DEPARTMENT OF LABOR

Employee Benefits Security Administration

29 CFR Part 2550

RIN 1210–AB13

Investment Advice—Participants and Beneficiaries

AGENCY: Employee Benefits Security Administration, DOL.

ACTION: Proposed rule.

SUMMARY: This document contains proposed regulations implementing the provisions of the statutory exemption set forth in sections 408(b)(14) and 408(g) of the Employee Retirement Income Security Act, as amended (ERISA or the Act), and parallel provisions in the Internal Revenue Code of 1986, as amended (Code), relating to the provision of investment advice described in the Act by a fiduciary adviser to participants and beneficiaries in participant-directed individual account plans, such as 401(k) plans, and beneficiaries of individual retirement accounts (and certain similar plans). Section 408(b)(14) provides an exemption from certain prohibited transaction provisions in ERISA with respect to the provision of investment advice, the investment transaction entered into 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 advice or the transaction pursuant to the advice. Section 408(g) describes the conditions under which the investment advice-related transactions are exempt. Upon adoption, the regulations will affect 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: Written comments on the proposed regulations should be submitted to the Department of Labor on or before October 6, 2008.

ADDRESSES: To facilitate the receipt and processing of comment letters, the Employee Benefits Security Administration (EBSA) encourages interested persons to submit their comments electronically by e-mail to *e-ORI@dol.gov* (Subject: Investment Advice Regulations), or by using the Federal eRulemaking portal at *http://www.regulations.gov* (follow instructions for submission of comments). Persons submitting comments electronically are encouraged not to submit paper copies. Persons interested in submitting paper copies should send or deliver their comments to the Office of Regulations and Interpretations, Employee Benefits Security Administration, Attn: Investment Advice Regulations, Room N–5655, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210. All comments will be available to the public, without charge, online at *http://www.regulations.gov* and *http://www.dol.gov/ebsa* and at the Public Disclosure Room, N–1513, Employee Benefits Security Administration, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210.

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

SUPPLEMENTARY INFORMATION:

A. Background

Section 3(21)(A)(ii) of ERISA includes 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.[1] The prohibited transaction provisions of ERISA and the Code prohibit an investment advice 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. 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.

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 the provision of investment advice might result in prohibited transactions.[2] Most recently, Congress and the Administration, responding to the need to afford participants and beneficiaries greater access to professional investment advice, amended the prohibited transaction provisions of ERISA and the Code, as part of the Pension Protection Act of 2006 (PPA),[3] 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 exemption under sections 408(b)(14) and 408(g) of ERISA. Parallel provisions were added to the Code at section 4975(d)(17) and 4975(f)(8).[4] Section 408(b)(14) sets forth the investment advice-related transactions that will be exempt from the prohibitions of 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.

On December 4, 2006, the Department published a Request for Information (RFI) in the **Federal Register** soliciting information to assist the Department in the development of regulations under sections 408(b)(14) and 408(g).[5] Specifically, the Department invited interested persons to address the qualifications for the ''eligible

[1] See also Code section 4975(e)(3)(B); 29 CFR 2510.3–21(c).

[2] 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).

[3] Public Law 109–280, 120 Stat. 780 (Aug. 17, 2006).

[4] Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 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.

[5] 71 FR 70429, Dec. 4, 2006. The Department, on the same date, also published a Request for Information in the **Federal Register** soliciting information to assist the Department in determining the feasibility of using computer models in connection with individual retirement accounts, as required by PPA section 601(b)(3). 72 FR 70427, Dec. 4, 2006.

investment expert'' that is required to certify that computer models used in connection with the statutory exemption meet the requirements of the statutory exemption. The Department also invited interested persons to provide information to assist the Department in developing procedures to be followed in certifying that a computer model meets the requirements of the statutory exemption. The Department also invited suggestions for a model disclosure form for purposes of the statutory exemption. In response to the RFI, the Department received 24 letters addressing a variety of issues presented by the statutory exemption. These comments have been taken into account in developing the proposed regulations.

On February 2, 2007, the Department issued Field Assistance Bulletin 2007–01 addressing certain issues presented by the new statutory exemption. This Bulletin affirmed that the enactment of sections 408(b)(14) and (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.[6] The Bulletin also confirmed the applicability of the principles set forth in section 408(g)(10) [Exemption for plan sponsor and certain other fiduciaries] to plan sponsors and fiduciaries who offered 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 for purposes of an eligible investment advice arrangement described in section 408(g)(2)(A)(i). The Department's views on that issue are set forth in the discussion of the proposed regulations that follows.

The proposed regulations contained in this notice would, upon adoption, implement the provisions of the statutory exemption for the provision of investment advice to participants and beneficiaries under sections 408(b)(14) and 408(g). In this regard, the Department notes that, in an effort to ensure broad availability of investment advice to both participants and beneficiaries in individual account plans and beneficiaries with individual retirement accounts, the Department also is publishing a proposed class exemption for the provision of investment advice to such individuals. The proposed class exemption appears in the Notice section of today's **Federal Register**.

B. Overview of Proposed § 2550.408g–1

1. General

In general, proposed § 2550.408g–1 tracks the requirements under section 408(g) 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) of the proposal 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.'' Paragraph (a) also notes that the Code contains parallel provisions at section 4975(d)(17) and (f)(8).

Paragraph (b) of the proposal provides that, for purposes of sections 408(g)(1) of ERISA and section 4975(f)(8) of the Code, an ''eligible investment advice arrangement'' shall mean an arrangement that meets either the requirements of paragraph (c) [describing investment advice arrangements that use fee-leveling] or paragraph (d) [describing investment advice arrangements that use computer modeling] of the proposal or both.

2. Fee-Leveling

With respect to arrangements that use fee-leveling, paragraph (c) of the proposal requires that any investment advice be based on generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time, although nothing in the proposal is intended to preclude investment advice from being based on generally accepted investment theories that take into account additional considerations. Paragraph (c) also requires that any investment advice take into account information furnished by a participant or beneficiary relating to age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and investment preferences, although nothing in the proposal is intended to preclude a fiduciary adviser from taking into account additional information that a participant or beneficiary may provide. While section 408(g)(2)(A)(i) does not specifically reference such conditions, the principles are so fundamental to the provision of informed, individualized investment advice that a failure on the part of a plan fiduciary to insist on such conditions in the selection of an investment adviser for plan participants would, in the Department's view, raise serious questions as to the fiduciary's exercise of prudence. For this reason, the Department determined that such conditions are sufficiently significant that they should be included in the regulation implementing the statutory exemption for investment advice.

With regard to compensation and fees for the provision of investment advice, paragraph (c)(1)(iii) provides that any fees or other compensation (including salary, bonuses, awards, promotions, commissions or other things of value) received, directly or indirectly, by *any employee, agent or registered representative that provides investment advice on behalf of a fiduciary adviser* does not vary depending on the basis of any investment option selected by a participant or beneficiary. Paragraph (c)(1)(iv) provides that any fees (including any commission or other compensation) received by *the fiduciary adviser* for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets do not vary depending on the basis of any investment option selected by a participant or beneficiary.

The individual compensation requirement in paragraph (c)(1)(iii) is designed to safeguard against a firm's creation of incentives for individuals to recommend certain investment products. It appears that, while an individual may have a general interest in the overall success of his or her employing firm, this interest, by itself, would not be inconsistent with the individual compensation requirement. This would not be the case, however, if the individual's direct or indirect compensation or benefits vary based on the selection of particular investment options. In order to determine whether more precise guidance can be developed, we request public comment on the types and formulations of direct and indirect compensation arrangements being utilized, and how they may operate under this provision.

[6] 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).

With regard to the foregoing, the Department, in interpreting the scope of the fee-leveling requirement for purposes of section 408(g)(2)(A)(i), expressed its view, in Field Assistance Bulletin 2007–01 (February 2, 2007), that only the fees or other compensation of the fiduciary adviser may not vary. In contrast to other provisions of section 408(b)(14) and section 408(g), the Department explained, section 408(g)(2)(A)(i) references only the fiduciary adviser, not the fiduciary adviser or an affiliate. Inasmuch as a person, pursuant to section 408(g)(11)(A), can be a fiduciary adviser only if that person is a fiduciary of the plan by virtue of providing investment advice, an affiliate of a registered investment adviser, a bank or similar financial institution, an insurance company, or a registered broker dealer will be subject to the varying fee limitation only if that affiliate is providing investment advice to plan participants and beneficiaries. The Department further noted that, consistent with past 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 would result solely by reason of providing investment advice and thus there would be no need for a prohibited transaction exemption.[7] The Department, therefore, concluded that Congress did not intend for the requirement that fees not vary depending on the basis of any investment options selected to extend to affiliates of the fiduciary adviser, unless, of course, the affiliate is also a provider of investment advice to a plan. This continues to be the view of the Department.

The Department also noted in the Bulletin that, although section 408(g)(11)(A) generally limits ''fiduciary advisers'' to certain types of entities, it also permits employees, agents, or registered representatives of those entities to also qualify as fiduciary advisers if they satisfy the requirements of applicable insurance, banking, and securities laws relating to the provision of the advice. *See* section 408(g)(11)(A)(vi). As with affiliates, such an individual must, for purposes of section 408(g)(11)(A), not only be an employee, agent, or registered representative of one of those entities, but also must provide investment advice in his or her capacity as employee, agent, or registered representative. The Department, therefore, concluded that the language of section 408(g)(11)(A) required a finding that, for purposes of the statutory exemption, when an individual acts as an employee, agent or registered representative on behalf of an entity engaged to provide investment advice to a plan, that individual, as well as the entity, must be treated as the fiduciary adviser for purposes of section 408(g)(11)(A) and, accordingly subject to the limitations of section 408(g)(2)(A)(i). In an effort to accommodate a wider variety of business structures and practices, making investment advice more available while protecting participants and beneficiaries, the Department is proposing a class exemption addressing fee leveling requirements for employees, agents and registered representatives, also appearing in today's **Federal Register**.

In addition to the foregoing, fiduciary advisers utilizing investment advice arrangements that employ fee-leveling must comply with the requirements of paragraphs (e) [authorization by plan fiduciary], (f) [audits], (g) [disclosure], (h) [miscellaneous], and (i) [maintenance of records] of the proposal, each of which is discussed in more detail below.

3. Computer Models

Paragraph (d) of the proposal addresses the requirements applicable to investment advice arrangements that rely on computer models. In this regard, paragraph (d) provides, consistent with the provisions of section 408(g)(3)(B), (C) and (D), that an arrangement shall be 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 (d)(1) and (2) of this section under an investment advice program, and with respect to which the requirements of paragraphs (e) [authorization by plan fiduciary], (f) [audits], (g) [disclosure], (h) [miscellaneous], and (i) [maintenance of records] of the proposal are met and any acquisition, holding or sale of a security or other property pursuant to such advice occurs solely at the direction of the participant or beneficiary.

Paragraph (d)(1), consistent with section 408(g)(3)(B)(i)–(v), sets forth the standards applicable to computer models. Specifically, paragraph (d)(1) requires that a computer model be designed and operated to: apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time, although nothing in the proposal is intended to preclude a computer model from applying generally accepted investment theories that take into account additional considerations; utilize information furnished by a participant or beneficiary relating to age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and investment preferences, although nothing in the proposal precludes a computer model from taking into account additional information that a plan or a participant or beneficiary may provide; and utilize appropriate objective criteria to provide asset allocation portfolios comprised of investment options available under the plan. See paragraph (d)(1)(i)–(iii) of the proposal.

In addition to the foregoing, a computer model, consistent with section 408(g)(3)(B)(iv),[8] must be designed and operated to avoid investment recommendations that: inappropriately favor investment options offered by the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser over other investment options, if any, available under the plan; or 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. In order to determine if further guidance can be developed with respect to this provision, the Department seeks public comment on circumstances under which it would be appropriate or inappropriate to favor particular investment options. For example, the Department believes that favoring a higher-cost investment alternative over an otherwise identical investment alternative with lower cost would be inappropriate.

As reflected in the language, a computer model would not fail to meet this requirement merely because the only investment options offered under the plan are options offered by the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser. The language also makes clear that models cannot be designed and operated to inappropriately favor those investment options that generate the most income for the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser. The proposal defines

[7] See AO 2005–10A; AO 97–15A.

[8] Pursuant to section 408(g)(3)(B)(iv), a computer model must operate ''in a manner that is not biased in favor of investments offered by the fiduciary adviser or a person with a material affiliation or contractual relationship with the fiduciary adviser.''

a ''material affiliation'' and ''material contractual relationship'' at paragraphs (j)(6) and (j)(7), respectively.

Paragraph (d)(1) further requires, consistent with section 408(g)(3)(B)(v),[9] that computer models take into account all ''designated investment options'' available under the plan without giving inappropriate weight to any investment option. See paragraph (d)(1)(v) of the proposal. The term ''designated investment option'' is defined in paragraph (j)(1) of the proposal, 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.

Paragraph (d)(1)(v) also provides that a computer model shall not be treated as failing to take all designated investment options into account merely because it does not take into account an investment option that constitutes an investment primarily in qualifying employer securities. Any such limitation on the investment advice to be generated by the computer model, however, must be disclosed to participants and beneficiaries under paragraph (g)(1)(vi) of the proposal, discussed below. Information received by the Department in response to both of its RFIs indicated that there are challenges attendant to developing computer models, which generally are based on underlying theories that rely on diversified asset classes, that address a single undiversified security, such as qualifying employer securities, in connection with generating investment recommendations that would enable a participant to construct a well-diversified investment portfolio. The Department is concerned that extending this requirement to qualifying employer securities might discourage arrangements based on utilization of a computer model, or otherwise limit their availability.[10] Accordingly, the Department has excluded investments primarily in qualifying employer securities from the requirement of paragraph (d)(1)(v) of the proposal.

Paragraph (d)(2) of the proposal requires that, prior to utilization of the computer model, the fiduciary adviser obtain a written certification that the computer model meets the requirements of paragraph (d)(1), discussed above. If the model is modified in a manner that may affect its ability to meet the requirements of paragraph (d)(1), the fiduciary adviser, prior to utilization of the modified model, must obtain a new certification. With regard to the certification, paragraph (d)(2) requires that the fiduciary adviser obtain a certification that meets the requirements of paragraph (d)(4) from an ''eligible investment expert,'' within the meaning of paragraph (d)(3).

Paragraph (d)(3) of 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 (d)(4), whether a computer model meets the requirements of paragraph (d)(1) 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. After consideration of the public comments, the Department has concluded that it would be very difficult to define a specific set of academic or other credentials that would serve to define the appropriate expertise and experience for an eligible investment expert.

Accordingly, under the proposal, it is the fiduciary adviser who is responsible for determining whether an eligible investment expert, itself or its employees, possesses the requisite training and experience to certify whether a given computer model meets the requirements of paragraph (d)(1) in a manner consistent with paragraph (d)(4) of the proposal. Paragraph (d)(5) of the proposal provides that, for purposes of the statutory exemption, the selection of the eligible investment expert by the fiduciary adviser is a fiduciary act governed by section 404(a)(1) of ERISA.

The Department notes that, although the proposal gives latitude to a fiduciary adviser in selecting an eligible investment expert to certify a computer model, as the party seeking prohibited transaction relief under the exemption, the fiduciary adviser has the burden of demonstrating that all applicable requirements of exemption are satisfied with respect to its arrangement. We also note that section 404 of ERISA requires the fiduciary adviser to act reasonably and prudently in its selection.

Paragraph (d)(4) of the proposal 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 (d)(1) of this section; an explanation of how the applied methodology or methodologies demonstrated that the computer model met the requirements of paragraph (d)(1) of this section; 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 (d)(1). 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 (d)(1); and a statement certifying that the eligible investment expert has determined that the computer model meets the requirements of paragraph (d)(1). Finally the certification must be signed by the eligible investment expert.

With regard to the certification described in paragraph (d)(4) of the proposal, public comments suggested a number of different approaches that could be followed in determining computer model consistency with the statutory criteria. The comments did not, however, suggest a single suitable approach. The Department, therefore, is wary of mandating a methodology under the proposal. The Department also believes that as computer models and their use under investment advice arrangements continue to develop, experts may need the flexibility to develop new methodologies for examining those models. Accordingly, paragraph (d)(4) does not require a particular methodology to be applied for purposes of certification.

[9] Section 408(g)(3)(B)(v) provides that computer models must take ''into account all investment options under the plan in specifying how a participant's account balance should be invested and is not inappropriately weighted with respect to any investment option.''

[10] It should be noted that, even in the absence of individualized advice, participants are reminded on a quarterly basis, via their pension benefit statements, of the importance of maintaining a diversified portfolio. Model language for purposes of this disclosure was set forth in Field Assistance Bulletin 2006–03 (Dec. 20, 2006). Among other things the model language provides that ''[I]f you invest more than 20% of your retirement savings in any one company or industry, your savings may not be properly diversified. Although diversification is not a guarantee against loss, it is an effective strategy to help you manage investment risk.''

4. Authorized by a Plan Fiduciary

Consistent with the section 408(g)(4) of ERISA, the proposal provides, at paragraph (e), that 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. The proposal further provides that for purposes of such authorization, an IRA beneficiary will not be treated as an affiliate of a person solely by reason of being an employee of such person, thereby enabling employees of a fiduciary adviser to take advantage of investment advice arrangements offered by their employer under the exemption.

5. Annual Audit

Paragraph (f) addresses the audit requirements of section 408(g)(6) of ERISA. Specifically, paragraph (f)(1) 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 investment advice arrangements for compliance with the requirements of the proposal and 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, consistent with paragraph (e) of the proposal, setting forth the specific findings of the auditor regarding compliance of the arrangement with the requirements of the proposal.

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 for IRAs. This alternative is set forth in paragraph (f)(2) of the proposal. The alternative provides that, with respect to an arrangements with an IRA, the fiduciary adviser shall, within 30 days following receipt of the report from the auditor, furnish a copy of the report to the IRA beneficiary or make such report available on its website, provided that such beneficiaries are provided information, along with other required disclosures (see paragraph (g) of the proposal), concerning the purpose of the report, and how and where to locate the report applicable to their account. With respect to making the report available on a website, the Department believes that this alternative to furnishing reports to IRA beneficiaries satisfies the requirement of section 104(d)(1) of the Electronic Signatures in Global and National Commerce Act (E–SIGN) [11] 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 solicits comments on this finding. Paragraph (f)(2) also provides that, when the report of the auditor identifies noncompliance with the requirements of the regulation, the fiduciary adviser must send a copy of the report to the Department. As proposed, the fiduciary adviser must submit the report to the Department within 30 days following receipt of the report from the auditor. The submission of this report will enable the Department to monitor compliance with the statutory exemption in those instances where there is no authorizing ERISA plan fiduciary to carry out that function.

For purposes of paragraph (f) of the proposal, 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 any designated investment options under the plan. The terms ''material affiliation'' and ''material contractual relationship'' are defined in paragraphs (j)(6) and (7) of the proposal.

With regard to the scope of the audit, paragraph (f)(4) 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 (f)(4) 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 proposal, therefore, 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 proposal leaves to the auditor the determination as to the appropriate scope of their review and the extent to which they can rely on representative samples for determining compliance with the exemption.

6. Disclosure

The disclosure provisions are set forth in paragraph (g) of the proposal and generally track the disclosure provisions of the statutory exemption at section 408(g)(6) of ERISA. In this regard, the proposal, at paragraph (g)(1), requires that the fiduciary adviser provide to participants and beneficiaries, 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 or in connection with the sale, acquisition, or holding of the security or other property; 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, including, with respect to an arrangement described in paragraph (d) utilizing a computer model, any limitations on the ability of the model to take into account an investment primarily in qualifying employer securities, as provided for in paragraph (d)(1)(v) of the proposal; 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.

[11] 15 U.S.C. 7004(d)(1) (2000).

Paragraph (g)(2) of the proposal requires that the notification furnished to participants and beneficiaries 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.

The appendix to the proposal contains a model disclosure form that may be used for purposes of satisfying the fee and compensation disclosure requirement of paragraph (g)(1)(iii), as well as the requirements of paragraph (g)(2), of the proposal. The proposal makes clear, however, that the use of the model disclosure form is not mandatory.

Paragraph (g)(3) makes clear that the required disclosures may be provided in written or electronic form.

Paragraph (g)(4) of the proposal, like section 408(g)(6)(B) of ERISA, sets forth miscellaneous recordkeeping and furnishing responsibilities of the fiduciary adviser. Specifically, paragraph (g)(4) provides 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 described in paragraph (g)(1) in accurate form; provide, without charge, accurate information 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, accurate information to the recipient of the advice concerning any material change to the information required to be provided to the recipient of the advice at a time reasonably contemporaneous to the change in information.

7. Other Conditions

Paragraph (h) of the proposal, like section 408(g)(7) of ERISA, sets forth additional conditions applicable to the provision of 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; the sale, acquisition, or holding occurs solely at the direction of the recipient of the advice; 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 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.

8. Maintenance of Records

Paragraph (i) of the proposal sets forth the record maintenance requirements. Consistent with section 408(g)(9) of ERISA, paragraph (i) of the proposal provides that the fiduciary adviser must maintain, for a period of not less than 6 years after the provision of investment advice pursuant to the arrangement, any records necessary for determining whether the applicable requirements of the proposal have been met. Also, paragraph (i), as with section 408(g)(9), makes clear that a prohibited transaction 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.

9. Definitions

Paragraph (j) of the proposal sets forth a number of definitions relevant to the statutory exemption and this proposed regulation.

Paragraph (j)(1), as discussed earlier, defines the term ''designated investment option.'' Paragraph (j)(2) sets forth the definition of ''fiduciary adviser,'' as it appears in section 408(g)(11)(A) of ERISA. With regard to that part of the fiduciary adviser definition that treats persons who develop computer models or market investment advice programs or computer models as a fiduciary of the plan by reason of providing investment advice and as a fiduciary adviser for purposes of section 408(b)(14), the Department is proposing a separate regulation (§ 2550.408g–2), discussed below, pursuant to which a single fiduciary adviser may elect to be treated as a fiduciary with the respect to the plan.

Paragraph (j)(3) of the proposal adopts the statutory definition of ''registered representative'' 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 investment adviser referred to in such section).

Paragraph (j)(4), consistent with section 601(b)(3)(A)(i) of the Pension Protection Act of 2006, defines the term ''Individual Retirement Account'' 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.

Paragraph (j)(5) of the proposed rule defines the term ''affiliate.'' For purposes of the proposal, 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; 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; any person directly or indirectly controlling, controlled by, or under common control with, such other person; and any officer, director, partner, copartner, or employee of such other person. 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), except that it does not reflect clauses (E) and (F) thereof. The Department has initially 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.[12] Also, such parties will nonetheless be treated as an affiliate because they would be a person directly or indirectly controlling, controlled by, or under common control with, such other person. See paragraph (j)(5)(iii) of the proposal. Additionally, the Department is concerned that including provisions similar to clauses (E) and (F), which focus on functions involving investment companies, but not other types of vehicles in which plans may invest, could have the unintended consequence of possibly subjecting persons associated with investment companies to different requirements under these proposed regulations. Therefore, the Department is proposing to define affiliate without regard to clauses (E) and (F) of section 2(a)(3) of the ICA.

In a variety of places in the regulation reference is made to persons with

[12] ICA section 2(a)(3)(E) and (F) include in the definition of 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).

''material affiliations'' and ''material contractual relationships.'' See paragraphs (d)(1)(iv), (d)(3), (f)(3), (g)(1)(i), (g)(1)(iv) and (g)(1)(viii) of the proposal. For purposes of this regulation, those terms are defined in paragraphs (j)(6) and (j)(7), respectively.

Paragraph (j)(6) of the proposal describes a person with a ''material affiliation'' with another person as: Any affiliate of such other person; any person directly or indirectly owning, controlling, or holding, 5 percent or more of the interests of such other person; or any person 5 percent or more of whose interests are directly or indirectly owned, controlled, or held, by such other person. In determining ''interest,'' paragraph (j)(6)(ii) provides that 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 (j)(7) of the proposal 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 believes that one person's receipt of more than 10 percent of gross revenue from another person is sufficiently significant to be considered material. However, the Department specifically invites comments on whether the percentage test should be higher or lower and, if so, why.

The proposal, at paragraph (j)(8), defines ''control'' to mean the power to exercise a controlling influence over the management or policies of a person other than an individual.

C. Overview of Proposed § 2550.408g–2

Proposed § 2550.408g–2, as indicated above, addresses 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. See section 408(g)(11)(A).

Section 408(g)(11)(A) provides that, with respect to an arrangement that relies on use of a computer model to qualify as an ''eligible investment advice arrangement,'' 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, and shall be treated as a ''fiduciary adviser'' for purposes of ERISA section 408(b)(14) and (g). Section 4975(f)(8) of the Code contains a parallel provision to ERISA section 408(g)(11)(A). Proposed § 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 under such an eligible investment advice arrangement. See paragraph (a) of § 2550.408g–2.

Paragraph (b)(1) of § 2550.408g–2 provides that if an election meets the requirements of paragraph (b)(2) of the proposal, 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; and identify the person who is the fiduciary adviser, the person who develops the computer model or markets the computer model or investment advice program with respect to the arrangement, and the person who 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 § 2550.408g–2 also 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 plan fiduciary who authorized use of the arrangement; and that the writing be retained in accordance with the record retention requirements of § 2550.408g–1(i).

D. Effective Date

The Department proposes that the regulations contained in this notice will be effective 60 days after publication of the final regulations in the **Federal Register**. The Department invites comments on whether the final regulations should be made effective on a different date.

E. Request for Comments

The Department invites comments from interested persons on the proposed regulations. To facilitate the receipt and processing of comment letters, the Employee Benefits Security Administration (EBSA) encourages interested persons to submit their comments electronically by e-mail to *e-ORI@dol.gov* (Subject: Investment Advice Regulations), or by using the Federal eRulemaking portal at *http://www.regulations.gov* (follow instructions for submission of comments). Persons submitting comments electronically are encouraged not to submit paper copies. Persons interested in submitting paper copies should send or deliver their comments to the Office of Regulations and Interpretations, Employee Benefits Security Administration, Attn: Investment Advice Regulations, Room N–5655, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210. All comments will be available to the public, without charge, online at *http://www.regulations.gov and http://www.dol.gov/ebsa* and at the Public Disclosure Room, N–1513, Employee Benefits Security Administration, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210.

The comment period for the proposed regulations will end 45 days after publication of the proposed rule in the **Federal Register**. The Department believes that this period of time will afford interested persons an adequate amount of time to analyze the proposals and submit comments. Written comments on the proposed regulations should be submitted to the Department of Labor on or before October 6, 2008.

F. Regulatory Impact Analysis

Summary

The Department anticipates that this proposed regulation and proposed class exemption, by extending quality, expert investment advice to more retirement plan participants, together will improve their investment results by approximately $14 billion or more annually, at a cost of $4 billion, thereby producing a net financial benefit of $10 billion or more. The improved investment results will reflect reductions in investment errors such as payment of higher than necessary fees and expenses, poor trading strategies, and inadequate diversification. The provisions of this proposed regulation and the conditions attached to this proposed class exemption reflect the Department's efforts to ensure that the advice provided pursuant to them will be affordable and of high quality.

Introduction

Workers' retirement security increasingly depends on their investment decisions. Unfortunately

there is evidence that many participants and beneficiaries in participant-directed defined contribution (DC) plans and beneficiaries of individual retirement accounts (IRAs) (collectively hereafter, ''participants''), beset by flawed information or reasoning, make poor investment decisions. These participants may pay higher fees and expenses than necessary for investment products and services, engage in excessive or poorly timed trading or fail to rebalance their portfolios, inadequately diversify their portfolios and thereby assume uncompensated risk, take more or less than optimal levels of compensated risk, and/or pay unnecessarily high taxes. Financial losses (including foregone earnings) from such mistakes likely amount to more than $100 billion per year. 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 federal law that effectively preclude a variety of arrangements whereby financial professionals might otherwise provide retirement plan participants with expert investment advice. These ''prohibited transaction'' provisions of ERISA and the Internal Revenue Code prohibit fiduciaries from dealing with DC plan or IRA assets in ways that advance their own interests. These provisions prohibit plan fiduciaries from exercising the authority, control, or responsibility that makes such persons fiduciaries when they have an interest which may conflict with the interests of the plan for which they act. Under these provisions financial advisers who have a direct or indirect stake in participants' investment decisions generally may not provide them with investment advice. In recognition that certain transactions could nonetheless be beneficial to plans and their participants and beneficiaries, subject to safeguards appropriate to protect against potential abuses, Congress enacted a number of statutory prohibited transaction exemptions, and also gave the Department conditional authority to grant prohibited transaction exemptions. In this regard, the prohibited transaction exemption for the provision of investment advice added by the Pension Protection Act of 2006 (PPA) opened the door to more types of investment advice arrangements by conditionally permitting arrangements where the fiduciary adviser or an affiliate thereof has a financial stake in the advised participants' investment decisions. The Department is proposing a regulation to further specify the PPA's applicable conditions, together with a class exemption to establish alternative conditions under which such arrangements may operate. Together these actions are intended to increase the availability of investment advice.

The results of this proposed regulation and proposed class exemption will depend on their impacts on the availability, cost, use, and quality of participant investment advice. The Department expects that, as a result of these actions, quality, affordable advice will proliferate, producing significant net gains for participants.

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 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 suffer from overconfidence, myopia, or simple inertia.[13]

Such informational and behavioral problems translate into at least five distinct types of investment mistakes,[14] which together generate financial losses (including foregone earnings) of $109 billion or more annually[15] for DC plan and IRA participants, the Department estimates.

Fees and Expenses

Investors sometimes pay higher fees and expenses than necessary for investment products and services. There is evidence that mutual funds with poorer gross performance (that is performance before deducting fees) also have higher fees. This suggests that higher fees sometimes do not reflect value added by managers. Investors often pay inadequate attention to fee differences, even in connection with highly comparable products like competing S&P 500 index funds.[16]

[13] 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).

[14] It should be noted 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 it sometimes is bad. This is explored more below.

[15] As discussed below, this estimate is subject to wide uncertainty.

[16] A number of studies conclude that investors often pay higher fees than necessary.

Javier Gil-Bazo & Pablo Ruiz-Verdú, *Yet Another Puzzle? Relation Between Price and Performance in the Mutual Fund Industry,* Social Science Research Network Abstract 947448 (March 2007) find that funds with worse before-fee performance charge higher fees. They suggest that funds faced with insensitive investors charge higher fees, finding that even after controlling for performance sensitivity, funds with lower expected performance set higher fees. They hypothesize that lower performing funds lose sophisticated investors to higher performing funds, then are left with relatively unsophisticated investors who are not as responsive to price.

According to Ali Hortacsu & Chad Syverson, *Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds,* Social Science Research Network Abstract 405642 (April 2003), 75 percent of S&P 500 Index Funds have expense ratios in excess of 47 basis points, 50 percent in excess of 72 basis points and 25 percent in excess of 149 basis points. The highest cost fund charged annualized investor fees that were nearly 30 times greater than the lowest-cost fund (268 vs. 9.5 basis points). Low-cost funds have a dominant market share, but the asset share of the low-cost funds has fallen consistently since 1995.

Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds,* The Journal of Economic Perspectives, Volume 18, Number 2 (2004) extends the Ali Hortacsu & Chad Syverson, *Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds,* Social Science Research Network Abstract 405642 (April 2003) result of two classes of investors, the experienced that buy low-cost no-load funds, and the novice who uses a broker and buys high-cost load funds. He finds that, even after separating the expense ratio into administrative fees and 12b–1 fees, funds with loads still have administrative fees 15 basis point higher than the no-load funds.

Brad M. Barber *et al., Out of Sight, Out of Mind, The Effects of Expenses on Mutual Fund Flows,* Journal of Business, Volume 79, Number 6 2095, 2095–2119 (2005) find that investors are sensitive to load fees. They argue that front-end load fees are generally observable as a dollar amount on the first statement while the effects of administrative fees on the account balance are hidden by the volatility of fund returns. They find evidence of learning; repeat mutual fund purchasers pay on average about half the load fees of first time mutual fund purchasers.

Todd Houge & Jay W. Wellman, *The Use and Abuse of Mutual Fund Expenses,* Social Science Research Network Abstract 880463 (Jan. 2006) present evidence that less knowledgable investors pay consistently higher asset management fees than more knowledgable investors holding similar funds. Less sophisticated investors are more likely to invest in funds with loads. Load funds on average have annual expense ratios that are 50 basis points higher than no-load funds. While a large part of the higher expense ratio is composed of 12b–1 fees, load funds also have higher asset management fees. They conclude that ''Load fund shareholders often pay high fees to market and grow the fund, but the

Continued

The Department estimates that DC plan participants [17] and IRA beneficiaries together recently paid fees and expenses that were higher than necessary by $8 billion or more annually on aggregate.[18] Good advice could eliminate some of this unnecessary expense.[19]

Poor Trading Strategies

There is evidence that some participants trade excessively, while many more trade too little, failing even to rebalance. In DC plans, participant trading often worsens performance, and those with automatic rebalancing generally fare best.[20] Relative to automatic rebalancing, inferior trading strategies recently cost participants perhaps $56 billion or more annually, the Department estimates.[21] 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.[22] Investors often buy and sell in response to short-term past returns, and suffer as a result.[23] Good advice is likely to discourage market timing efforts and encourage rebalancing, thereby 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.[24] Relative to full diversification,[25] employer stock investments recently cost DC plan participants perhaps $3 billion [26] annually, the Department estimates.[27] Other lapses in diversification may involve omission from portfolios of

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fund's advisor is the most likely beneficiary of this growth.''

Edwin J. Elton *et al., Are Investors Rational? Choices Among Index Funds,* Social Science Research Network Abstract 340482 (June 2002) find that buying S&P 500 index mutual funds using expenses as the predictor of future success leads to picking funds with better returns. They find that the ten percent of funds with the lowest expenses out performs the ten percent of funds with the highest expenses by 0.92 percent a year. They find that for S&P 500 index mutual funds, the incentive for brokers and financial planners to push the fund (as represented by loads) is more important for new flows than is avoiding high cost and poorly performing funds. They are unable to find any effect of the quality of services on flows.

James J. Choi *et al., Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds,* National Bureau of Economic Research Working Paper W12261 (May 2006) offer experimental evidence that index fund investors are largely insensitive to fees.

Some other studies suggest, however, that fee levels may in fact be competitive and efficient. Many studies fail to measure potential non-financial benefits investors might derive from professional investment advice. 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) present results of a survey ''that identifies the benefits investors say they receive from using professional financial advisers,'' and contrast this perspective with that of studies that rely on ''performance and other publicly available measures to examine the value'' of such advice. Other studies find that investors with more intelligence or financial literacy often pay similar fees as those with less, and suggest this is consistent with the hypothesis that fees are competitive and efficient (see, *e.g.*, Sebastian Miller & Martin Weber, *Financial Literacy and Mutual Fund Investments: Who Buys Actively Managed Funds?,* Social Science Research Network Abstract 1093305 (Feb. 2008); and Mark Grinblatt *et al., Are Mutual Fund Fees Competitive? What IQ-Related Behavior Tells Us,* Social Science Research Network Abstract 1087120 (Nov. 2007)).

The Department understands that some of what might otherwise appear to be higher than necessary fees paid by investors pursuant to advice may in fact reflect indirect payment of the reasonable cost of the advice itself.

[17] DC plan participants' investment choices typically are limited to a menu selected by a plan fiduciary who is responsible for ensuring that the associated fees and expenses are reasonable. However, such participants may pay more overall than would be optimal if they do not appropriately consider fees and expenses when allocating their assets across available investments.

[18] ''Higher than necessary'' here means that the participant could have obtained equal value without incurring the expense. This calculation assumes that participants on average pay 11 or more basis points in unnecessary fees and expenses, in the form of expense ratios or loads. This assumption is likely to be conservative in light of evidence on the distribution of investor expense levels presented in Deloitte Financial Advisory Services LLP, *Fees and Revenue Sharing in Defined Contribution Retirement Plans* (Dec. 6, 2007) (unpublished, on file with the Department of Labor); Brad M. Barber *et al., Out of Sight, Out of Mind, The Effects of Expenses on Mutual Fund Flows,* Journal of Business, Volume 79, Number 6 2095, 2095–2119 (2005); Edwin J. Elton *et al., Are Investors Rational? Choices Among Index Funds,* Social Science Research Network Abstract 340482 (June 2002); James J. Choi *et al., Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds,* National Bureau of Economic Research Working Paper W12261 (May 2006); and Sarah Holden & Michael Hadley, *The Economics of Providing 401(k) Plans: Services, Fees and Expenses 2006,* Investment Company Institute Research Fundamentals, Volume 16, Number 4 (Sept. 2007). This estimate of excess expense does not take into account less visible expenses such as mutual funds' internal transaction costs (including explicit brokerage commissions and implicit trading costs), which are sometimes larger than funds' expense ratios (Deloitte Financial Advisory Services LLP, *Fees and Revenue Sharing in Defined Contribution Retirement Plans* (Dec. 6, 2007) (unpublished, on file with the Department of Labor); Jason Karceski *et al., Portfolio Transactions Costs at U.S. Equity Mutual Funds,* University of Florida Working Paper (2004), at *http://thefloat.typepad.com/the_float/files/2004_zag_study_on_mutual_fund_trading_costs.pdf).*

[19] Conversely, there is evidence that some higher than necessary expense currently is a direct result of what might be called bad advice, meaning certain marketing activities carried out by intermediaries such as brokers as well as direct consumer advertising by vendors of funds and competing financial products.

[20] 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).

[21] This estimate is derived from the risk adjusted returns attributed to participants with different trading strategies, see id.

[22] See, *e.g.*, Dalbar Inc., *Quantitative Analysis of Investor Behavior 2007* (2007).

[23] 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).

[24] 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).

[25] 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)). It 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)).

[26] 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.

[27] These estimates neglect any behavioral impact full diversification might have on asset allocation. There is 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).*

asset classes such as overseas equity or debt, small cap stocks, or real estate. Such lapses may sometimes reflect limited investment menus supplied by DC plans.[28] Yet even where adequate choices are available and company stock is not a factor, investors sometimes fail to diversify adequately.[29] Inadequate diversification other than excessive concentration in company stock recently cost participants perhaps $42 billion annually, the Department estimates.[30] Good advice should address over concentration in employer stock and other failures to properly diversify.

Inappropriate Risk

Investors who avoid the foregoing three mistakes might be said to invest efficiently, in the sense that they generally can expect the maximum possible return given their level risk. However, they 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, their investments may be too risky or too safe for their own tastes. The Department lacks a basis on which to estimate the magnitude of such mistakes, but believes they may be common and large. A diversified portfolio's risk and return characteristics generally is determined by its 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 ones), certainly entail large welfare losses.[31] 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 investment and tax strategies. Households saving for 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. A significant number of households do not follow this practice, however. By one estimate, to fully implement this practice in 1998, U.S. households would have had to relocate some $251 billion in assets.[32] It is not clear, however, whether such households are in fact making investment mistakes. In practice, this simple asset location rule may fail to minimize taxes.[33] As a result the Department has no basis to estimate the magnitude of excess taxes that might derive from DC plan and IRA participants' investment mistakes. In any event it is unclear whether or to what extent investment advisers would be positioned to provide advice on tax efficiency.

Promoting Investment Advice

Permissible Arrangements

Federal law limits the variety of arrangements whereby participants may obtain investment advice. Specifically, ERISA and the Internal Revenue Code generally prohibit fiduciaries from dealing with DC plan or IRA assets in ways that advance their own interests. These provisions effectively preclude participants from obtaining advice under arrangements that are widely used by other investors. For example, under many common arrangements, the adviser may receive a commission or other consideration when the investor enters into a transaction pursuant to the advice. The adviser's employer or an affiliate thereof may receive a sales load or other consideration in connection with the transaction. Stated generally, many common investment advice arrangements present financial advisers with opportunities to self deal.

While generally prohibiting arrangements that present such opportunities, federal law also provides for conditional exemptions whereby otherwise prohibited transactions are permitted. Some exemptions are contained in the statute. The Department has authority to grant others. The conditions attached to such exemptions serve to mitigate the adverse effects of the conflicts of interest that are present and thereby protect participants' interests. However, the Department invites suggestions for other safeguards against conflicts of interest that would be consistent with the goal of making quality advice more widely available.

The Pension Protection Act of 2006 opened the door to more types of investment advice arrangements by conditionally permitting arrangements where the fiduciary adviser or an affiliate thereof has a financial stake in

[28] 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.

[29] 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).

[30] See id. This estimate assumes annual return decrements from inadequate diversification of 0.3 percent of invested assets for investors that are already investing in risky assets (like stocks and mutual funds) and 3.3% for investors that are not yet investing in risky assets. The Department estimates that in the U.S. about 85% of investors include risky assets in their portfolios.

[31] The potential financial effects of changes in asset allocation hint at the likely magnitude of these welfare effects. The Department previously has estimated that movement of DC plan default investments from stand-alone, low-risk capital preservation instruments to diversified portfolios that include equities will improve investment results for a large majority of affected individuals, increasing aggregate account balances by an estimated $5 billion to $7 billion in 2034 (See 72 FR 60,452, 60,466 (Oct. 24, 2007)).

[32] 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).

[33] For example, tax-exempt municipal bonds are available, and actively managed equity mutual funds are not always tax-efficient (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); and John B. Shoven & Clemens Sialm, *Asset Location in Tax-Deferred and Conventional Savings Accounts,* Journal of Public Economics, Volume 88 (2003)). Using historical returns data and tax rate data for the period 1962–98, 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) find that when investing in actively managed mutual funds, and with the availability of tax-exempt bonds, households would have more after-tax wealth in most cases if they had first placed equities in the tax-deferred account. 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) describes how accessibility restrictions on assets in tax-deferred retirement accounts create a tension between making tax-efficient placements and the risk of having to make costly withdrawals in the event of a bad labor income shock. He presents empirical evidence that holding apparently tax-inefficient portfolios is related to accessibility restrictions and to precautionary motives. Lorenzo Garlappi & Jennifer C. Huang, *Are Stocks Desirable in Tax-Deferred Accounts?,* Journal of Public Economics, Volume 90 2257, 2257–2283 (July 2006) explain how a tax-deferred account essentially confers a tax subsidy onto its holdings. While the level of the tax subsidy may be maximized by first placing bonds in the tax-deferred account, this strategy may lead to a more volatile tax benefit. Risk-averse households may wish to smooth this volatility by holding a mix of equities and bonds in both tax-deferred and taxable accounts, as some are observed to do in practice. 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) find that even when tax-exempt bonds are available and even when there are liquidity shocks, for most investors it is best to put taxable bonds in the tax-deferred account and equity in the taxable account.

the advised participants' investment decisions. The Department is proposing a regulation to further specify the PPA's applicable conditions, together with a class exemption to establish alternative conditions under which such arrangements may operate. Table 1 summarizes the effect of the PPA and this proposed class exemption on permissible investment advice arrangements.

The Department calibrated this proposed regulation to in an effort to protect participants while promoting the affordability of investment advice arrangements operating pursuant to the PPA's statutory exemptive relief, in order that such arrangements will proliferate and thrive, to the benefit of participants.

The PPA's relief (listed at B. in table 1) is conditioned in part on audits. In order to promote the affordability of advice, this proposed regulation provides that audits may rely on a representative sample of similar arrangements. In order to protect participants, this proposed regulation requires that audit reports identifying noncompliance in connection with advice provided to IRA beneficiaries be furnished to the Department.

1—PERMISSIBLE INVESTMENT ADVICE ARRANGEMENTS

Is it permissible for compensation to vary depending on participants' investment decisions?	Person providing advice	Fiduciary adviser entity	Fiduciary advisers' affiliates
A. Absent any exemptive relief:			
1. Except as described at 2. below	No	No	No.
2. Advice is determined solely by a computer model that is provided by an independent entity and over which the fiduciary adviser has no control.	N/a*	Yes	Yes.
B. Under PPA statutory exemption:			
1. Subject to conditions including authorization by a separate fiduciary, independent audits, disclosure, and recordkeeping.	No	No	Yes.
2. Subject to conditions listed above at 1., and advice is provided by a computer model that is certified by an independent expert and satisfies conditions including conformance to investment theories and objectivity.	N/a*	Yes	Yes.
C. Under proposed class exemption:			
1. Subject to conditions including conformance to investment theories, authorization by a separate fiduciary, independent audits, disclosure, and recordkeeping.	No	Yes	Yes.
2. Subject to conditions listed above at 1. and additional conditions including prudence and loyalty, advance provision of benchmark recommendations or educational material, and documentation.	Yes	Yes	Yes.

* Under these arrangements, the investment advice is formulated exclusively by use of the computer model.

The PPA's statutory exemptive relief for investment advice arrangements that use computer models (listed at B.2. in table 1) is conditioned in part on independent expert certification of such models. The expert must meet requirements specified by the Secretary and certifications and renewals thereof must be completed in accordance with rules established by the Secretary. This proposed regulation establishes such requirements and rules.

In advance of formulating these requirements and rules the Department invited and considered extensive public input on the nature, functions, and performance of existing models. The Department also closely examined and road tested some popular models with particular attention to the criteria set forth in section 408(g)(3)(B) of ERISA. The Department came to the conclusion that existing computer models can take into account various information about individuals, their preferences and available investment options and, in its limited attempt to examine whether recommendations provided were optimal, the Department did not find evidence of computer models recommending investment portfolios that have risk return profiles inferior to any individual investment alternative available.

On these bases the Department understands that models capable of satisfying the exemption's conditions are various and evolving. The variety and evolution reflect healthy competition to develop superior products that deliver more value to participants.

The Department sought to calibrate this proposed regulation to nurture such competition while keeping advice affordable and protecting participants' interests. This proposed regulation consequently provides for transparency and procedural rigor but generally does not attempt to specify precise and fixed substantive standards. For example, pursuant to the proposed regulation the experts' qualifications will be reviewed by a fiduciary, and each certification will be documented in detail. The proposed regulation also provides that models may be certified once for similar applications across multiple DC plans or IRAs, rather than separately for each individual application, thereby promoting affordability of arrangements using models.

The Department likewise sought to calibrate this proposed class exemption to protect participants while promoting the affordability of investment advice arrangements operating pursuant to it, in order that such arrangements likewise will proliferate and thrive, to the benefit of participants. As detailed below, the proposed class exemption, by relaxing bars against arrangements that place fiduciary advisers in positions where they have potential conflicts of interest, will increase the variety of investment advice arrangements that are available and potentially lower the cost and promote the marketing of such arrangements, to the benefit of participants. Conditions attached to the proposed class exemption will mitigate the adverse impact of the conflicts and thereby ensure the quality of advice provided pursuant to it.

Availability and Use

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 already 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. It is likely that 40 percent or more of DC plan sponsors currently provide access to investment advice either on line, by phone, or in-person. Where offered, approximately 25 percent of participants use advice. In-person advice seems to be offered by the 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.[34]

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.[35] Overall 60 percent of U.S. workers and retirees say they use the advice of a financial professional when making retirement savings and investment decisions; 40 percent say this advice was more helpful to them than alternatives.[36] It is not clear how recently this advice was obtained, however: In the same survey just 28 percent say that in the past year they obtained investment advice from a professional financial adviser who was paid through fees or commissions.[37]

The new statutory exemptive relief provided by the PPA is expected to increase the availability of advice, but it is too early to observe by how much.[38] The Department believes that absent this proposed class exemption some segments of the plan and participant market will lack adequate access to quality, affordable investment advice. Some potential fiduciary advisers will be deterred from entering the market by the complexity of advice arrangements that conform to the conditions of the PPA's statutory exemptive relief.[39] Some plan sponsors and participants will be deterred by the cost of such arrangements,[40] or by dissatisfaction with the types of advice arrangements that are available at lower costs, such as automated computer investment advice programs.[41] As a result some DC plan sponsors will not offer advice, and where it is offered some participants will not use it.[42] IRA beneficiaries may face similar obstacles to obtaining affordable, quality investment advice.

From the point of view of DC plan sponsors, the PPA and this proposed class exemption could help relieve certain concerns that have impeded some from providing investment advice in the past. A few years prior to the enactment of the PPA less than one in four surveyed DC plan sponsors provided advice, according to one survey.[43] Those not providing advice were asked to cite reasons and rate the reasons' importance on a 0-to-5 scale. Two reasons cited by large majorities and rated moderately important might be ameliorated by this proposed class exemption: ''Fiduciary concern about ensuring that the advice provider has no conflict of interest''[44] (cited by 84 percent and rated 3.1) and ''cost of providing advice''[45] (cited by 69 percent and rated 2.0).[46] In another pre-PPA survey 35 percent of DC plan sponsors not offering advice cited cost as a reason.[47]

From the point of view of prospective fiduciary advisers whose business models involve conflicts—*e.g.*, who are compensated by the companies that manufacture, manage, and/or trade the investment products that they recommend—the PPA and this proposed class exemption grant conditional access to a very large and

[34] 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. Other types of support include providing general investment education via seminars or written materials, offering one-stop, pre-mixed investment alternatives such as lifestyle funds, and offering managed accounts.

[35] 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)). Because 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. The Department has no basis to estimate the fraction of these beneficiaries that receive true investment advice from such professionals, however. It is possible that some make their purchase decisions without receiving any recommendation or material guidance from the professional making the sale.

[36] 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.''

[37] See, *e.g.*, Employee Benefit Research Institute, *2007 Retirement Confidence Survey, Wave XVII,* Posted Questionnaire (Jan. 2007).

[38] The statutory exemptive relief for investment advice provided by the PPA generally became effective for advice provided after December 31, 2006. In February 2007 EBSA issued guidance on the new statutory exemptive relief for arrangements using fiduciary advisers whose affiliates' revenue might vary depending on the fiduciary advisers' fiduciary acts. It is likely that some such arrangements exist today, and that more will in the future. The PPA also provided relief for arrangements that provide advice via independently certified computer models. The PPA withheld this exemptive relief in connection with IRAs, however, unless and until the Department found and reported to Congress that a model satisfying certain criteria exists. Concurrent with issuance of this proposed class exemption, the Department has reached this finding and reported it to Congress. Therefore statutory relief for this latter type arrangement is just now being extended to IRAs. In addition, the PPA provides that the Department will by regulation specify the process by which computer models will be certified. Concurrent with issuance of this proposed class exemption, the Department is proposing such a regulation. Given this timing it is unlikely that many such latter type arrangements yet exist.

[39] Such complexity can include the need to enlist an adviser who is independent of or merely affiliated with the plan's or IRA's investment manager, in order to avoid direct exposure of the adviser to potential conflicts.

[40] As discussed below, arrangements that avoid potential conflicts may entail higher or more visible costs.

[41] In one survey of DC plan sponsors, among those offering investment advice, ''access to financial counselors in person'' was rated most effective, followed by ''access to financial counselors via telephone.'' ''Web-based'' advice received the lowest effectiveness ratings (see, *e.g.*, Deloitte Development LLC, *Annual 401(k) Benchmarking Survey, 2005/2006 Edition* (2006)). This finding is corroborated by another survey, in which in-person advice appears to be used by participants more often than advice delivered via the Internet (see, *e.g.*, Profit Sharing/401(k) Council of America, *Investment Advice Survey 2001* (2001)).

[42] Where investment advice is available to DC plan participants, only one in four uses it, according to one plan sponsor survey (see, *e.g.*, Profit Sharing/401(k) Council of America, *50th Annual Survey of Profit Sharing and 401(k) Plans* (2007)). On-line advice appeals more to higher-salaried, full-time workers (see, *e.g.*, 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)). In one survey, two-thirds of workers and 85 percent of retirees expressed discomfort with ''obtaining advice from financial professionals on-line. This raises the possibility that many participants, perhaps especially lower-paid, part-time participants, may be underserved if the regulatory environment excessively favors on-line advice.

[43] See, *e.g.*, Profit Sharing/401(k) Council of America, *Investment Advice Survey 2001* (2001).

[44] Both the PPA and this proposed class exemption extend conditional relief from ERISA's prohibited transaction provisions, but neither relieves plan fiduciaries of their general obligations under ERISA.

[45] The cost of advice is discussed further immediately below.

[46] Other fiduciary concerns, cited more frequently and rated more important, are not addressed by this proposed class exemption.

[47] See, *e.g.*, Deloitte Development LLC, *Annual 401(k) Benchmarking Survey, 2005/2006 Edition* (2006).

fast growing new market segment.[48] These advisers might be in a position to offer their services at low or no direct cost to the companies' DC plan and IRA clients (relying instead on compensation from the companies). They might market their services to the companies' clients more actively than have independent advisers historically.

For purposes of this impact assessment, the Department anticipates that owing to the statutory exemptive relief provided by the PPA, advice of some type (on-line, telephone and/or in person) will soon be available to perhaps one-half of DC plan participants, with in-person advice available to perhaps one in four. This proposed class exemption will boost these fractions to perhaps 60 percent and 35 percent, respectively. The Department's assumptions are summarized in Table 2.[49]

2—AVAILABILITY OF ADVICE TO DC PLAN PARTICIPANTS

Policy context	Any advice (computer or live) (percent)	Live advisor (percent)
Pre-PPA	40	20
PPA	50	25
Class exemption	60	35

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 it. 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.[50] 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 as long as they trusted the source.[51] 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.'' [52]

The PPA and this proposed class exemption together could boost DC plan participants' use of advice where offered, in at least two ways. First, because it appears that in-person advice arrangements are more heavily used than automated computer advice programs, wider availability of in-person advice programs wherein advisers can exercise discretion in formulating personalized advice (rather than merely communicate the recommendations of a computer model)—a likely consequence of this proposed class exemption—might be expected to boost use rates. The shift anticipated by the Department (discussed immediately above) would increase the use rate slightly from 25 percent to 26 percent.[53] Second, if the cost of advice falls, participants who must pay for advice will become more inclined to use it. However, historically employers have usually paid directly for advice, or passed the cost to all participants whether they use advice or not,[54] and as explained below it is unclear by how much the cost of advice will fall. Therefore for purposes of this impact assessment the Department did not take into account any cost-driven increase in use of advice by DC plan participants, but assumed that this proposed class exemption will increase the fraction of DC plan participants using advice where available from 25 percent to 26 percent.[55] Given the Department's assumptions regarding availability of advice to DC plan participants, this translates into an increase in the incidence of advice due to this proposed class exemption from 10 percent to 16 percent.

The PPA and this proposed class exemption could also boost IRA participants' use of advice. As noted above, advisers doing business pursuant to this class exemption are likely to actively market advice services to IRA participants and to offer them reduced prices for such services. The reduced prices will reflect both the availability to advisers of other compensation and possible cost saving in the production and delivery of advice. Advisers doing business pursuant to this proposed class exemption may thereby attract business both from IRA participants who otherwise would be without advice and from IRA participants who otherwise would obtain advice through an arrangement that does not require the relief provided by this proposed class exemption. IRA participants who would otherwise be without advice may obtain advice in response to such marketing and pricing activity because the activity reduces their search cost to find and select an adviser, and/or because the reduced price falls below their reservation price. Likewise, IRA participants who would otherwise have obtained advice via some other arrangement may switch to an arrangement pursuant to the PPA or this proposed class exemption (and may increase the amount of advice services they use) because the advisers' marketing activity broadens their search and/or in pursuit of lower prices.

In proposing this class exemption the Department considered carefully the importance of transparency in pricing. Participants' decisions whether and where to obtain advice should be well informed with respect to the cost associated with alternative arrangements. As a condition of this proposed class exemption an adviser must disclose to the participant certain information regarding other revenue sources. This condition is intended to enable participants to decide whether, where, and how much advice to obtain, in light of the associated direct and indirect costs to them.[56] Therefore the

[48] Combined participant directed DC plan and IRA assets exceed $7 trillion.

[49] The Department based its assumptions on its 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).

[50] 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).

[51] 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.

[52] See, *e.g.*, Employee Benefit Research Institute, 2008 Retirement Confidence Survey, Wave XVIII, Posted Questionnaire (Jan. 2008).

[53] This assumes that the use rate for where in person advice is available is approximately 50 percent higher (30 percent) as where only on-line or telephone advice is available (20 percent) (see, *e.g.*, Employee Benefit Research Institute, *2007 Retirement Confidence Survey, Wave XVII,* Posted Questionnaire (Jan. 2007)).

[54] See, *e.g.*, Profit Sharing/401(k) Council of America, *Investment Advice Survey 2001* (2001).

[55] One survey found that 64 percent of workers already use professional financial advice when making retirement savings and investment decisions, and that 54 percent are very or somewhat likely to use advice if offered by their employer in connection with a DC plan (see, *e.g.*, Employee Benefit Research Institute, *2007 Retirement Confidence Survey, Wave XVII,* Posted Questionnaire (Jan. 2007)). This seems to suggest a higher baseline rate of advice use than assumed here. However, because the latter fraction is smaller than the former, it is unclear whether this suggests that this proposed class exemption would increase DC plan participants' use of advice by more or less than assumed here.

[56] In particular, participants should be able to adequately compare the prices offered by advisers

Department intends that any cost-driven increase in use of advice by IRA participants will be driven by overall cost decreases and not solely by direct price reductions.

As noted above there is evidence that a large fraction of IRA participants already use advice. For purposes of this assessment the Department assumes that as a result of the PPA and this proposed class exemption the proportion of IRA beneficiaries using advice will increase from one-third to two-thirds. The Department's assumptions regarding use of advice are summarized in table 3.[57]

3—USE OF ADVICE BY DC PLAN AND IRA PARTICIPANTS

Policy context	DC plans		IRA	Dollars advised ($trillions)
	Where offered (percent)	Overall (percent)		
Pre-PPA	25	10	33	$1.7
PPA	25	13	50	2.5
Class exemption	26	16	67	3.2

It seems 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 (together with possible flaws in some advice, as discussed immediately below).

Cost

As noted above the PPA and this proposed class exemption are expected to make advice available to participants at a lower direct price, because advisers will be able to rely on alternative revenue sources to compensate their efforts. More importantly, however, the Department believes that the total cost of the advice to participants will be reduced. Bars against transactions wherein fiduciary advisers' and participants' interests may conflict carry 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.[58] And to avoid such conflicts they must carefully monitor and calibrate their relationships and compensation arrangements, or incur the opportunity cost associated with exclusive reliance on level fees. The Department therefore expects the PPA and this proposed class exemption 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 whether or by how much costs might be reduced, however.

Quality

The effect of investment advice also depends on its quality. Good advice can reduce investment errors, steering investors away from higher than necessary expenses and toward optimal trading strategies, broad diversification, and asset allocations consistent with the investors' tastes for risk and return. The Department believes that, although there is no universally accepted single and complete theory of optimal investing, and although there is some evidence of lapses in the quality investment advice,[59] professional advisers'

doing business pursuant to this exemption with those offered by other advisers such as those offering their services for a flat fee.

[57] These assumptions are based on the Department's 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 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 by this proposed class exemption. For all of these reasons IRA beneficiaries may use advice more frequently than DC plan participants.

[58] For example, an adviser employed by an asset manager can share the manager's research instead of buying or producing such research independently.

[59] There is no single, complete, universally accepted theory of optimal investment. Instead there are competing and evolving theories which have much in common (what might be called ''generally accepted'' theories) but also important differences (see, *e.g.*, Martin Wallmeier & Florian Zainhofer, *How to Invest Over the Life Cycle: a Review,* Social Science Research Network Abstract 951167 (Dec. 2006); and Deloitte Financial Advisory Services LLP, *Generally Accepted Investment Theories* (July 11, 2007) (unpublished memorandum, on file with the Department of Labor)). In practice this means that different experts may give different advice; often the differences will be small but occasionally they might be large.

There is some evidence of lapses in the quality of investment advice. Investment advisers' advice does not always conform to generally accepted investment theories. For example, they sometimes neglect investors' debt, or exhibit ''home bias'' toward domestic investment. Home bias may be larger in advice given to more risk averse investors; this conflicts with theory insofar as home bias reduces diversification and therefore increases risk. Investment advisers in some sense have two functions: to provide *investment* advice and to provide *investor* advice. The former ought to conform to financial theories, while the latter involves helping investors overcome behavioral biases and errors. Together these functions may result in a nuanced balance between what the investor theoretically ''should'' choose and what the investor is comfortable choosing (see, *e.g.*, Elisa Cavezzali & Ugo Rigoni, *Investor Profile and Asset Allocation Advice,* Social Science Research Network Abstract 966178 (Feb. 2007)). Some advice computer models and educational material may furnish misleading information regarding risk and consequently may do harm (see, *e.g.*, Zvi Bodie, *An Analysis of Investment Advice to Retirement Plan Participants, in The Pension Challenge: Risk Transfers and Retirement Income Security* 19, 19–32 (Olivia S. Mitchell & Kent Smetters eds., 2003)). Advice computer models generally fail to coordinate financial investments with financial risks associated with individuals' jobs, homes, and health (see, *e.g.*, John Ameriks & Douglas Fore, *Financial Planning: On the Issue of Advice,* Benefits Quarterly, Fourth Quarter 6, 6–14 (2002)). While it is widely agreed that such coordination is important, theories about how this should be done

Continued

recommendations are likely to be superior to unadvised participants' investment practices.[60] It is therefore likely that participants who obtain and follow advice, including advice provided pursuant to the PPA or this proposed class exemption and advice provided under alternative permissible arrangements, will substantially reduce their investment mistakes and thereby derive substantial financial benefits and improve their welfare.

In its effort to ensure the quality of advice, the Department carefully considered the substantial risks attendant to opportunities for self-dealing that may exist among fiduciary advisers doing business pursuant to the PPA or this proposed class exemption. There is evidence that advisers sometimes seize such opportunities and thereby reap profit at investors' expense.[61] The provisions of this proposed regulation and conditions attached to this proposed class exemption are intended to guard against these risks while keeping advice affordable.[62]

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 possible flaws in some advice (together with participant failures to follow advice, discussed immediately above).[63] Additionally for purposes of this analysis the Department assumes that all permissible advice arrangements (including those operating pursuant to exemptive relief provided by the PPA and those operating pursuant to this proposed class exemption) deliver

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continue to evolve (see, *e.g.*, Günter Franke *et al.*, *Non-Market Wealth, Background Risk and Portfolio Choice,* Social Science Research Network Abstract 968096 (Mar. 2007)). Typical advice as reflected in target-date funds conforms to some financial theories but conflicts with others (see, *e.g.*, Luis M. Viceira, *Life-Cycle Funds,* Social Science Research Network Abstract 988362 (May 2007)).

[60] Rene Fischer & Ralf Gerhardt, *Investment Mistakes of Individual Investors and the Impact of Financial Advice,* Science Research Network Abstract 1009196 (Aug. 2007) ''present financial advice as (potentially) correcting'' a variety of investment mistakes that left uncorrected ''lead to considerable welfare losses.''

[61] These risks consist of the possibility that some advisers will pursue profit by dispensing advice that increases their own revenue at the expense of participants' interests.

Consideration of these risks is especially important because advice pursuant to this proposed class exemption, while extending to many participants who otherwise would invest without guidance or support, may also extend to many others who absent this class exemption would have benefited from alternative forms of support for their investment decisions, such as alternative permissible advice arrangements, target-date funds, managed accounts, or automatic rebalancing.

In considering these risks the Department devoted separate attention to the application of this proposed class exemption to IRAs. In contrast to DC plan participants, IRA participants may be more vulnerable to risks attendant to conflicts of interest insofar as they: (1) May include more retirees, who may be in greater need of advice, but who also may be more vulnerable to abusive practices (see, *e.g.*, Phyllis C. Borzi & Martha Priddy Patterson, *Regulating Markets for Retirement Payouts: Solvency, Supervision and Credibility,* Pension Research Council Working Paper PRC WP2007–21 (Sept. 2007)); (2) are not represented by a plan fiduciary, independent of the adviser and connected to their interests via an employment relationship, who selects and monitors the advice arrangement and pre-screens the menu of investment options for quality; and (3) may not, under the conditions of this proposed class exemption, have the benefit of specific advice provided by an independent or independently-certified computer model to compare with (and possibly follow in lieu of) advice delivered pursuant to the proposed class exemption. In addition, while advisers to DC plan participants are subject to standards of fiduciary conduct and attendant liability under Title I of ERISA, advisers to IRA beneficiaries are not. Finally, the Department's authority to enforce the conditions of this proposed exemption generally extends only to DC plans and not to IRAs. On the other hand, IRA beneficiaries' vulnerability to risks attendant to conflicts of interest may be mitigated by their ability to make rational and well informed purchases in a vibrant, competitive market for investment advice and other financial products and services in which some vendors will offer unconflicted advice.

The Department believes that absent effective controls conflicts can sometimes bias advice, although it is unclear how much or in exactly what ways. Biased advice may be less beneficial to investors than unbiased advice, or possibly even harmful in some cases.

There is a theoretical basis to believe that investors may be harmed (or may benefit less) where managers pay intermediary advisers for inflows, and that such payments may increase the role of intermediaries (fewer investors may invest directly) (see, *e.g.*, Neal M. Stoughton *et al.*, *Intermediated Investment Management,* Social Science Research Network Abstract 966255 (Mar. 2007)). This suggests that advisers whose fees are not level relative to their clients' investment elections may give biased advice that enriches managers at investors' expense (the motivation for and potential to profit from conflicts and bias may attach more to the manager who compensates the adviser than to the adviser). It also suggests that advisers doing business pursuant to this proposed class exemption might displace alternative forms of investment decision support.

According to one empirical study, ''there exists conflict of interests between load fund investors and brokers and financial advisers: brokers and financial advisers apparently serve their own interests by guiding investors into funds with higher loads, which generate higher income to the brokers and financial advisers but increase the expenses of investors.'' High load funds have larger inflows than low load funds with otherwise similar performance. Recent increases in fund loads suggest that funds are seeking favor from brokers and advisers (see, *e.g.*, Xinge Zhao, *The Role of Brokers and Financial Advisors Behind Investment Into Load Funds,* China Europe International Business School Working Paper (Dec. 2005), *at http://www.ceibs.edu/faculty/zxinge/brokerrole-zhao.pdf*). Another study reaches similar conclusions. ''Relative to direct-sold funds, broker-sold funds deliver lower risk-adjusted returns, even before subtracting distribution costs. * * * Further, broker-sold funds exhibit no more skill at aggregate-level asset allocation than do funds sold through the direct channel.'' Even before accounting for the higher distribution expenses, the underperformance cost investors $4.6 billion in 2004. Brokers devote more effort to selling funds that generate more revenue for them (see Daniel B. Bergstresser *et al.*, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry,* forthcoming in The Review of Financial Studies).

Yet another study finds that ''investors who transact through investment professionals that are compensated through conventional distribution channels incur substantially poorer timing performance than investors who purchase pure no load funds.'' The underperformance amounts to approximately 100 or 150 basis points (see, *e.g.*, Mercer Bullard *et al.*, *Investor Timing and Fund Distribution Channels,* Social Science Research Network Abstract 1070545 (Dec. 2007)).

Some other studies are less conclusive. For example, one finds that captive brokers add more value for investors in purchasing funds, while unaffiliated brokers add the most value in redeeming them. Direct, no-load investors' redemptions are the least sensitive to performance. This study also finds that higher payments from fund companies to unaffiliated brokers buys some inflows for funds (see, *e.g.*, Susan Christoffersen *et al.*, *The Economics of Mutual-Fund Brokerage: Evidence from the Cross Section of Investment Channels,* Social Science Research Network Abstract 687522 (Dec. 2005)).

[62] The Department has no basis to estimate how much risk might remain. However the Department notes that the safeguards associated with the PPA and this class exemption are likely to be stronger than those associated with available research studies, cited above, that quantify substantial losses to investors. First, advisers to DC plan participants are subject to ERISA's fiduciary standards. Second, the PPA and this class exemption provide substantive conditions including unbiasedness, together with procedural protections such as provision of advice generated by computer models that are certified by independent experts, documentation of bases for advice, and audits of investment advice programs' conformance to applicable substantive conditions. Such protections generally are not provided in other U.S. contexts. For a discussion of protections applicable where advice is delivered by investment advisers or brokers to investors outside of IRAs and ERISA-covered retirement plans, see Angela A. Hung *et al.*, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* RAND Corporation Technical Report (2008), at *http://www.sec.gov/news/press/2008/2008–1_randiabdreport.pdf.*

[63] Whether advice corrects errors depends on whether the advice is followed and whether it is good. There is reason to believe that many people receiving advice will follow it. In a 2008 survey, among those obtaining investment advice, 36 percent say they implemented ''all'' of the advice, 58 percent ''some,'' and just 5 percent ''none'' (Employee Benefit Research Institute, *2008 Retirement Confidence Survey, Wave XVII,* Posted Questionnaire (Jan. 2008)). There is also reason to believe that good advice will be available. According to Bluethgen, *et al.*, *High-Quality Financial Advice Wanted!,* Social Science Research Network Abstract 1102445 (Feb. 2008), ''There is a high degree of heterogeneity in quality among financial advisors * * * the extent to which advisors receive compensation in the form of fixed fees instead of sales commissions as well as the extent to which advisors exhibit a high degree of rationality in decision making are predictive of high-quality financial advice.'' According to Bluethgen, *et al.*, *Financial Advice and Individual Investors' Portfolios,* Social Science Research Network Abstract 968197 (Mar. 2008), ''advice enhances portfolio diversification, makes investor portfolios more congruent with predefined model portfolios, and increases investors' fees and expenses. Our empirical evidence is broadly in line with honest financial advice.''

advice of similar quality and effectiveness.

Benefits

The Department expects the PPA and this proposed class exemption to reduce investment errors to the benefit of participants. As noted above, prior to implementation of the PPA, investment mistakes cost participants $109 billion or more annually. Increased use of investment advice under the PPA will reduce such mistakes by $7 billion, and this proposed class exemption will reduce them by another $7 billion, the Department estimates. Altogether after implementation of this proposed class exemption, use of investment advice by DC plan and IRA participants will eliminate $29 billion worth of investment errors annually. The Department's estimates of investment errors and reductions from investment advice are summarized in table 4.

4—INVESTMENT ERRORS AND IMPACT OF ADVICE ($BILLIONS, ANNUAL)

Policy context	Remaining errors	Errors eliminated by advice	
		Incremental	Cumulative
No advice	$124	$0	$0
Pre-PPA advice only	109	15	15
PPA	102	7	22
Class exemption	95	7	29

Costs

Participant gains from investment advice must be weighed against the cost of that advice. 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 cost of advice as summarized in table 5.[64]

5—COST OF ADVICE

	Pre-PPA	PPA	Class exemption
Incremental:			
Advice cost ($billions)	$3.8	$1.8	$2.3
Advice cost rate (bps, average)	23	23	29
Error reduced per $1 of advice, average	$3.90	$3.80	$3.10
Cumulative (combined with policies to the left):			
Advice cost ($billions)	$3.8	$5.6	$7.9
Advice cost rate (bps, average)	23	23	24
Error reduced per $1 of advice, average	$3.90	$3.90	$3.70

Alternatives

In formulating this proposed regulation and proposed class exemption, the Department considered several alternative approaches.

Specific Substantive Standards for Model Certification

This proposed regulation provides mostly procedural standards for the certification of computer models pursuant to PPA's statutory exemptive relief. In crafting these provisions the Department carefully considered whether to establish specific substantive standards as well.

Computer models are evolving, driven by advances in information technology and financial theories, and by market competition. A recipe for testing the robustness of one current technology might not be effective when applied to a future technology. Ongoing refinements and revisions to financial theories, the product of healthy competition among ideas, would soon belie any specification of generally accepted theory that might be enshrined in regulation. The Department therefore believes that a substantive standard generally would not serve to protect participants but instead might diminish the benefits of the PPA's relief for arrangements using models. However, the Department invites comments on the advantages and disadvantages of a more substantive standard than what is proposed, and asks for suggestions for what a more substantive standard might include.

Deferring Action on Class Exemption

The Department considered deferring proposing a class exemption for a year or more in order to observe the market impact of the exemptive relief provided by the PPA. This might have provided fuller information on the degree to which some market segments would remain underserved by advice and on the barriers responsible for such ongoing under service, and thereby assisted the Department's effort to determine whether and how to provide additional exemptive relief.

However, the Department is concerned that deferring action might delay the proliferation of advice and prolong correctable investment errors and believes that the need for additional exemptive relief is already adequately

[64] The Department notes that costs probably often will not be distributed across advised participants in proportion to the size of their accounts. Rather, it is likely that some costs of providing advice are fixed relative to account size, so the cost borne by small account holders probably will be larger in relation to account size than that borne by large account holders. The average estimates reported in table 4 are dollar weighted. For the average participant, the basis point cost will be higher than this dollar weighted average, and the amount by which investment errors are reduced per dollar of advice will be lower.

clear. The exemptive relief provided by the PPA does not embrace business models that occupy large parts of the non-IRA retail market,[65] and therefore may leave major segments of the DC plan and IRA markets underserved. In addition, by excluding popular business models, the PPA's exemptive relief by itself would tilt the playing field in favor of other business models, which may sometimes be more expensive or less beneficial. This raises the possibility that some segments of the market would be inefficiently served. This proposed class exemption will level the playing field for competing business models and thereby promote efficiency in the market for investment advice.

Level Fee Condition

The PPA provides conditional exemptive relief for advice arrangements wherein the revenue of a fiduciary adviser's affiliates varies on the basis of advised participants' investment decisions, but not to arrangements wherein the revenue of the fiduciary adviser itself so varies. This proposed class exemption extends conditional relief to the latter.

The Department considered including as a mandatory condition of this proposed class exemption a requirement that the compensation received by the person providing the advice on behalf of the fiduciary adviser does not vary on the basis of participants' investment decisions. Such a condition might ease enforcement of the exemption's conditions, and might reduce the risks attendant to conflicts of interest that may exist among advisers doing business pursuant to the proposed class exemption. But it also would exclude from exemptive relief popular business models that are well established in the non-IRA retail market and that operate without similar compensation requirements, and therefore might unduly impair the availability of advice. Therefore Department elected to make this ''level fee'' condition [66] one of two alternative conditions,[67] thereby allowing the person's compensation to vary as long as the other condition is met. The other condition provides alternative protections against the risks attendant to conflicts of interest.

Model Generated Advice for IRA Beneficiaries

The Department considered including as part of the immediately aforementioned alternative condition a requirement that IRA beneficiaries always be provided with specific, model generated investment recommendations, similar to those which under the condition must be provided to DC plan participants.[68] However the Department believes that such a requirement sometimes might be neither practical nor effective as applied to IRAs. It might not be practical because, while such models exist, their availability, affordability and effectiveness are not yet proven in all segments of the IRA market. It might not be effective because the wide range of investment options open to most IRA beneficiaries could make comparisons of model generated advice with the advisers' recommendations difficult for beneficiaries. Therefore the conditions of this proposed class exemption allow that IRA beneficiaries may under certain circumstances be provided with educational material or recommendations on asset allocation across asset classes rather than with specific, model generated investment recommendations.[69]

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,[70] there is ample evidence that that magnitude is large.

The Department is also confident that this proposed class exemption, by relaxing rules governing arrangements under which advice can be delivered, will promote wider use of advice. 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 proposed class exemption would change in response to alternative assumptions regarding the availability, use, and quality of advice. Table 6 summarizes the results of these tests.

6—UNCERTAINTY IN ESTIMATE OF INVESTMENT ERROR REDUCTION

Primary estimates denoted *	Impact of PPA	Impact of class exemption	Impact of all advice	Remaining errors
Advice eliminates:				
50% of errors *	$7	$7	$29	$95
75% of errors	11	11	47	86
25% of errors	3	3	14	102
After PPA/class exemption, advice reaches:				
13%/16% of DC and 50%/67% of IRA *	7	7	29	95
15%/21% of DC and 60%/80% of IRA	11	9	35	89
11%/13% of DC and 40%/50% of IRA	3	4	22	102

[65] 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); and Employee Benefit Research Institute, *2007 Retirement Confidence Survey, Wave XVII,* Posted Questionnaire (Jan. 2007).

[66] See paragraph (f).

[67] The alternative condition is at paragraph (e). Paragraph (d) provides that the two are alternatives.

[68] See paragraph (e)(1).

[69] See paragraph (e)(2).

[70] The incidence and magnitude of investment errors is uncertain. Because errors are generally measured with reference to some optimal benchmark, the evolving character of investment theory contributes to this uncertainty. For a given level of incidence and effectiveness of advice, the reduction in errors will be proportionate to the errors reduced. The Department did not attempt to estimate the magnitude of losses from inappropriate risk or excess taxes, so its estimate of this proposed class exemption's impact omit potential reductions in such errors. As noted above, the Department's estimate of higher than necessary expenses is conservative in light of referenced literature and omits certain less visible expenses such as mutual funds' internal transaction costs. Its estimates of losses from poor trading strategies and inadequate diversification are moderate, if not conservative, taking account of the losses that were measured in the referenced studies. The Department believes that the combined magnitude of investment errors, and therefore of the reduction in such errors that can be expected from wider use of advice, is at least as large as reported here, and possibly much larger.

The Department is uncertain whether the magnitude and incidence of investment errors and the potential for correction of such errors in the context of IRAs might differ from that in the context of ERISA-covered DC plans. If a DC plan's menu of investment options is efficient then the incidence and/or magnitude of errors might be smaller than in the IRA context. If it is inefficient then errors might be more numerous and/or larger, but the potential for correcting them might be constrained. As noted earlier, evidence on the efficiency of existing menus is mixed.

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 proposed class exemption displace alternative arrangements? Will advice arrangements operating pursuant to this proposed class exemption be more, less, or equally effective as alternative arrangements?

This analysis has assumed that all types of 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, for a number of reasons. For example, as illustrated above in table 1, advisers operating pursuant to different exemptive relief may be subject to different levels of conflicts of interest. Individuals providing advice pursuant to this proposed class exemption may face particularly direct conflicts, in the form of opportunities to tailor advice to directly profit themselves at participants' expense. The Department's consideration of this risk was detailed above.

The conditions attached to exemptive relief under the PPA and this proposed class exemption are intended to control this risk while keeping advice affordable. The Department notes that if users of advice are fully informed and rational then more cost effective arrangements will dominate the market. This proposed class exemption 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 proposed regulation and proposed class exemption. 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 proposed regulation and proposed class exemption. 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 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 lacks bases to estimate include financial market impacts of changes in investor behavior and related macroeconomic effects.

The Department invites comments on how to improve this analysis, with particular attention to the assessment and explanation of attendant uncertainty, and how such analysis could be carried out. Comments that include specific suggestions or data to help support our analysis of impacts and the characterization of uncertainty would be especially useful.

Executive Order 12866

Under Executive Order 12866, the Department must determine whether a regulatory action is significant and therefore subject to the requirements of the Executive Order and review by the Office of Management and Budget (OMB). This action, comprising this proposed regulation and proposed class exemption, is economically significant under section 3(f)(1) of the Executive Order because it is likely to have an effect on the economy of $100 million or more in any one year. Accordingly, the Department undertook the foregoing analysis of the actions' impact. On that basis the Department believes that the actions' benefits justify their costs.

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.[71] 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 proposed regulation and proposed class exemption.

The primary effect of this proposed regulation and proposed class exemption 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 proposed regulation and proposed class exemption. The Department invites the public to comment on its definition of small entities and its certification.

Notwithstanding this certification, the Department did separately consider the impact of this proposed regulation and proposed class exemption on participants in small plans.

As noted earlier, 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 proposed class exemption 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 proposed class exemption will reduce small DC plan participant investment errors

[71] EBSA requests comments on the appropriateness of the size standard used in evaluating the impact of these proposed rules on small entities. 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).

respectively by $105 million or more and $126 million or more, at respective costs of $22 million and $28 million. The estimated impacts on small plans and their participants are summarized on table 7.

7—SMALL DC PLAN PARTICIPANT IMPACTS

	Pre-PPA	PPA	Class exemption
Dollars advised ($ billions)	$47	$59	$73
Investment errors ($ billions)	$8.0	$7.9	$7.8
Incremental:			
Errors reduced by advice ($ millions)	$421	$105	$126
Advice cost ($ millions)	$86	$22	$28
Advice cost rate (bps, average)	18	18	20
Error reduced per $1 of advice, average	$4.88	$4.88	$4.46
Cumulative (combined with policies to the left):			
Errors reduced by advice ($ millions)	$421	$526	$652
Advice cost ($ millions)	$86	$108	$136
Advice cost rate (bps, average)	18	18	19
Error reduced per $1 of advice, average	$4.88	$4.88	$4.79

Congressional Review Act

This notice of proposed rulemaking 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, if finalized, 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 notice of proposed rulemaking 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.

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 proposed 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 this proposed 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

As part of its continuing effort to reduce paperwork and respondent burden, the Department of Labor conducts a preclearance consultation program to provide the general public and Federal agencies with an opportunity to comment on proposed and continuing collections of information in accordance with the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3506(c)(2)(A)). This helps to ensure that the public understands the Department's collection instructions; respondents can provide the requested data in the desired format, reporting burden (time and financial resources) is minimized, collection instruments are clearly understood, and the Department can properly assess the impact of collection requirements on respondents.

Currently, EBSA is soliciting comments concerning the proposed information collection request (ICR) included in the Proposed Class Exemption for the Provision of Investment Advice to Participants and Beneficiaries of Self-Directed Individual Account Plans and IRAs and in the Proposed Investment Advice Regulation (Proposed Investment Advice Initiative). A copy of the ICR may be obtained by contacting the PRA addressee shown below or at *http://www.RegInfo.gov*. PRA Addressee: Gerald B. Lindrew, 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) 219–5333. These are not toll-free numbers.

The Department has submitted a copy of the Proposed Investment Advice Initiative to the Office of Management and Budget (OMB) in accordance with 44 U.S.C. 3507(d) for review of its information collections. The Department and OMB are particularly interested in comments that:

- Evaluate whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, permitting electronic submission of responses.

Comments should be sent to the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503; Attention: Desk Officer for the Employee Benefits Security Administration. OMB requests that comments be received within 30 days of publication of the Proposed Investment Advice Initiative to ensure their

consideration. Please note that comments submitted to OMB are a matter of public record.

The Department notes that a federal agency cannot conduct or sponsor a collection of information unless it is approved by OMB under the PRA, and displays a currently valid OMB control number, and the public is not required to respond to a collection of information unless it displays a currently valid OMB control number. Also, notwithstanding any other provisions of law, no person shall be subject to penalty for failing to comply with a collection of information if the collection of information does not display a currently valid OMB control number. EBSA will publish a notice of OMB's action at the final rule stage.

In order to use the statutory exemption and/or the class exemption [72] to provide investment advice to participants and beneficiaries in participant-directed defined contribution (DC) plans and beneficiaries of individual retirement accounts (IRAs) (collectively hereafter, ''participants''), investment advisory firms would be required to make disclosures to participants and hire an independent auditor every year. Investment advice firms following the conditions of the exemption based on disclosure of computer model-generated investments would be required to obtain certification of the model from an eligible investment expert.[73] The class exemption conditions relief on establishing written policies and procedures and both exemptions impose recordkeeping requirements.[74] These paperwork requirements are designed to safeguard the interests of participants in connection with investment advice covered by the exemptions.

The Department has 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 [75] 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.[76]

• The Department assumes that investment advisory firms will use existing in-house resources to prepare the policies and procedures and 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 2008 of $79 for a financial manager, $21 for clerical personnel, $109 for a legal professional, and $67 for a computer programmer.[77]

The Statutory Exemption

The Department assumes that approximately 16,000 investment advisory firms [78] (including broker-dealers) will take advantage of this statutory exemption to provide advice to participants.[79] The number of investment advisory firms using this statutory exemptive relief is assumed to be constant over time. The Department estimates that under the statutory exemption approximately 52,000 DC plans will seek to provide advice to their participants and beneficiaries. These DC plans represent approximately 6,611,000 participants and beneficiaries, of which approximately 1,487,000 will seek advice from the investment advisory firm servicing their employer-sponsored retirement investment plan. IRAs can also make use of this statutory exemption, and the Department estimates that approximately 8.7 million IRA beneficiaries will seek advice under this statutory exemption.[80]

Disclosures to Participants

In general, under section 2550.408(g)–1(g) of the proposal, a fiduciary adviser is required to furnish detailed information to a participant about an advice arrangement before initially providing investment advice, annually, upon participant request and if there is any material change to the information. The information includes the following: The relationship between the adviser and the parties that developed the investment advice program or selected the investment options available under the DC plan or IRA; to the extent such information is not otherwise provided, the past performance and historical rates of return of investments available under the DC plan or IRA; all fees and other compensation the fiduciary adviser or any affiliate is to receive in connection with the provision of investment advice or in connection with the investment; the fiduciary adviser's material relationship, if any, to any investment under the arrangement; the types of services the fiduciary adviser provides in connection with the provision of investment advice; the manner in which participant information may be used or disclosed; an acknowledgement that the fiduciary adviser is acting as a fiduciary of the DC Plan or IRA in connection with providing the investment advice; and notice that the recipient of the advice may separately arrange for advice from

[72] The Department assumes that all advisory firms use both the statutory exemption and the class exemption.

[73] All costs associated with model certification are assigned to the statutory exemption.

[74] All costs associated with composing written policies and procedures are assigned to the class exemption.

[75] 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.

[76] The Department assumes that plans will deliver disclosures electronically in compliance with the Department's rules relating to the use of electronic media (29 CFR 2520.104b–1(c)). The Department has not estimated any additional burden for plans to receive affirmative consents from participants to receive required disclosures electronically. The Department welcomes comments on this assumption.

[77] Hourly wage estimates are based on data from the Bureau of Labor Statistics Occupational Employment Survey (May 2005) and the Bureau of Labor Statistics Employment Cost Index (Sept. 2006). All hourly wage rates include wages and benefits. 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.

[78] Unless otherwise noted, numbers are rounded to the nearest 1,000.

[79] This estimate is derived from Angela A. Hung *et al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND Corporation Technical Report (2008), at *http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf*.

[80] To be conservative, the Department assumes that all 16,000 advisory firms give advice pursuant to both the statutory and class exemptions as they all will have some clients who request only level fee or computer model advice under the statutory exemption and other clients who request off-model advice under the class exemption. The Department estimates that there are approximately 209,000 DC plans that are currently offering advice (pre-statutory exemption advice), that after the statutory exemption is published approximately 261,000 DC plans will offer advice and that after the class exemption is published approximately 314,000 DC plans will offer advice. The Department cannot determine which of these plans will be offering advice under pre-statutory exemption, statutory exemption or class exemption conditions; thus the Department decided to apply costs to the statutory and class exemptions based on the incremental change in the number of DC plans offering advice. This method is also applied to the number of IRA beneficiaries receiving advice; the Department estimates that approximately 16.8 million IRA beneficiaries received advice under pre-statutory exemption conditions, approximately 25.5 million will receive advice under statutory exemption conditions and approximately 34.0 will receive advice under class exemption conditions. The Department welcomes comments on this assumption.

another adviser that could have no relationship to, and receive no fees in connection with, the investments. If applicable, the fiduciary adviser also furnishes in writing to the DC plan fiduciary an election, as permitted under the regulation, to be treated as the sole fiduciary providing investment advice through a computer model to an ERISA-covered DC plan participant. The Department assumes that investment advisory firms will compile all of these notices into a single four-page disclosure package for each participant given advice. As these disclosures are to be given to the participants and are based upon the investments that are recommended, the Department further assumes that these disclosures will be generated at three levels: The investment advisory firm level, the DC plan level and the IRA beneficiary level. The firms will generate a template for each of these disclosures levels.[81]

Preparation of Statutory Exemption Disclosure Package

For the first year (initial) disclosures, the Department assumes that it takes a legal professional approximately six hours per investment advisory firm to prepare disclosures that are common to all of their participants, about 100 hours per investment advisory firm to assist an out-sourced computer programmer in creating computer software that will generate disclosure notices for IRA beneficiaries, and approximately two and one-half hours per DC plan to prepare disclosures that are common to all DC plan participants and beneficiaries in the same DC plan. These hours add up to an hour burden of approximately 1,779,000 hours; at a wage rate of $109 for a legal professional the equivalent cost is approximately $194,792,000.

For the annual updating of disclosures required by Section 2550.408g–1(g)(4)(ii), the Department assumes that the preparation time needed for updating the notices that are the same for all participants will be about three hours for each of the 16,000 investment advisory firms.[82] The Department assumes that updating notices that are the same for all DC plan participants and beneficiaries is estimated to take on average one hour and a half for each of over 52,000 DC plans. The preparation time needed for individualized notices for IRAs is estimated to average 50 hours for each of 16,000 investment advisory firms. Thus the annual hour burden for preparation is estimated to be approximately 903,000 hours with an equivalent cost of approximately $98,829,000.

The Department assumes that all firms will outsource the creation of a computer program to enable them to prepare disclosures for IRA participants. This computer model will be used to generate disclosures to participants under both the statutory exemption and the class exemption. The Department estimates that a computer programmer will charge on average $1,200 per firm in the first year and $600 each subsequent year.[83] Thus the cost burden, given there are almost 16,000 investment advisory firms, will be approximately $18,662,000 in the first year and approximately $9,331,000 in all subsequent years.

Distribution of Statutory Exemption Disclosure Package

The Department assumes that a clerical professional will be required to spend one minute per page (four minutes per disclosure package) to photocopy the 20 percent of disclosure packages that are delivered in paper and one minute per disclosure package to prepare the ten percent of disclosures that are mailed each year.[84] These hours add up to an hour burden of approximately 864,000 hours; at a wage rate of approximately $21 for a clerical professional the equivalent cost is approximately $3,225,000.

The Department assumes that the paper and photocopy costs are five cents per page; thus, given that there are approximately 2,030,000 participants receiving paper disclosures, the associated cost burden for paper and photocopying under the statutory exemption is estimated to be $406,000 annually. Under the basic United States Postal Service postage at a cost of $0.42 [85] per disclosure package for approximately 1,015,000 participants receiving mailed disclosures, the postage costs are estimated at about $426,000 annually. Thus the cost burden associated with distributing disclosures to participants is $832,000 per year.

Independent Certification

If the fiduciary adviser provides the investment advice through use of a computer model, then before providing the advice, Section 2550.408g–1(d)(2) of the proposed regulation would require the fiduciary adviser to obtain the certification of an eligible investment expert as to the computer model's compliance with certain standards (*e.g.*, applies generally accepted investment theories, unbiased operation, objective criteria) set forth in the regulation. The Department assumes that there are six companies that will provide the investment advice computer model [86] and that legal professionals working at these six companies supply in-house support by providing documentation and other information to the eligible investment expert who certifies the company's investment advice computer model. These legal professionals are assumed to spend about 40 hours for each of the six investment advice computer model providers and on average 40 hours for each of the almost 16,000 investment advisory firms to whom the computer model providers supply their models. Thus, the investment advice computer model providers have an hour burden of approximately 622,000 hours for an equivalent cost of about $68,125,000.

The Department assumes that the investment advisory firm will need in-house legal professionals to provide documentation and other information to the eligible investment expert who certifies the investment advisory firm's investment advice computer model. These legal professionals will spend on average ten hours for each of over 52,000 DC plans and on average 50

[81] The following disclosures are assumed to be constant for all participants advised: The material affiliation or material contractual relationships, use of participant information, type of services provided by the fiduciary adviser, acknowledgment that the adviser is acting as a fiduciary of the DC plan or IRA, and a statement that the participant can arrange for advice from an adviser who does not receive fees in connection with the investment or has no material affiliation with the investments recommended. The following disclosures are assumed to be constant for each participant of an individual DC plan: The fees and compensation the adviser receives in connection with the suggested investments and the material affiliation to the suggested investments. As discussed below these last two disclosures are also the only disclosures that are specific to the IRA beneficiary, and as such will require the adviser to generate individual disclosures for each IRA beneficiary advised using the computer model generated by the service providers.

[82] The Department assumes that investment advisory firms will distribute the same disclosures throughout the year and that they only update their disclosure content for the annual disclosures. The Department further assumes that few disclosures are requested each year (one per firm on average) and most requested disclosures are distributed either electronically at a negligible cost or in person at small costs. The Department welcomes comments on these assumptions.

[83] The Department has based this cost estimate on limited industry data.

[84] Eighty percent of disclosures are assumed to be distributed electronically. In addition, the Department assumes that one half of all paper disclosures are delivered in person and one half are delivered through the mail.

[85] The USPS increased the cost of First Class Postage to $0.42 as of May 2008.

[86] Based on limited information with respect to the investment computer model industry, the Department estimates that there are six companies that produce investment advice computer models.

hours for each of the almost 16,000 investment advisory firms. Thus the hour burden in the first year for the certification of the investment advice computer model is approximately 1,924,000 hours with an equivalent cost of about $210,571,000.

The Department assumes that in subsequent years the hours required for any investment advice computer model recertification will be approximately half of the first certification and that investment advisory firms will have their investment advice computer model recertified on average once a year. Thus in the subsequent years the hour burden is approximately 962,000 hours with an equivalent cost of approximately $105,286,000.

Recordkeeping Requirements

Consistent with the statutory exemption, section 2550.408g–1(i) of the proposed regulation would require fiduciary advisers to maintain records with respect to the investment advice provided in reliance on the regulation necessary to determine whether the applicable requirements of the regulation have been satisfied. The Department assumes that all investment advisory firms maintain recordkeeping systems as part of their normal business practices. The Department assumes that all records that are required to be maintained will be kept electronically under normal business practices; therefore, no printing and negligible holding costs are anticipated to be associated with records maintenance.

Audit Requirement

Any fiduciary adviser relying on the exemption would be required to engage, at least annually, an independent auditor to conduct an audit of the investment advice arrangement for compliance with the conditions of the exemption pursuant to section 2550.408g–1(f)(1) of the proposed regulation. All firms are assumed to outsource this service but use some internal clerical and legal professional time to assist the auditor.[87] The clerical staff is expected to spend about three hours per advisory firm and on average ten minutes per participant to gather documentation and other information. The in-house legal professional is expected to need approximately four hours per advisory firm to assist the auditor with the statutory exemption audit. The Department estimates that about one percent of participants will be audited per year, resulting in approximately 101,000 audits. Overall, the annual in-house hour burden for the annual audit requirement is estimated at 126,000 hours, with equivalent costs of approximately $8,157,000.

The Department assumes that the statutory exemption audits will be outsourced to an independent legal professional for each of the almost 16,000 investment advisory firms and will cost on average $18,000.[88] Thus the annual cost burden will be approximately $279,936,000.

Summary of Statutory Exemption Hour and Cost Burden

In summary, the third-party disclosures, computer model certification, and audit requirements for the statutory exemption require approximately 3,981,000 burden hours with an equivalent cost of approximately $416,745,000 and a cost burden of approximately $579,367,000 in the first year. In each subsequent year the total labor burden hours are estimated to be approximately 2,143,000 hours with an equivalent cost of approximately $215,497,000 and the cost burden is estimated at approximately $430,067,000 per year.

The Class Exemption

The Department assumes that all of the 16,000 investment advisory firms that take advantage of the statutory exemption will also provide advice that relies on the class exemption. As mentioned above, all investment advisory firms provide advice under both DC plans and IRAs, and the number of investment advisory firms using this class exemptive relief is assumed to be constant over time. The Department estimates that under the class exemption approximately 52,000 DC retirement plans will seek to provide advice to their participants and beneficiaries. These plans represent approximately 6,611,000 participants and beneficiaries, of which approximately 2,016,000 will seek advice from the investment advisory firm employed on behalf of their employer sponsored retirement investment plan. IRAs can also make use of this class exemption, and the Department estimates that approximately 8.5 million IRA beneficiaries will seek advice under this class exemption.[89]

Disclosures to Participants

In general, section III(g)(1) of the Class Exemption requires a fiduciary adviser to furnish detailed information to a participant about an advice arrangement before initially providing investment advice, annually, upon participant request, and if there is any material change to the information. The information to be provided is the same under the class exemption as the statutory exemption (see Section I(a) above for a listing of all required disclosures). Additional disclosures required before providing investment advice would depend on which alternative conditions the arrangement is designed to satisfy. If the investment advice arrangement is based on the disclosure of computer-generated investment selections, the fiduciary adviser is required to furnish those selections to the participant. If the fiduciary adviser determines computer modeling of the number and types of investment choices available to an IRA is reasonably precluded, the fiduciary adviser may instead furnish asset class allocation models to the participant. Alternatively, such disclosures may not be required if a fiduciary adviser satisfies the condition that would require that the compensation of the person providing advice on behalf of the fiduciary adviser may not vary based on the particular investments selected. The Department assumes that investment advisory firms will compile all notices into a single five-page disclosure package for each participant given advice under the class exemption and that these disclosures will be prepared at the investment advisory firm, DC plan, and IRA beneficiary levels.

Preparation of Class Exemption Disclosure Package

The Department assumes that disclosures that are common to all of the advisory firm's client participants as well as the computer program used to

[87] Audit firms are expected to transmit the final audit report to the advisory firm through electronic means at no additional costs. The advisory firms must either furnish a copy of the audit report to IRA beneficiaries or make the audit report available on their Web site and inform IRA beneficiaries of the purpose of the report and how and where to locate the report applicable to their account with the other disclosures discussed above. The Department assumes that all advisory firms will make the audit report available on their Web site and add a few sentences to the single disclosure package at negligible costs. Any advisory firm whose audit report identifies noncompliance with the requirements of the statutory or class exemption must send a copy of the report to the Department within 30 days following receipt of the report. The Department assumes that the majority of advisory firms will comply with the exemption; therefore, the costs associated with sending the audit reports to the Department are expected to be negligible. The Department welcomes comments on this assumption.

[88] The Department has based this cost estimate on limited industry data.

[89] See footnote 51 above for an explanation of the number of entities affected by the regulation. The Department assumes that these DC plans are offering, and DC participants and beneficiaries, and IRA beneficiaries are receiving advice under the class exemption but not the statutory exemption.

generate disclosures to IRA beneficiaries will have been prepared to conform to the requirements of the statutory exemption and will not impose any additional burden on respondents.

For the first year disclosures, the Department assumes that the 16,000 investment advisory firms might require a legal professional to work on average 80 hours each to assist an out-sourced computer programmer in creating computer software that will generate individualized disclosure notices for IRA participants, and approximately two hours per DC plan to prepare disclosures that are common to all participants in the same DC plan. These hours add up to an hour burden of approximately 1,349,000 hours; at a wage rate of $109 for a legal professional the equivalent cost is approximately $147,662,000.

For the annual updating of disclosures the Department assumes that the preparation time needed for updating the notices will be on average one hour per DC plan (for DC plan individualized disclosures) and on average 40 hours for each investment advisory firms (for IRA beneficiary individualized disclosures). Thus, the annual hour burden is estimated to be approximately 674,000 with an equivalent cost of approximately $73,831,000.

Distribution of Class Exemption Disclosure Package

The Department assumes that a clerical professional will spend five minutes [90] to photocopy each of the approximately 2,102,000 disclosure packages that are delivered in paper and one minute to prepare each of the 1,051,000 disclosures that are mailed each year. These hours add up to an hour burden of approximately 193,000 hours; at a wage rate of $21 for a clerical professional the equivalent cost is approximately $4,082,000.

Using a paper and photocopy cost of five cents per page, the associated cost burden for paper and photocopying under the class exemption is estimated to be $525,000 annually. Under the basic USPS postage at a cost of $0.42 per disclosure package, the cost burden of the mailing disclosures under the class exemption will be approximately $441,000 annually. Thus the overall cost burden associated with distributing disclosures to participants is estimated at about $967,000 per year.

Independent Certification

The entire costs of the certification requirements are accounted for under the statutory exemption.

Policies and Procedures

Section III(i) of the Class Exemption requires investment advisory firms that wish to provide investment advice pursuant to the class exemption to develop written policies and procedures that insure the firm follows all of the class exemption requirements. The Department estimates that updating the written policies and procedures will generally require no additional costs. It is assumed that the preparation of these policies and procedures will require on average seven hours of legal professional time for each of the almost 16,000 investment advisory firms. This leads to an hour burden in the first year of about 109,000 hours with an equivalent cost of approximately $11,917,000.

Recordkeeping Requirements

Section III(n) of the proposed class exemption requires fiduciary advisers to maintain records with respect to the investment advice provided in reliance on the exemption necessary to determine, explain or verify compliance with the conditions of the exemption, including those records necessary to determine that the disclosures described above have been made. In this connection, the fiduciary adviser would be required to maintain records necessary to determine, among other things, that an independent fiduciary has provided express authorization of the arrangement under which the investment advice is provided, that, if applicable, an eligible investment expert has provided the requisite certification, that the compensation to the fiduciary adviser and its affiliates in connection with the investments is reasonable, that the terms of the purchase sale or holding of the investment are at least as favorable to the plan or IRA as those in an arm's length transactions would be, and in cases where the advice is not provided after disclosure of computer generated investments or an asset class allocation model, the fees or other compensation received by an employee, agent or registered representative providing investment advice on behalf of the fiduciary adviser does not vary depending on the option. The Department assumes that all investment advisory firms maintain recordkeeping systems to satisfy these information collections requirements.

A fiduciary adviser may provide individualized investment advice to participants or beneficiaries (''off-model advice'') following the furnishing of investment advice generated by a computer model as described in section III(e)(1) of the Class Exemption, or in the case of beneficiaries of IRAs described in section III(e)(2), following the furnishing of investment education-type materials (graphs, pie charts, etc) that produce or reflect asset allocation models. However, section III(e)(4) of the Class Exemption requires that, with respect to any off-model advice that recommends investment options that may generate for the adviser or certain other parties greater income than other investments in the same asset class, the individual who provides investment advice on behalf of the fiduciary adviser, not later than 30 days after providing the advice, must document the basis for concluding that the recommendation is in the best interest of the participant or beneficiary. The Department assumes that such off -model advice will be provided in ten percent of the possible DC plan cases, and 30 percent of the possible IRA beneficiary cases. Thus, of the approximately 2,016,000 DC participants and approximately 8.5 million IRA beneficiaries receiving advice under the class exemption, almost 202,000 DC plan participants and 2.5 million IRA beneficiaries will receive off-model advice.[91]

The Department further assumes that each participant receiving advice will receive this advice an average of four times per year (once a quarter), resulting in almost 10,996,000 reports. The Department assumes that each investment advisor who provides off-model advice will need approximately 15 minutes to write this report. Generating these reports is estimated to result in approximately 2,749,000 annual burden hours for the financial manager with an associated equivalent cost of $217,125,000.

Audit

Any fiduciary adviser relying on the class exemption also would be required to engage, at least annually, an independent auditor to conduct an audit of the investment advice arrangement for compliance with the class exemption and written policies and procedures (as described below) designed to assure

[90] The Department estimates that most of the investment advisory firms that take advantage of the class exemption will determine that computer modeling of the number and types of investment choices available to an IRA is not possible, and will instead furnish asset class allocation models to the beneficiaries. As such, the disclosure package for participants who receive advice pursuant to the class exemption is estimated as being five pages in length, instead of four.

[91] Based on limited information on the type of advice given to participants, the Department estimates that ten percent of DC plan participants and 30 percent of IRA beneficiaries will receive off-Model Advice.

compliance with the conditions of the exemption. The fiduciary adviser would be required to issue a written report to each plan fiduciary who authorized the use of the investment advice arrangement, and to IRA beneficiaries, setting forth the auditor's findings. With respect to IRA's, the fiduciary adviser may instead make the report available on its Web site. Also with respect to an arrangement with an IRA, if the auditor finds noncompliance with the exemption, the fiduciary adviser must file the report with the Department of Labor.

All firms are assumed to outsource this service but use some internal clerical and legal professional time to assist the auditor. As an audit is required under the statutory exemption, the fixed in-house hours are attributed to the statutory exemption and only the variable clerical hours are divided between the statutory and class exemption. Under the class exemption clerical staff is expected to spend on average ten minutes per audited participant to pull each audited participant's files or to provide other documentation or information. The Department estimates that about 105,000 participants will be audited annually. Overall, the annual in-house hour burden for the audit requirement is estimated at 18,000 hours with equivalent costs of approximately $371,000.

The Department assumes that the class exemption audits will be outsourced to an independent legal professional for each of the almost 16,000 investment advisory firms and will cost on average $4,000 per year for each investment advisory firm.[92] Thus the annual cost burden will be approximately $62,208,000.

Summary of Class Exemption Hour and Cost Burden

In summary, the third-party disclosures, written policies and procedures, recordkeeping and audit requirements for the class exemption are estimated to require a total of approximately 4,417,000 burden hours with an equivalent cost of approximately $381,157,000 and a total cost burden of approximately $63,175,000 in the first year. In each subsequent year the total burden hours are estimated at approximately 3,634,000 hours with an equivalent cost of approximately $295,409,000 and a total cost burden of approximately $63,175,000 per year.

[92] The Department has based this cost estimate on limited industry data.

Overall Exemption Hour and Cost Burden Summary

In summary, the third-party disclosures, computer model certification, written policies and procedures, recordkeeping and audit requirements for the statutory and class exemptions require approximately 8,398,000 burden hours with an equivalent cost of approximately $797,903,000 and a cost burden of approximately $642,541,000 in the first year. The labor burden hours in each subsequent year are approximately 5,776,000 hours with an equivalent cost of approximately $510,906,000 and the cost burden in each subsequent year is approximately $493,242,000 per year.

These paperwork burden estimates are summarized as follows:

Type of Review: New collection (Request for new OMB Control Number).

Agency: Employee Benefits Security Administration, Department of Labor.

Titles: (1) Proposed Class Exemption for the Provision of Investment Advice to Participants and Beneficiaries of Self-Directed Individual Account Plans and IRAs and (2) Proposed Investment Advice Regulation.

OMB Control Number: 1210–NEW.

Affected Public: Business or other for-profit.

Estimated Number of Respondents: 16,000.

Estimated Number of Annual Responses: 20,656,000.

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

Estimated Total Annual Burden Hours: 8,398,000 hours in the first year; 5,776,000 hours in each subsequent year.

Estimated Total Annual Burden Cost: $642,541,000 for the first year; $493,242,000 for each subsequent year.

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, the Department proposes to amend Chapter XXV, subchapter F, part 2550 of Title 29 of the Code of Federal Regulations as follows:

Subchapter F—Fiduciary Responsibility Under the Employee Retirement Income Security Act of 1974

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. 1–2003, 68 FR 5374 (Feb. 3, 2003). Sec. 2550.401b–1 also issued under sec. 102, Reorganization Plan No. 4 of 1978, 43 FR 47713 (Oct. 17, 1978), 3 CFR, 1978 Comp. 332, effective Dec. 31, 1978, 44 FR 1065 (Jan. 3, 1978), 3 CFR, 1978 Comp. 332. Sec. 2550.401c–1 also issued under 29 U.S.C. 1101. Sec. 2550.404c–1 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, Pub. L. 107–16, 115 Stat. 38). Sec. 2550.408b–1 also issued under 29 U.S.C. 1108(b)(1) and sec. 102, Reorganization Plan No. 4 of 1978, 3 CFR, 1978 Comp. p. 332, effective Dec. 31, 1978, 44 FR 1065 (Jan. 3, 1978), and 3 CFR, 1978 Comp. 332. Sec. 2550.412–1 also issued under 29 U.S.C. 1112.

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

§ 2550.408g–1 Investment Advice—Participants and Beneficiaries.

(a) *General.* Section 408(g)(1) of the Employee Retirement Income Security Act, as amended (ERISA), provides 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.'' Section 4975(d)(17) and (f)(8) of the Internal Revenue Code, as amended (the Code), contain parallel provisions to ERISA section 408(b)(14) and (g)(1).

(b) *Eligible investment advice arrangement.* 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 (c) of this section or paragraph (d) of this section, or both.

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

(1)(i) Any investment advice is based on generally accepted investment theories that take into account the historic 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;

(ii) Any investment advice takes into account information furnished by a participant or beneficiary relating to age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and investment preferences, although nothing herein shall preclude any investment advice from taking into account additional information that a participant or beneficiary may provide;

(iii) Any fees or other compensation (including salary, bonuses, awards, promotions, commissions or other things of value) received, directly or indirectly, by any employee, agent or registered representative that provides investment advice on behalf of a fiduciary adviser does not vary depending on the basis of any investment option selected by a participant or beneficiary;

(iv) Any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets do not vary depending on the basis of any investment option selected by a participant or beneficiary; and

(2) The requirements of paragraphs (e), (f), (g), (h), and (i) of this section are met.

(d) *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 (d)(1) and (2) of this section under an investment advice program and with respect to which the requirements of paragraphs (e), (f), (g), (h), and (i) are met, and any acquisition, holding or sale of a security or other property pursuant to such advice occurs solely at the direction of the participant or beneficiary.

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

(i) Apply generally accepted investment theories that take into account the historic 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;

(ii) Utilize information furnished by a participant or beneficiary relating to age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and investment preferences, although nothing herein shall preclude a computer model from taking into account additional information that a plan or a participant or beneficiary may provide;

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

(iv) Avoid investment recommendations that:

(A) 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

(B) 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;

(v) Take into account all designated investment options, within the meaning of paragraph (j)(1) of this section, available under the plan without giving inappropriate weight to any investment option; except that a computer model shall not be treated as failing to meet this requirement merely because it does not take into account an investment option that constitutes an investment primarily in qualifying employer securities.

(2) Prior to utilization of the computer model, the fiduciary adviser shall obtain a written certification, meeting the requirements of paragraph (d)(4) of this section from an eligible investment expert, within the meaning of paragraph (d)(3) of this section, that the computer model meets the requirements of paragraph (d)(1) of this section. If, following a certification, a computer model is modified in a manner that may affect its ability to meet the requirements of paragraph (d)(1), 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 (d)(1).

(3) 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 (d)(4) of this section, whether a computer model meets the requirements of paragraph (d)(1) 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.

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

(i) Be in writing;

(ii) Contain—

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

(B) An explanation of how the applied methodology or methodologies demonstrated that the computer model met the requirements of paragraph (d)(1) of this section;

(C) 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 (d)(1) of this section;

(D) 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 (d)(1);

(E) A statement certifying that the eligible investment expert has determined that the computer model meets the requirements of paragraph (d)(1) of this section; and

(iii) Be signed by the eligible investment expert.

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

(e) *Arrangement must be authorized by a plan fiduciary.* 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.

(f) *Annual audit.* (1) 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:

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

(ii) 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, consistent with paragraph (e) of this section, setting forth the specific findings of the auditor regarding compliance of the arrangement with the requirements of this section.

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

(i) Within 30 days following receipt of the report from the auditor, as described in paragraph (f)(1)(ii) of this section, shall furnish a copy of the report to the IRA beneficiary or make such report available on its website, provided that such beneficiaries are provided information, with the information required to be disclosed pursuant to paragraph (g) of this section, concerning the purpose of the report, and how and where to locate the report applicable to their account; and

(ii) 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—Statutory, U.S. Department of Labor, Employee Benefits Security Administration, Room N–1513, 200 Constitution Ave., NW., Washington, DC, 20210.

(3) For purposes of this paragraph (f), 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 any designated investment options under the plan.

(4) For purposes of this paragraph (f), 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.

(g) *Disclosure.* (1) 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—

(i) Of 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;

(ii) Of 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;

(iii) Of 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 or in connection with the sale, acquisition, or holding of the security or other property;

(iv) Of any material affiliation or material contractual relationship of the fiduciary adviser or affiliates thereof in the security or other property;

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

(vi) Of the types of services provided by the fiduciary adviser in connection with the provision of investment advice by the fiduciary adviser, including, with respect to a computer model arrangement referred to in paragraph (d) of this section, any limitations on the ability of a computer model to take into account an investment option that constitutes an investment primarily in qualifying employer securities, as provided for in paragraph (d)(1)(v) of this section;

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

(viii) 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.

(2)(i) The notification required under paragraph (g)(1) 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.

(ii) The appendix to this section contains a model disclosure form that may be used to provide notification of the information described in paragraph (g)(1)(iii) 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 requirement of paragraphs (g)(1) and (2)(i) of this section with respect to such information.

(3) The notification required under paragraph (g)(1) of this section may, in accordance with 29 CFR 2520.104b–1, be provided in written or electronic form.

(4) At all times during the provision of advisory services to the participant or beneficiary pursuant to the arrangement, the fiduciary adviser must—

(i) Maintain the information described in paragraph (g)(1) of this section in accurate form and in the manner described in paragraph (g)(2) of this section,

(ii) Provide, without charge, accurate information to the recipient of the advice no less frequently than annually,

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

(iv) Provide, without charge, accurate information to the recipient of the advice concerning any material change to the information required to be provided to the recipient of the advice at a time reasonably contemporaneous to the change in information.

(h) *Other Conditions.* The requirements of this paragraph are met if—

(1) 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,

(2) The sale, acquisition, or holding occurs solely at the direction of the recipient of the advice,

(3) 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

(4) 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.

(i) *Maintenance of Records.*—The fiduciary adviser must maintain, for a period of not less than 6 years after the provision of investment advice pursuant to the arrangement, 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.

(j) *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.

(2) 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—

(i) 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,

(ii) 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,

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

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

(v) An affiliate of a person described in any of clauses (i) through (iv), or

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

(vii) 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 (d) 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; or

(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 (j)(4)(i) through (v) of this section.

(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;

(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 (j)(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 written 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.

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 Advisor 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] has a material affiliation or material contractual relationship [93]) 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

[93] See 29 CFR 2550.408g–1.

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 of 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.

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.

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 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 not material affiliation with or receive compensation in connection with the investment funds or products offered under the plan. This type of advice is/is not available through your plan.

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 section 408(b)(14) and (g). Section 4975(f)(8) of the Internal Revenue Code, as amended (the Code), contains a parallel provision to ERISA section 408(g)(11). 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 subparagraph 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(j)(2) (i) through (v),

(B) Develops the computer model, or markets the computer model or investment advice program, utilized in satisfaction of 29 CFR 2550.408g–1(d) 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 fiduciary who authorized the arrangement, in accordance with 29 CFR 2550.408g–1(e); and

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

Signed at Washington, DC, this 15th day of August, 2008.

Bradford P. Campbell,

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

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