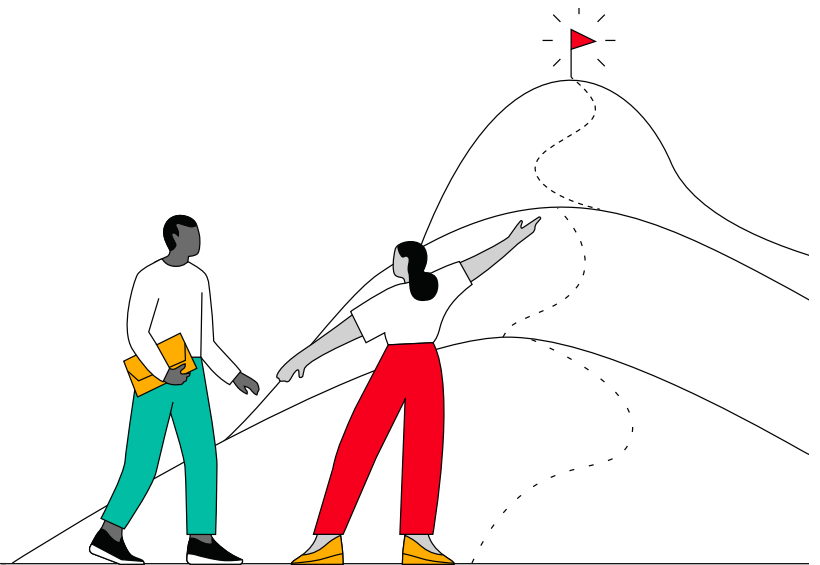


Participant advice: The current state

Behavioral finance research has shown that many participants in defined contribution (DC) retirement plans lack the financial planning skills, time, and/or interest to make appropriate investment decisions. Sound investment decisions, aided by good investment advice, can help participants forge a clear path toward retirement security. Plan sponsors and plan fiduciaries concerned about their participants' investment acumen should consider whether to offer investment advice.

This regulatory brief will review the evolution of advice and provide an overview of the current rules affecting advice as well as Vanguard's advice offerings.



Authors



Jeff Clark
Product Owner,
Strategic
Retirement
Consulting



Mike Palumbo
ERISA Consultant,
Strategic
Retirement
Consulting



Shelly Preston
Senior ERISA
Consultant,
Strategic
Retirement
Consulting

Evolution of advice

In 1996, the U.S. Department of Labor (DOL) issued guidance allowing plan sponsors to provide education to participants. While offering education on investment decisions was helpful, it was soon recognized that participants can benefit more from professional investment advice than from education.

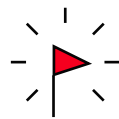
Responding to this need, in 2001, the DOL issued an advisory opinion (the SunAmerica opinion), which clarified that plan fiduciaries may use computer models from a third-party advisor to provide investment advice to participants but that the plan sponsor must exercise prudence in selecting and monitoring these models.

Another common approach for offering investment advice based on DOL advisory opinions is the "fee-leveling or offset" approach. This method of providing advice complies with the prohibited transaction rules of the Employee Retirement Income Security Act of 1974 (ERISA) by reducing the advisory fee by the amount of revenue the provider receives from the funds such that no additional income is generated based on the fund chosen. The fee-leveling or offset approach is sanctioned by the DOL in the Frost Bank and COUNTRY Trust advisory opinions.¹

Pension Protection Act and the final regulation

By 2006, there was recognition that participants require greater access to advice programs to help them make better asset allocation decisions. However, under ERISA, it is considered a conflict of interest for a plan fiduciary to engage in a transaction that affects the amount or timing of compensation or fees paid to the fiduciary (and certain others in whom the fiduciary has an interest). Without a prohibited transaction exemption, fiduciaries may not offer investment advice where the offering of such advice could earn them additional compensation and thereby affect their judgment. With this in mind, in 2006,

Congress signaled its strong support for advice programs when it passed the Pension Protection Act (PPA), which provided such an exemption.



In 2006, Congress signaled its strong support for advice programs when it passed the Pension Protection Act (PPA)

The PPA's advice provisions were designed to ensure that the advice being offered is not biased and does not favor investments that produce an additional revenue source to the provider. In order to encourage advice programs but avoid such conflicts of interest, the PPA (and the DOL's subsequent final advice regulation passed in 2008 [the "final regulation"]) provides that the participant advice programs must constitute an eligible investment advice arrangement through the use of either a level-fee arrangement or a computer-model approach.

Under the level-fee arrangement, an advice program may qualify for the PPA exemption as long as the investments selected by participants do not affect the service provider's compensation either for the advice or because of any resulting purchase or sale of plan investments based on the advice provided. The final regulation confirms that only the fees or other compensation provided to the fiduciary advisor are applicable. The exemption does not require fees paid to affiliates (including affiliated mutual funds) to be level.

Under the computer model, an advice program may qualify for the PPA exemption if the model:

- Uses generally accepted investment theories that take into account asset classes and historic investment returns over defined periods of time.

¹DOL Advisory Opinion 97-15A (May 22, 1997) (Frost Bank) and DOL Advisory Opinion 2005-10A (May 11, 2005) (COUNTRY Trust Bank).

- Considers relevant participant information (such as age and risk tolerance).
- Uses prescribed objective criteria to provide asset allocation portfolios composed of investment options offered under the plan.
- Operates in a manner that is not biased toward investments offered by the fiduciary advisor.
- Takes into account all investment options offered under the plan.

Under the final regulation, the computer model must consider historical risks and returns of different asset classes, but it may also take into account other factors. No performance data for a particular investment may be inappropriately weighted, allowing for better comparisons between funds of different types, such as actively managed funds and index funds.

Numerous added conditions are imposed on all eligible arrangements, regardless of whether the arrangement uses the fee-leveling or computer-model option. These conditions require that:

1. The arrangement be expressly authorized by a plan fiduciary other than the person providing the advice program.
2. The fiduciary advisor obtain an annual audit from an independent expert demonstrating compliance with the conditions of the exemption.
3. Comprehensive disclosures be given periodically to participants or beneficiaries.
4. Transactions be made at arm's length and for reasonable compensation.

Finally, the 2008 final regulation reaffirms that the selection and monitoring of an investment advice provider is a fiduciary act. If the plan sponsor follows a prudent selection and monitoring process and determines that selection of a particular advice provider is prudent and consistent with the best interests of participants

and beneficiaries, the sponsor will not be liable for the advice furnished to plan participants. This is true whether the advice program is modeled upon the SunAmerica, Frost, or COUNTRY Trust advisory opinions or upon advice programs covered by the PPA.

What constitutes an "eligible investment advice arrangement"? As noted above, the PPA specifies that an eligible investment advice arrangement is advice provided through:

- A computer model certified as unbiased; or
- An advisor compensated on a level-fee basis (that is, fees do not vary based on the investment selected by the participant).

Qualified advice programs should result in fewer investment errors—and therefore potentially greater retirement readiness.



Adoption of advice programs is strongly encouraged

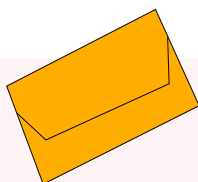
By enacting the PPA, Congress signaled its strong support for advice programs. In the final regulation, the DOL continues its advocacy of qualified advice programs. In the preamble to the final regulation, the DOL states its expectation that the rules will increase the availability of affordable, high-value advice programs for participants. Such programs should result in fewer investment errors—and therefore potentially greater retirement readiness—for DC plan participants, their beneficiaries, and beneficiaries of individual retirement accounts (IRAs).

Plan sponsors can feel confident that adoption of compliant advice programs, such as Vanguard's advice services, will further the DOL's objectives for increasing retirement security.

Client planning note

In the final regulation, the DOL reviews five distinct types of investment errors participants make that may be countered by good advice:

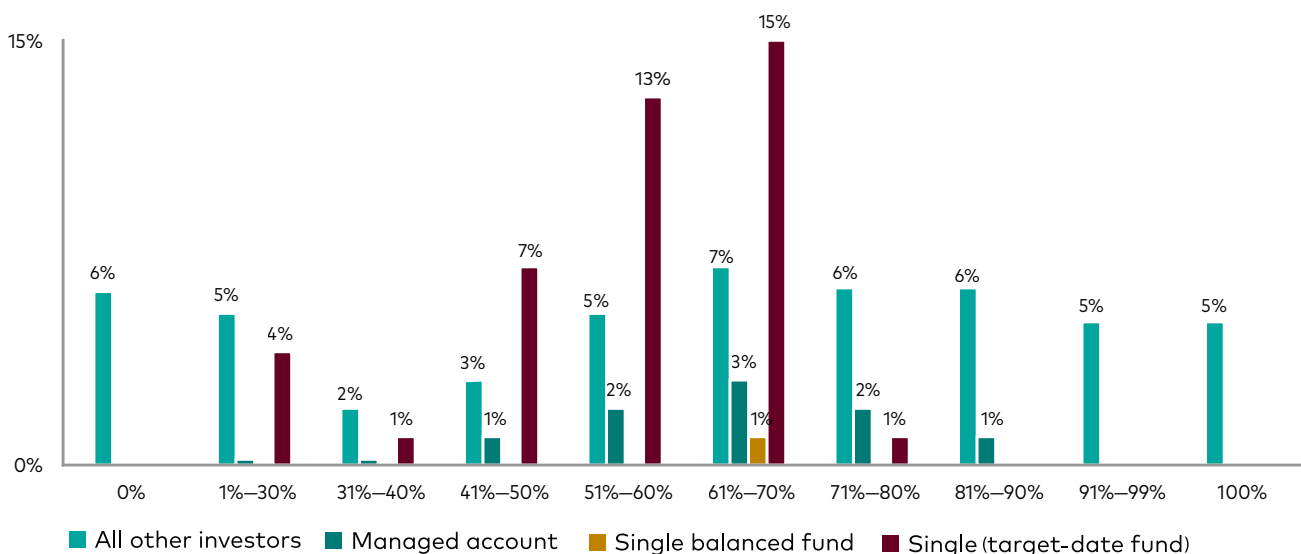
1. Payment of inefficiently high investment fees.
2. Poor trading strategies.
3. Inadequate diversification (such as a high concentration of company stock).
4. Inappropriate risk.
5. Payment of excess taxes due to a disconnect between investments and current tax strategies.



50% of participants ages 55 and older were not implementing a professionally managed allocation.

Recent Vanguard [research](#) highlights that 50% of participants ages 55 and older were not implementing a professionally managed allocation (pure target-date fund, other balanced fund, or enrolled in an advice service).² While older participants with professionally managed allocations had equity exposure between 40% and 80%, those who constructed their own portfolio had a wide dispersion of equity allocations, which were somewhat evenly distributed from 0% to 100%.

Figure 1. Distribution of equity exposure by older investors, 2022
Vanguard defined contribution plan participants ages 55+



	All other investors	Managed account	Single balanced fund	Single target-date fund
Percentage of population	50%	9%	<1%	41%
Average balance	\$324,636	\$240,076	\$167,424	\$76,965
Median balance	\$152,414	\$126,071	\$62,576	\$20,683

Source: Vanguard, 2023.

What does this mean for plan sponsors?

Behavioral finance research has shown that many participants in DC retirement plans lack the financial planning skills, time, and/or interest to

make appropriate investment decisions. Sound investment decisions, aided by good investment advice, can help participants forge a clear path

² *How Americans Use Professionally Managed Allocations*. Vanguard, 2023.

toward retirement security. Vanguard has a suite of services designed to comply with existing guidance. This suite includes Advice from Vanguard and Advice powered by Edelman Financial Engines, a third-party advisor. Below are brief descriptions of each of these products along with the DOL guidance on which they rely.

Advice from Vanguard

Advice from Vanguard offers participants a range of service options that include digital experiences, one-time advisor consultations, extensive financial planning capabilities, and ongoing access to advisors. Employees have three options for meeting their advice needs:

- **Vanguard Digital Advisor®**, an all-digital financial planning and discretionary managed account service for investors who want traditional investment management and financial wellness guidance.
- **Vanguard Personal Advisor®**, a high-tech, high-touch service for participants who want advice both digitally and from a Vanguard advisor who's focused on their needs.
- **Vanguard Situational Advisor™**, a point-in-time financial advice program providing consultation with a Vanguard advisor to discuss life's important financial moments, including buying a home, changing jobs, or receiving a windfall.

Whether an employee uses Vanguard Digital Advisor, Vanguard Personal Advisor, or Vanguard Situational Advisor, Vanguard Advisers, Inc. (VAI) is a fiduciary under ERISA and the Investment Advisers Act of 1940 and is subject to fiduciary requirements of ERISA and the Advisers Act. Vanguard's Digital Advisor and Personal Advisor offers comply with ERISA's prohibited transaction

Next steps

With a more favorable regulatory environment, plan sponsors are increasingly choosing to offer advice services to address participants' needs for assistance with investing, planning, and balancing competing goals. Vanguard continues to be a leader in innovative education and advice programs for all participants. As more plans adopt advice, more participants are taking advantage of its benefits—trends we expect will continue.

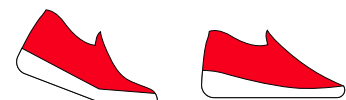
rules by reducing the advisory fee by the amount of revenue Vanguard receives from its own funds, along with any revenue Vanguard receives from non-Vanguard funds. This means Vanguard receives no additional income based on the funds chosen by the service. This approach is consistent with the DOL guidance in the Frost and COUNTRY Trust advisory opinion letters. Vanguard's Situational Advisor is a "level-fee" arrangement that complies with requirements set forth in the PPA (described above) for resolving conflicts of interest.

Personal Online Advisor powered by Financial Engines

As participants' portfolios become increasingly complex, they often want advice more personalized to their needs, including retirement savings sufficiency analyses and additional opportunities for customization, as well as fund recommendations that consider assets outside the company's retirement plan. Personal Online Advisor powered by Financial Engines (POA) is an online, self-directed advice tool for participants who want additional personalization and control over implementing recommendations. POA is designed to comply with the SunAmerica advisory opinion.

Vanguard Managed Account Program

The Vanguard Managed Account Program (VMAP) is a fee-based service that provides professional portfolio construction and management. Program participants get diversified, low-cost portfolios customized to their individual situations—portfolios that are professionally managed for as long as they remain in the program. VMAP offers investment advice, retirement savings sufficiency analyses, and personalized ongoing management of the retirement account, powered by Financial Engines. VMAP is designed to comply with the SunAmerica advisory opinion.



Connect with Vanguard®

institutional.vanguard.com

All investing is subject to risk.

Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in target-date funds is not guaranteed at any time, including on or after the target date.

Vanguard Financial Planning Services are provided by Vanguard Advisers, Inc., a registered investment advisor.

The Vanguard Group has partnered with Financial Engines to provide subadvisory services to the Vanguard Managed Account Program and Personal Online Advisor. Financial Engines is an independent, registered investment advisor that does not sell investments or receive commission for the investments it recommends. Advisory services are provided by Vanguard Advisers, Inc. (VAI) a federally registered investment advisor and an affiliate of The Vanguard Group, Inc. (Vanguard). Vanguard is owned by the Vanguard funds, which are distributed by Vanguard Marketing Corporation, a registered broker-dealer affiliated with VAI and Vanguard. Neither Vanguard, Financial Engines, nor their respective affiliates guarantee future results.

Vanguard Asset Management Services are provided by Vanguard National Trust Company, which is a federally chartered, limited-purpose trust company operated under the supervision of the Office of the Comptroller of the Currency. The annual service fee, payable quarterly, is based on the market value of assets under management at the end of each quarter. A minimum of \$500,000 is necessary to establish a relationship, and the minimum annual fee is \$4,500. The annual fee includes the cost of brokerage commissions and other security transaction expenses incurred in the account. A different fee schedule applies to qualified plans and relationships with \$10 million or more. There is an additional fee for trust services/fiduciary accounts.

For institutional use only. Not for public distribution.

The Vanguard logo, featuring the word "Vanguard" in a bold, red, serif font with a registered trademark symbol.

© 2024 The Vanguard Group, Inc.
All rights reserved.