(B) Contain—

(1) An identification of the methodology or methodologies applied in determining whether the computer model meets the requirements of paragraph (b)(4)(i) of this section;

(2) An explanation of how the applied methodology or methodologies demonstrated that the computer model met the requirements of paragraph (b)(4)(i) of this section;

(3) A description of any limitations that were imposed by any person on the eligible investment expert’s selection or application of methodologies for determining whether the computer model meets the requirements of paragraph (b)(4)(i) of this section;

(4) A representation that the methodology or methodologies were applied by a person or persons with the educational background, technical training or experience necessary to analyze and determine whether the computer model meets the requirements of paragraph (b)(4)(i); and

(5) A statement certifying that the eligible investment expert has determined that the computer model meets the requirements of paragraph (b)(4)(i) of this section; and

(C) Be signed by the eligible investment expert.

(v) The selection of an eligible investment expert as required by this section is a fiduciary act governed by section 404(a)(1) of ERISA.

(5) *Arrangement must be authorized by a plan fiduciary.* (i) Except as provided in paragraph (b)(5)(ii) of this section, the arrangement pursuant to which investment advice is provided to

participants and beneficiaries pursuant to this section must be expressly authorized by a plan fiduciary (or, in the case of an Individual Retirement Account (IRA), the IRA beneficiary) other than: The person offering the arrangement; any person providing designated investment options under the plan; or any affiliate of either. Provided, however, that for purposes of the preceding, in the case of an IRA, an IRA beneficiary will not be treated as an affiliate of a person solely by reason of being an employee of such person.

(ii) In the case of an arrangement pursuant to which investment advice is provided to participants and beneficiaries of a plan sponsored by the person offering the arrangement or a plan sponsored by an affiliate of such person, the authorization described in paragraph (b)(5)(i) of this section may be provided by the plan sponsor of such plan, provided that the person or affiliate offers the same arrangement to participants and beneficiaries of unaffiliated plans in the ordinary course of its business.

(iii) For purposes of the authorization described in paragraph (b)(5)(i) of this section, a plan sponsor shall not be treated as a person providing a designated investment option under the plan merely because one of the designated investment options of the plan is an option that permits investment in securities of the plan sponsor or an affiliate.

(6) *Annual audit.* (i) The fiduciary adviser shall, at least annually, engage an independent auditor, who has appropriate technical training or experience and proficiency, and so represents in writing to the fiduciary adviser, to:

(A) Conduct an audit of the investment advice arrangements for compliance with the requirements of this section; and

(B) Within 60 days following completion of the audit, issue a written report to the fiduciary adviser and, except with respect to an arrangement with an IRA, to each fiduciary who authorized the use of the investment advice arrangement, in accordance with paragraph (b)(5) of this section, that—

(1) Identifies the fiduciary adviser,

(2) Indicates the type of arrangement (*i.e.*, fee leveling, computer models, or both),

(3) If the arrangement uses computer models, or both computer models and fee leveling, indicates the date of the most recent computer model certification, and identifies the eligible investment expert that provided the certification, and

(4) Sets forth the specific findings of the auditor regarding compliance of the arrangement with the requirements of this section.

(ii) With respect to an arrangement with an IRA, the fiduciary adviser:

(A) Within 30 days following receipt of the report from the auditor, as described in paragraph (b)(6)(i)(B) of this section, shall furnish a copy of the report to the IRA beneficiary or make such report available on its Web site, provided that such beneficiaries are provided information, with the information required to be disclosed pursuant to paragraph (b)(7) of this section, concerning the purpose of the report, and how and where to locate the report applicable to their account; and

(B) In the event that the report of the auditor identifies noncompliance with the requirements of this section, within 30 days following receipt of the report from the auditor, shall send a copy of the report to the Department of Labor at the following address: Investment Advice Exemption Notification, U.S. Department of Labor, Employee Benefits Security Administration, Room N–1513, 200 Constitution Ave., NW., Washington, DC 20210, or submit a copy electronically to [InvAdvNotification@dol.gov](mailto:InvAdvNotification@dol.gov).

(iii) For purposes of this paragraph (b)(6), an auditor is considered 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 with any designated investment options under the plan, and does not have any role in the development of the investment advice arrangement, or certification of the computer model utilized under the arrangement.

(iv) For purposes of this paragraph (b)(6), the auditor shall review sufficient relevant information to formulate an opinion as to whether the investment advice arrangements, and the advice provided pursuant thereto, offered by the fiduciary adviser during the audit period were in compliance with this section. Nothing in this paragraph shall preclude an auditor from using information obtained by sampling, as reasonably determined appropriate by the auditor, investment advice arrangements, and the advice pursuant thereto, during the audit period.

(v) The selection of an auditor for purposes of this paragraph (b)(6) is a fiduciary act governed by section 404(a)(1) of ERISA.

(7) *Disclosure to participants.* (i) The fiduciary adviser must provide, without charge, to a participant or a beneficiary before the initial provision of

investment advice with regard to any security or other property offered as an investment option, a written notification of:

(A) The role of any party that has a material affiliation or material contractual relationship with the fiduciary adviser in the development of the investment advice program, and in the selection of investment options available under the plan;

(B) The past performance and historical rates of return of the designated investment options available under the plan, to the extent that such information is not otherwise provided;

(C) All fees or other compensation that the fiduciary adviser or any affiliate thereof is to receive (including compensation provided by any third party) in connection with—

(1) The provision of the advice;

(2) The sale, acquisition, or holding of any security or other property pursuant to such advice; or

(3) Any rollover or other distribution of plan assets or the investment of distributed assets in any security or other property pursuant to such advice;

(D) Any material affiliation or material contractual relationship of the fiduciary adviser or affiliates thereof in the security or other property;

(E) The manner, and under what circumstances, any participant or beneficiary information provided under the arrangement will be used or disclosed;

(F) The types of services provided by the fiduciary adviser in connection with the provision of investment advice by the fiduciary adviser;

(G) The adviser is acting as a fiduciary of the plan in connection with the provision of the advice; and

(H) 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.

(ii)(A) The notification required under paragraph (b)(7)(i) of this section must be written in a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant and must be sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of the information required to be provided in the notification.

(B) The appendix to this section contains a model disclosure form that may be used to provide notification of the information described in paragraph (b)(7)(i)(C) of this section. Use of the model form is not mandatory. However,

use of an appropriately completed model disclosure form will be deemed to satisfy the requirements of paragraphs (b)(7)(i) and (ii) of this section with respect to such information.

(iii) The notification required under paragraph (b)(7)(i) of this section may, in accordance with 29 CFR 2520.104b-1, be provided in written or electronic form.

(iv) With respect to the information required to be disclosed pursuant to paragraph (b)(7)(i) of this section, the fiduciary adviser shall, at all times during the provision of advisory services to the participant or beneficiary pursuant to the arrangement—

(A) Maintain accurate, up-to-date information in a form that is consistent with paragraph (b)(7)(ii) of this section,

(B) Provide, without charge, accurate, up-to-date information to the recipient of the advice no less frequently than annually,

(C) Provide, without charge, accurate information to the recipient of the advice upon request of the recipient, and

(D) Provide, without charge, to the recipient of the advice any material change to the information described in paragraph (b)(7)(i) at a time reasonably contemporaneous to the change in information.

(8) *Disclosure to authorizing fiduciary.* The fiduciary adviser shall, in connection with any authorization described in paragraph (b)(5)(i) of this section, provide the authorizing fiduciary with a written notice informing the fiduciary that:

(i) The fiduciary adviser intends to comply with the conditions of the statutory exemption for investment advice under section 408(b)(14) and (g) of the Employee Retirement Income Security Act and this section;

(ii) The fiduciary adviser's arrangement will be audited annually by an independent auditor for compliance with the requirements of the statutory exemption and related regulations; and

(iii) The auditor will furnish the authorizing fiduciary a copy of that auditor's findings within 60 days of its completion of the audit.

(9) *Other conditions.* The requirements of this paragraph are met if—

(i) The fiduciary adviser provides appropriate disclosure, in connection with the sale, acquisition, or holding of the security or other property, in accordance with all applicable securities laws,

(ii) Any sale, acquisition, or holding of a security or other property occurs solely at the direction of the recipient of the advice,

(iii) The compensation received by the fiduciary adviser and affiliates thereof in connection with the sale, acquisition, or holding of the security or other property is reasonable, and

(iv) The terms of the sale, acquisition, or holding of the security or other property are at least as favorable to the plan as an arm's length transaction would be.

(c) *Definitions.* For purposes of this section:

(1) The term “*designated investment option*” means any investment option designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term “*designated investment option*” shall not include “*brokerage windows*,” “*self-directed brokerage accounts*,” or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan. The term “*designated investment option*” has the same meaning as the term “*designated investment alternative*” as defined in 29 CFR 2550.404a-5(h).

(2)(i) The term “*fiduciary adviser*” means, with respect to a plan, a person who is a fiduciary of the plan by reason of the provision of investment advice referred to in section 3(21)(A)(ii) of ERISA by the person to the participant or beneficiary of the plan and who is—

(A) Registered as an investment adviser under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 *et seq.*) or under the laws of the State in which the fiduciary maintains its principal office and place of business,

(B) A bank or similar financial institution referred to in section 408(b)(4) of ERISA or a savings association (as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)), but only if the advice is provided through a trust department of the bank or similar financial institution or savings association which is subject to periodic examination and review by Federal or State banking authorities,

(C) An insurance company qualified to do business under the laws of a State,

(D) A person registered as a broker or dealer under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*),

(E) An affiliate of a person described in paragraphs (c)(2)(i)(A) through (D), or

(F) An employee, agent, or registered representative of a person described in paragraphs (c)(2)(i)(A) through (E) of this section who satisfies the requirements of applicable insurance, banking, and securities laws relating to the provision of advice.

(ii) Except as provided under 29 CFR 2550.408g-2, a fiduciary adviser includes any person who develops the computer model, or markets the computer model or investment advice program, utilized in satisfaction of paragraph (b)(4) of this section.

(3) A “*registered representative*” of another entity means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(18)) (substituting the entity for the broker or dealer referred to in such section) or a person described in section 202(a)(17) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(17)) (substituting the entity for the investment adviser referred to in such section).

(4) “*Individual Retirement Account*” or “*IRA*” means—

(i) An individual retirement account described in section 408(a) of the Code;

(ii) An individual retirement annuity described in section 408(b) of the Code;

(iii) An Archer MSA described in section 220(d) of the Code;

(iv) A health savings account described in section 223(d) of the Code;

(v) A Coverdell education savings account described in section 530 of the Code;

(vi) A trust, plan, account, or annuity which, at any time, has been determined by the Secretary of the Treasury to be described in any of paragraphs (c)(4)(i) through (v) of this section;

(vii) A “simplified employee pension” described in section 408(k) of the Code; or

(viii) A “simple retirement account” described in section 408(p) of the Code.

(5) An “*affiliate*” of another person means—

(i) Any person directly or indirectly owning, controlling, or holding with power to vote, 5 percent or more of the outstanding voting securities of such other person;

(ii) Any person 5 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person;

(iii) Any person directly or indirectly controlling, controlled by, or under common control with, such other person; and

(iv) Any officer, director, partner, copartner, or employee of such other person.

(6)(i) A person with a “*material affiliation*” with another person means—

(A) Any affiliate of the other person;

(B) Any person directly or indirectly owning, controlling, or holding, 5 percent or more of the interests of such other person; and

(C) Any person 5 percent or more of whose interests are directly or indirectly owned, controlled, or held, by such other person.

(ii) For purposes of paragraph (c)(6)(i) of this section, “*interest*” means with respect to an entity—

(A) The combined voting power of all classes of stock entitled to vote or the total value of the shares of all classes of stock of the entity if the entity is a corporation;

(B) The capital interest or the profits interest of the entity if the entity is a partnership; or

(C) The beneficial interest of the entity if the entity is a trust or unincorporated enterprise.

(7) Persons have a “*material contractual relationship*” if payments made by one person to the other person pursuant to contracts or agreements between the persons exceed 10 percent of the gross revenue, on an annual basis, of such other person.

(8) “*Control*” means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(d) *Retention of records.* The fiduciary adviser must maintain, for a period of not less than 6 years after the provision of investment advice under this section any records necessary for determining whether the applicable requirements of this section have been met. A transaction prohibited under section 406 of ERISA shall not be considered to have occurred solely because the records are lost or destroyed prior to the end of the 6-year period due to circumstances beyond the control of the fiduciary adviser.

(e) *Noncompliance.* (1) The relief from the prohibited transaction provisions of section 406 of ERISA and the sanctions resulting from the application of section 4975 of the Code described in paragraph (b) of this section shall not apply to any transaction described in such paragraphs in connection with the provision of investment advice to an individual participant or beneficiary with respect to which the applicable conditions of this section have not been satisfied.

(2) In the case of a pattern or practice of noncompliance with any of the applicable conditions of this section, the relief described in paragraph (b) of this section shall not apply to any transaction in connection with the provision of investment advice provided by the fiduciary adviser during the period over which the pattern or practice extended.

(f) *Effective date and applicability date.* This section shall be effective December 27, 2011. This section shall

apply to transactions described in paragraph (b) of this section occurring on or after December 27, 2011.

## Appendix to § 2550.408g-1

### Fiduciary Adviser Disclosure

This document contains important information about [enter name of Fiduciary Adviser] and how it is compensated for the investment advice provided to you. You should carefully consider this information in your evaluation of that advice.

[enter name of Fiduciary Adviser] has been selected to provide investment advisory services for the [enter name of Plan]. [enter name of Fiduciary Adviser] will be providing these services as a fiduciary under the Employee Retirement Income Security Act (ERISA). [enter name of Fiduciary Adviser], therefore, must act prudently and with only your interest in mind when providing you recommendations on how to invest your retirement assets.

### Compensation of the Fiduciary Adviser and Related Parties

[enter name of Fiduciary Adviser] (is/is not) compensated by the plan for the advice it provides. (if compensated by the plan, explain what and how compensation is charged (e.g., asset-based fee, flat fee, per advice)). (If applicable, [enter name of Fiduciary Adviser] is not compensated on the basis of the investment(s) selected by you.)

Affiliates of [enter name of Fiduciary Adviser] (if applicable enter, and other parties with whom [enter name of Fiduciary Adviser] is related or has a material financial relationship) also will be providing services for which they will be compensated. These services include: [enter description of services, e.g., investment management, transfer agent, custodial, and shareholder services for some/all the investment funds available under the plan.]

When [enter name of Fiduciary Adviser] recommends that you invest your assets in an investment fund of its own or one of its affiliates and you follow that advice, [enter name of Fiduciary Adviser] or that affiliate will receive compensation from the investment fund based on the amount you invest. The amounts that will be paid by you will vary depending on the particular fund in which you invest your assets and may range from % to %. Specific information concerning the fees and other charges of each investment fund is available from [enter source, such as: your plan administrator, investment fund provider (possibly with Internet Web site address)]. This information should be reviewed carefully before you make an investment decision.

(if applicable enter, [enter name of Fiduciary Adviser] or affiliates of [enter name of Fiduciary Adviser] also receive compensation from non-affiliated investment funds as a result of investments you make as a result of recommendations of [enter name of Fiduciary Adviser]. The amount of this compensation also may vary depending on the particular fund in which you invest. This compensation may range from % to %. Specific information concerning the fees and other charges of each investment fund is

available from [enter source, such as: your plan administrator, investment fund provider (possibly with Internet Web site address)]. This information should be reviewed carefully before you make an investment decision.

(if applicable enter, In addition to the above, [enter name of Fiduciary Adviser] or affiliates of [enter name of Fiduciary Adviser] also receive other fees or compensation, such as commissions, in connection with the sale, acquisition or holding of investments selected by you as a result of recommendations of [enter name of Fiduciary Adviser]. These amounts are: [enter description of all other fees or compensation to be received in connection with sale, acquisition or holding of investments]. This information should be reviewed carefully before you make an investment decision.

(if applicable enter, When [enter name of Fiduciary Adviser] recommends that you take a rollover or other distribution of assets from the plan, or recommends how those assets should subsequently be invested, [enter name of Fiduciary Adviser] or affiliates of [enter name of Fiduciary Adviser] will receive additional fees or compensation. These amounts are: [enter description of all other fees or compensation to be received in connection with any rollover or other distribution of plan assets or the investment of distributed assets]. This information should be reviewed carefully before you make a decision to take a distribution.

#### Consider Impact of Compensation on Advice

The fees and other compensation that [enter name of Fiduciary Adviser] and its affiliates receive on account of assets in [enter name of Fiduciary Adviser] (enter if applicable, and non-[enter name of Fiduciary Adviser]) investment funds are a significant source of revenue for the [enter name of Fiduciary Adviser] and its affiliates. You should carefully consider the impact of any such fees and compensation in your evaluation of the investment advice that [enter name of Fiduciary Adviser] provides to you. In this regard, you may arrange for the provision of advice by another adviser that may have no material affiliation with or receive no compensation in connection with the investment funds or products offered under the plan. This type of advice is/is not available through your plan.

#### Investment Returns

While understanding investment-related fees and expenses is important in making informed investment decisions, it is also important to consider additional information about your investment options, such as performance, investment strategies and risks. Specific information related to the past performance and historical rates of return of

the investment options available under the plan (has/has not) been provided to you by [enter source, such as: your plan administrator, investment fund provider]. (if applicable enter, If not provided to you, the information is attached to this document.)

For options with returns that vary over time, past performance does not guarantee how your investment in the option will perform in the future; your investment in these options could lose money.

#### Parties Participating in Development of Advice Program or Selection of Investment Options

Name, and describe role of, affiliates or other parties with whom the fiduciary adviser has a material affiliation or contractual relationship that participated in the development of the investment advice program (if this is an arrangement that uses computer models) or the selection of investment options available under the plan.

#### Use of Personal Information

Include a brief explanation of the following— What personal information will be collected; How the information will be used; Parties with whom information will be shared; How the information will be protected; and When and how notice of the Fiduciary Adviser's privacy statement will be available to participants and beneficiaries.

Should you have any questions about [enter name of Fiduciary Adviser] or the information contained in this document, you may contact [enter name of contact person for fiduciary adviser, telephone number, address].

- 3. Add § 2550.408g–2 to read as follows:

#### § 2550.408g–2 Investment advice—fiduciary election.

(a) *General.* Section 408(g)(11)(A) of the Employee Retirement Income Security Act, as amended (ERISA), provides that a person who develops a computer model or who markets a computer model or investment advice program used in an “eligible investment advice arrangement” shall be treated as a fiduciary of a plan by reason of the provision of investment advice referred to in ERISA section 3(21)(A)(ii) to the plan participant or beneficiary, and shall be treated as a “fiduciary adviser” for purposes of ERISA sections 408(b)(14) and 408(g), except that the Secretary of Labor may prescribe rules under which only one fiduciary adviser may elect to be treated as a fiduciary with respect to the plan. Section

4975(f)(8)(I)(i) of the Internal Revenue Code, as amended (the Code), contains a parallel provision to ERISA section 408(g)(11)(A) that applies for purposes of Code sections 4975(d)(17) and 4975(f)(8). This section sets forth requirements that must be satisfied in order for one such fiduciary adviser to elect to be treated as a fiduciary with respect to a plan under an eligible investment advice arrangement.

(b)(1) If an election meets the requirements in paragraph (b)(2) of this section, then the person identified in the election shall be the sole fiduciary adviser treated as a fiduciary by reason of developing or marketing the computer model, or marketing the investment advice program, used in an eligible investment advice arrangement.

(2) An election satisfies the requirements of this paragraph (b) with respect to an eligible investment advice arrangement if the election is in writing and such writing—

(i) Identifies the investment advice arrangement, and the person offering the arrangement, with respect to which the election is to be effective;

(ii) Identifies a person who—

(A) Is described in any of 29 CFR 2550.408g–1(c)(2)(i)(A) through (E),

(B) Develops the computer model, or markets the computer model or investment advice program, utilized in satisfaction of 29 CFR 2550.408g–1(b)(4) with respect to the arrangement, and

(C) Acknowledges that it elects to be treated as the only fiduciary, and fiduciary adviser, by reason of developing such computer model, or marketing such computer model or investment advice program;

(iii) Is signed by the person identified in paragraph (b)(2)(ii) of this section;

(iv) Is furnished to the person who authorized the arrangement, in accordance with 29 CFR 2550.408g–1(b)(5); and

(v) Is maintained in accordance with 29 CFR 2550.408g–1(d).

Signed at Washington, DC, this 5th day of October 2011.

**Phyllis C. Borzi,**

*Assistant Secretary, Employee Benefits Security Administration, Department of Labor.*

[FR Doc. 2011–26261 Filed 10–24–11; 8:45 am]

**BILLING CODE 4510–29–P**