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February 3, 2011

U.S. Department of Labor
Employee Benefits Security Administration
Public Disclosure Room
200 Constitution Avenue, NW, Suite N-1513
Washington, DC 20210

Dear Regulators,

I would like to submit Fiduciary Compliance Center's reaction and comments regarding the proposed enhancement to the definition of a fiduciary. As you know, Fiduciary Compliance Center has joined others in requesting that the EBSA issue additional rules clarifying the definition of a fiduciary under ERISA prior to the unveiling of this proposal. Through these requests we highlighted specific areas of concern that have received inadequate attention and have been permitted to inappropriately escape fiduciary status under ERISA. The comments submitted in response to this proposal will address specific areas of the proposal as well as reiterate those areas of concern that have not been properly addressed in the proposal.

It appears that while the OIG report issued September 30, 2010 highlighted many areas of concern and legislators have publicly expressed outrage regarding the relaxed accountability awarded to service providers, the Department has responded by focusing its attention on strengthening the test only as it applies to the delivery of investment advice. I am concerned that after 35 years of inadequate attention to this area, the Department has not sufficiently addressed the areas of common abuse.

<u>Written Proposal vs. Media Statements</u>

Initially, my reaction to the proposal was positive, I was in fact pleasantly surprised to find that there were no omissions or exclusions offered to investment companies. However, that reaction quickly changed upon reading multiple articles which followed the release of the proposal published late in the day quoting Phyllis Borzi. The press was given the opportunity to hear directly from EBSA leaders regarding the proposal and those conversations generated a much different application to these rules than my read had rendered. An article published by Investment News on October 21, 2010 stated the following interpretations and intentions of the new proposal:

1. "the proposal would classify as a fiduciary anyone who offers "advice, appraisals or fairness opinions concerning the value of securities or other property; recommendations as to the advisability of investing in, purchasing, holding or selling securities or other property; or advice or recommendations as to the management of securities or other property.""

2. "The rule would also define as a fiduciary anyone defined as an adviser under the Investment Advisers Act of 1940. But it also reaches beyond that statute."

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3. "The regulation would not include target date funds nor would it define mutual fund advisers as fiduciaries."

4. "Ms. Borzi said that the new rule would prevent advisers from skirting fiduciary responsibility when they provide advice only once, such as recommending an annuity carrier for assets when a plan is terminated. It also would stop advisers from claiming that they weren't the primary source of investment advice if a plan had hired a number of advisers."

These statements are contradictory in nature. The first statement clearly imposes fiduciary status on target date providers. The second statement includes the registered investment advisors who advise mutual funds as they are not exempt from registration under the Advisers Act. The third statement indicated the Department intended to exclude target date and mutual fund advisors from the regulation although it was not provided for in the proposal. The fourth statement indicates the Department's intention to avoid allowing certain advisers to escape ERISA fiduciary status simply because they are not in fact the primary or sole advisor.

As stated in the proposal, "Courts have determined that these investment advisers owe fiduciary duties to their clients under the Advisers Act. In this regard, the SEC has stated: "the Investment Advisers Act imposes on investment advisers an affirmative duty to their clients of utmost good faith, full and fair disclosure of all material facts, and an obligation to employ reasonable care to avoid misleading their clients." Thus, the Department proposes to include these persons under the regulation." What was written to be included has verbally been claimed to be excluded. So why is the Department taking the position that mutual fund advisors owe no duty of loyalty to their clients by verbally stating the intention of this regulation is to exclude those advisors?

If the Department is simply taking the position that it will rely on the SEC to appropriately regulate the target date fund providers, then once again we see the passing of the baton to someone who is literally warming the bench. The SEC has not and clearly will not appropriately address these issues even though target date fund providers clearly violated the SEC's position on their affirmative duties. Not to mention, the opportunities for obtaining recovery and holding target date fund providers accountable for their wrongdoing under SEC rules are very restrictive and better suited for the industry than the participants who were defaulted into such arrangements while promised the protections of ERISA.

It seems that while the proposal read to implicate a broad based application covering any persons or entities rendering advice to the plan and/or its participants, EBSA leaders in fact intended to allow target date funds and the investment companies who manufacture them, most QDIA providers, to escape its application. By limiting the application of the fiduciary definitions under ERISA and excluding target date providers, the EBSA is essentially blessing the projections that more money will leave the protections of ERISA in the coming years than is awarded those protections as indicated by the studies relating to target date fund growth. According to a report issued by McKinsey & Company, "A new suite of target-driven solutions will account for 60 percent of DC assets and revenues by 2015 and capture $1.7 trillion of flows." This shift will make target date fund products account for 40% of total DC assets as presented in Exhibit 5 of the report and extracted below.[1] This is counterintuitive to maintaining reasonable regulatory enforcement as it relates to the protection of participant retirement savings. It is also evidence of the inappropriate level of power the Investment Company Institute has in Washington.

[1] *Winning the Defined Contribution Market of 2015 New Realities Shape the Competitive Landscape*, September 2010, McKinsey & Company, Page 2, 12

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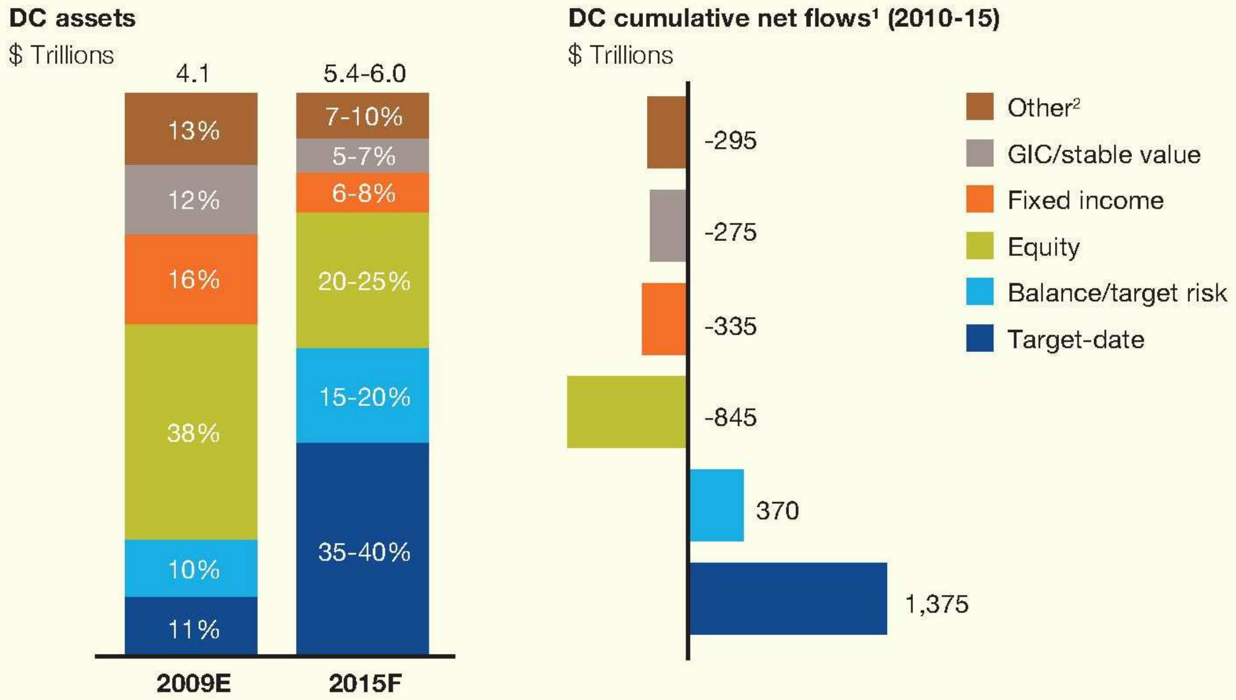

If the EBSA continues to ignore the impact of target date funds and the lacking regulatory oversight and if the McKinsey projections are accurate, we may not need the EBSA at all in about 10 years. There won't be any plan assets left under its regulatory authority. As I stated in my comments regarding the target date disclosure proposal, we are clearly turning over the control to the ICI. Either the EBSA has failed to recognize the significance of these trends or this is merely by design. Inarguably this has been well thought through and designed by the ICI leaders, the leading lobbyists for the mutual fund industry.

Target Date Funds & Investment Companies Should Not be Awarded an Escape Tunnel

While target date fund providers are basking in their great escape from being held accountable for actions many have argued transacted at a criminal level, experts are left wondering how exactly this escape has occurred. These fund of fund vehicles are unique to other mutual fund products for many reasons:

1. They far exceed the minimum 25% qualified plan investment test under ERISA's look through rules which apply to other pooled investment products and are actually comprised of approximately 70% of assets derived from qualified retirement plans.[2] This statistic makes it impossible to ignore that these vehicles are specifically designed for qualified retirement plan assets. Therefore, should they not be required to be managed as appropriate for such investors?

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[2] FRC Target Date Fund Study 2008, by Lynette Dewitt

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The plan asset exemption was adopted because mutual funds are generally not marketed to qualified plans exclusively and are often comprised of much lesser percentages of qualified plan monies. This is clearly not the case for target date funds. Target date funds were solely designed to be used in retirement savings plans – hence the retirement date label.

2. These vehicles provide investment advice for compensation, both direct and indirect, by design.
    a. First, they recommend the appropriate asset allocation for participants retiring at a specific point in time making them fiduciaries under ERISA § 3(21)(A)(ii).
    b. Second, they recommend and select which investments should be used to implement that asset allocation by selecting the underlying funds making them fiduciaries under ERISA § 3(21)(A)(ii) & (i).
    c. Third, they monitor both the asset allocation and the underlying funds and make changes to the management of the target date funds at their sole discretion making them fiduciaries under ERISA § 3(21)(A)(i).
    d. They deviate from the recommended and disclosed asset allocation at their sole discretion without the prior consent or notification of fiduciaries making them fiduciaries under ERISA § 3(21)(A)(i).
    e. They affect their own compensation without the explicit authority of fiduciaries by making changes to the asset allocation and by investing in underlying investment strategies which increase the compensation received making them a fiduciary under ERISA § 3(21)(A)(i).

Mutual fund complexes have successfully argued they are exempt from the plan asset rules and therefore do not provide these services in the context of plan assets. Thus, allowing them to operate in a fiduciary capacity without being deemed an ERISA fiduciary. I fail to understand how this advice and the exercise of full discretionary authority is any different than that provided by other investment advisors who are fiduciaries under ERISA. These products are used to invest participant contributions and account balances – plan assets.

These other advisors also advise on the purchase of registered mutual funds in many cases. In other cases, they offer managed accounts where they assume discretionary authority and purchase the mutual funds according to the advised allocation. If these investment advisors are not exempt from ERISA fiduciary status while they are essentially providing the same services and exert less actual control over the management of such assets then why would the mutual fund managers and their investment advisors be any different?

I fail to see why the Department would deliberately continue to offer these companies a free pass. The prior devastating effects the improper management of these vehicles has caused plan participants and the resulting embarrassment for our regulatory leaders could easily be avoided in the future by adopting appropriate regulatory policies. This proposed regulation as well as the proposed target date disclosure regulation offered the Department the golden opportunity to prevent such situations in the future, yet in both proposals the Department dodged the real issues at hand.

Proposed Limitations

Section 3(21)(C)(2) of the proposal sets forth limitations to the application of the fiduciary definition provisions. The first limitation states that persons who can demonstrate the recipient of the advice knows or should reasonably know the person providing the investment advice could be doing so in their own interests is excluded from the definition. This limitation will likely be the provision that many service providers who do not want to be found to be fiduciaries under ERISA will hide behind. In many if not most provider arrangements significant conflicts of interest are common, investment advice is generally related to the purchase or sale of a security that the adviser has some sort of stake in. Whether because it is offered proprietarily by the adviser's employing firm or the advising entity or because the adviser is acting in an agent or broker dealer capacity to sell securities on behalf of other issuers, the adviser could theoretically claim the recipient should have known they were not delivering the advice impartially. In a financial industry that is as imbedded with intertwined service provider relationships as the current system

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this provision offers a significant loophole to escape fiduciary standing for the most common service provider arrangements. This is especially true in bundled service provider arrangements where a menu is often recommended (but claimed to only be offered as an illustration), these service providers have traditionally escaped accountability for the investment advice they routinely deliver by disclaiming they in fact delivered advice.

Other Changes under Consideration

"The Department has requested comments and advisement regarding the inclusion of investment advice delivered to participants and beneficiaries with respect to account rollover and distribution arrangements. Oftentimes, the advisement of permissible plan distributions involves the recommendation of an investment product, account type or service arrangement; however, the Department has previously not considered this advice to fall under the ERISA definitions. Many service providers are delivering this investment advice to retirement plan participants and beneficiaries through licensed call center representatives, website offers, financial advisers, planners and other representatives seeking to capture the enormous assets available in the rollover marketplace. Commenters have expressed deep concerns regarding the abusive self dealing practices prevalent in the provision of this advice to participants and beneficiaries and I share these same concerns.

Capital Opportunities Created by Rollover Activities

Call centers and on-site "educators" who are often licensed financial advisers or securities representatives receive considerable compensation streams from the products sold during rollover processes. In most cases this advice is not delivered for the sole benefit of the recipient, but instead delivered to suit the licensed representatives' performance and revenue production interests. These situations are similar to the other advice arrangements the Department seeks to protect plans from under this definition. Furthermore, the opportunity for these sorts of sales is often created by the service provider arrangement with the plan and figured into when predicting compensation receipts from the services offered to retirement plan clients. The exclusion of this investment advice fails to protect participant account assets from conflicted investment advice and self dealing which is already and likely to continue to be a growing concern for participants and beneficiaries."[3]

"These call centers while claiming to be a cost burden to the service provider which is paid for by plan administration fees are also their own profit centers in many institutions. They produce their own revenue streams from the products and services they sell. This revenue is not reported to fiduciaries nor deducted from expenses imposed on the plan, which makes this aspect of the total plan administration costs unreasonable. The representatives receive performance based compensation which is derived from by affecting sales into these products and services, meaning they are compensated for delivering this investment advice. This common activity makes them a fiduciary under ERISA § 3(21)(A)(ii)."[4]

"Shortly following the change of the century it was predicted that more assets will leave employer sponsored retirement plans in the coming years than enter them as the baby boomers retire. This prediction caused the financial industry to take action to prepare for the opportunities presented by this forecast while mitigating the loss of assets under management. In 2004, like many other investment institutions Lincoln Benefit Life Company published a broker/dealer sales piece which stated that "Between 2003 and 2010, it is predicted that $2.4 trillion will be rolled over from employee-benefit plans to IRAs, with rollovers more than doubling from an estimated $188 billion in 2002, to more than $400 billion per year by the end of this decade." As a result of these forecasts, financial service firms and investment companies began aggressive structuring, product manufacturing, marketing and training to capture their share of the market for lucrative IRA rollovers.

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[3] *New ERISA Fiduciary Definition…Smoke in Mirrors or Meaningful Assignment of Accountability?* Article Authored by Jessica R. Flores to be published in unannounced industry publication first quarter 2011
[4] Fiduciary Compliance Center, LLC letter to EBSA requesting more guidance on fiduciary status dated September 21, 2010

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In a study produced by the Treasury Inspector General for Tax Administration in August 2010 it showed a total of $368 billion in employer sponsored retirement plan contributions and a total of $453 billion in disbursements for the year 2007. While that same year, according to data compiled by the Investment Company Institute (ICI) a total of $323 billion was rolled over from employer sponsored retirement plans to IRAs. These figures confirm the accuracy of the industry's projections and demonstrate the opportunity created by the rollover marketplace."[5]

According to a recent report issued by McKinsey & Company, $2 billion in rollover monies will be up for grabs in the next 5 years. "Born almost by accident nearly 30 years ago, defined contribution (DC) has become the favorite child of asset gatherers. Despite a trillion-dollar decline in assets during the recent financial crisis, DC has surpassed private defined benefit (DB) as the major pool of retirement funds with $4 trillion in assets. Although faced with the prospect of $2 trillion in outflows over the next five years due to retiring baby boomers, DC will continue to thrive, with an equal level of new contributions."[6]

"If the EBSA is to effectively protect retirement savings and regulate the service providers who seek to capitalize from the employer sponsored retirement plan marketplace, it is obvious that it would need to expand its focus to cover the investment advice delivered to participants and beneficiaries regarding the rollovers and distributions of their accounts. These industry trends simply create too much economic opportunity for service providers that have and will continue to breed schemes to self deal at the economic devastation of retirement savers."[7] The retirement plan service arrangements prevalent today offer the perfect captive audience for these sales practices to be very successful. Employer sponsored retirement plans have in essence created this captive audience, so it is only reasonable that these very obvious occurrences of investment advice delivered to plan participants would be included in this definition.

<u>It's Past Time to Use Common Sense and Ignore Lobbyists Representing Financial Powerhouses</u>

"It is counterintuitive to most that it is an acceptable financial industry model that financial institutions be permitted to manage someone else's assets for their own benefit instead of for that of the investor. However, by exempting these institutions from liability under ERISA it allows them to deal in their own self interests at the expense of plans, plan fiduciaries, participants and beneficiaries. Closing the ERISA fiduciary escape tunnel for the industry's service providers is imperative to stop the bleeding of the nation's retirement savings and to protect the future of the economy. If lobbyists prevail in the battle to insulate investment companies who commonly service the employer sponsored retirement plan marketplace by leaving open an escape route this opportunity to correct these concerns will have been lost."[8]

<u>Summary</u>

Also important to note, that much of this does not change what the rules under § 2510.3-21(c) were to start with before this new proposal. The functionality test under ERISA was quite clear and easily applicable; however, as noted in the GIO report, the Department failed to hold service providers accountable in situations where they clearly acted in fiduciary capacity simply because they disclaimed fiduciary status under ERISA. This proposal is only slightly modified, but fails to guarantee the Department will actually ever properly enforce fiduciary functionality tests. The substandard regulatory

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[5] *New ERISA Fiduciary Definition…Smoke in Mirrors or Meaningful Assignment of Accountability?* Article Authored by Jessica R. Flores to be published in unannounced industry publication first quarter 2011

[6] *Winning the Defined Contribution Market of 2015 New Realities Shape the Competitive Landscape*, September 2010, McKinsey & Company, Page 1

[7] *New ERISA Fiduciary Definition…Smoke in Mirrors or Meaningful Assignment of Accountability?* Article Authored by Jessica R. Flores to be published in unannounced industry publication first quarter 2011

[8] *New ERISA Fiduciary Definition…Smoke in Mirrors or Meaningful Assignment of Accountability?* Article Authored by Jessica R. Flores to be published in unannounced industry publication first quarter 2011

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actions taken by the Department needs to be addressed in some form. Our government agencies fail to be accountable for upholding their duties as proven repeatedly in their recent adoptions of new regulations. How will these regulations actually change that issue?

While the EBSA leaders have made it clear they have no intentions of the provisions contained in this proposal to appropriately apply to investment companies and target date mutual funds, the regulation certainly indicates a broader application which would in many cases incorporate those arrangements. The Department prepared this proposal partly in response to Senator Kohl's intentions to impose fiduciary status on target date providers. While arguably this regulation does address those concerns, the statements offered to the press by EBSA leader, Phyllis Borzi, indicate just the opposite. It is evident that Senator Kohl's concerns will not be addressed by this regulation nor were they intended to be.

It is unfortunate that the Department has elected to continue to expose plan participants to highly damaging conflicts of interest and self dealing with no regard to the losses the participants are incurring. The Department has failed to appropriately address the target date issues in both the new fiduciary definition proposal and the target date disclosure proposal. Clearly there is no desire to rectify these potentially catastrophic concerns.

Thank you for allowing Fiduciary Compliance Center to once again offer sound perspective regarding the impact of your regulatory efforts.

Respectfully submitted by,

Jessica R. Flores
Managing Partner
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