MONEY MANAGEMENT INSTITUTE

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February 3, 2011

Via Online Submission

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Definition of Fiduciary Proposed Rule
Room N–5655
U.S. Department of Labor
200 Constitution Avenue, NW.
Washington, DC 20210

Re: Comments of the Money Management Institute re Proposed Definition of "Fiduciary"

I am writing on behalf of the Legal and Regulatory Affairs Committee of The Money Management Institute (MMI)[1]. The Money Management Institute appreciates the opportunity to comment on the Employee Benefits Security Administration's (EBSA) proposed revisions to the definition of the term "fiduciary." While we appreciate that EBSA believes it needs to address certain gaps around the current definition, it is our opinion that the proposed revisions are overly broad and that they will likely result in unintended consequences to the detriment of ERISA plans and IRAs. Our concerns fall into two areas: (1) those that are specific to the managed account industry and, in particular, model portfolio-based programs; and (2) those that are more general, that we likely will share with other commenters. The bulk of this letter focuses on our concerns relating to separately managed accounts (SMAs).

I. Model Portfolio-based Programs

A. Background

We are concerned that the proposed definition of the term "fiduciary" could impose significant new requirements on investment managers that provide model portfolios for use in managed account-based services such as unified managed accounts. Although the use of model

[1] **The Money Management Institute (MMI):** Since 1997, MMI has been the leading voice for the global financial services organizations that provide advice and professionally managed solutions to individual and institutional investors. Through industry advocacy, educational initiatives, regulatory affairs, data reporting and professional networking, MMI supports and advances the growth of managed investments. Our members' advice-driven investment solutions are responsive to an evolving worldwide financial landscape, and their organizations are committed to the highest standards of fiduciary responsibility and ethical conduct.

portfolios to deliver investment strategies is a somewhat recent development within the managed accounts industry, it is a fast-growing practice.[2] I have provided a brief history and general overview below, though practices and legal structures within the industry vary considerably.

Traditionally, the separate account industry was typically comprised of single investment managers managing single custodial accounts according to a particular investment strategy or style. For clients to achieve diversification across multiple asset classes, managers, and styles, it meant opening and maintaining multiple individual custodial accounts. This made it difficult if not impossible to rebalance across strategies and to coordinate manager activity, such as imposing restrictions, proxy voting, preventing wash sales, or avoiding short-term gains. In response, the industry began developing several different new types of services to facilitate greater coordination across different asset classes. These efforts have resulted in the emergence of separate account-based services that offer multiple investment strategies – including separately managed portfolios of individual securities, as well as exchange-traded funds (ETFs) and mutual funds – in one custodial account, commonly referred to as a "unified managed account" or "UMA."

Generally, the UMA is a single custodial account managed on a discretionary basis by an "overlay manager." Instead of each investment style being managed in a single account by a single manager, the overlay manager receives a model portfolio from each investment manager consisting of recommended securities and their weights. For the purposes of this letter, investment managers providing a model portfolio are referred to as "model portfolio providers." Model portfolio providers typically also provide generic marketing collateral that the sponsor, advisor, or overlay manager can use in marketing the program. Model portfolio providers generally do not, however, provide any individualized advice to clients.

An overlay manager typically implements the model portfolios and is able to coordinate the recommended trades for client-specific mandates – such as restrictions and tax consequences, rebalancing, and cash flows. In addition, the overlay manager can implement rebalancing and allocation changes within the account without the need to transfer money or assets between custodial accounts or to open or close accounts. Overlay managers may also either vote proxies, if appointed by the client, or clients may vote proxies themselves.

In general, clients interact primarily with an individual advisor who provides initial and ongoing advice as to the selection of: model portfolio providers for each account, strategies, ETFs and mutual funds, their relative allocations within the account, and other account features like rebalancing frequency, restrictions, tax mandates, and proxy voting authorization. The sponsoring firm or an independent individual advisor usually has the responsibility of selecting and supervising the model portfolio providers available in a given program. Sponsors and advisors may also use the services of a third-party research firm to research and monitor model portfolio providers.

The overlay management functions are performed in several different ways, including by third-party discretionary overlay manager firms, by an in-house overlay management department, or by the individual advisor utilizing overlay management software. Their services and business

[2] See Unified Accounts Set to Break Through This Year, Tom Stabile, FundFire (January 6, 2011) (http://www.fundfire.com/c/141552/19702/unified_accts_break_through_this_year).

models may vary, but most rely on the use of model portfolios provided by model portfolio providers.

UMAs may have a bundled asset-based fee or may have unbundled fees for the services provided by different parties and for specific strategies. Overlay managers typically charge an asset-based fee that can range from 10 basis points (bps) or less to 30 bps depending on the services provided. With their trading and client-facing responsibilities having been eliminated, asset managers who act as model portfolio providers typically receive substantially lower fees (25-35 bps) compared to the manager of an SMA account (50-75 bps). In a typical UMA or other model portfolio-based service, the individual advisor/sponsor and overlay manager are generally investment advisers and/or investment managers and, therefore, fiduciaries for purposes of ERISA under both the current and proposed definitions.

The proposed definition would potentially expand the scope of the definitions of “fiduciary” and “investment adviser” to include model portfolio providers to an overlay manager of accounts of ERISA plans and IRA clients, even though only the advisor/sponsor and overlay manager have any relationship with the client and even though model portfolio providers at most provide only impersonal, non-individualized advice. Such an expansion of scope would likely have an adverse effect on the use of model portfolios to distribute investment strategies within the managed account segment of the investment management industry. It would create an ERISA fiduciary relationship between the plan or IRA client and the model portfolio providers where SEC rules, guidance, and industry practice do not create an advisory relationship. It would put investment management services that use model portfolios at a competitive disadvantage to ETFs and mutual funds. It would impose direct and indirect compliance costs on a greater number of participants. These costs could ultimately limit the availability of model portfolio-based services for plans and IRA clients, and could thereby deny ERISA plans and IRA clients the transparency, flexibility, and customization available through managed account services – effectively limiting their investment options to mutual funds for managed investment strategies. The proposing release does not indicate that EBSA has identified any pattern of abuse involving the use of model portfolio providers or other non-discretionary sub-advisors, nor of vendors to investment managers generally.

Therefore, we ask that EBSA consider revising the rule to exclude non-discretionary model portfolio providers to discretionary investment managers to plans and IRAs, where such model portfolio providers do not provide individualized investment advice to the plan and where such model portfolio providers are subject to ongoing supervision by the sponsor or by an investment advisor or other fiduciary to the plan or IRA account. We further ask EBSA to consider the effect that such an expansive definition of “fiduciary” will have on other vendors and service providers retained by plans and to consider whether imposing fiduciary status on them will result in limiting the services available to plans generally. We also encourage EBSA to perform a more comprehensive study of industry practices and to conduct a hearing on the proposed definitions.

B. Proposed Definition Appears to Define Model Portfolio Providers as “Fiduciaries”

Under the existing definition, a person provides "investment advice" (and is therefore a fiduciary) if said person provides advice (1) regarding the value of securities or other property or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property; (2) on a regular basis; (3) pursuant to a mutual understanding, arrangement or agreement; (4) that will serve as a primary basis for the client's investment decisions; and (5) that is individualized based on the particular needs of the plan. Currently, model portfolio providers fail to meet conditions (3) and (5) above and so are not providing "investment advice" and are not fiduciaries.

The current proposal would replace the existing definition with one that provides that the term "fiduciary" should include a person who (1) provides such advice pursuant to an agreement, arrangement, or understanding – written or otherwise – between such person and the plan, a plan fiduciary, or a plan participant or beneficiary; (2) that such advice may be considered in connection with making investment or management decisions with respect to plan assets; and (3) will be individualized to the needs of the plan, a plan fiduciary, or a participant or beneficiary.

Parsing this new definition results in the following: A person [model portfolio adviser] who provides advice [model portfolios] pursuant to an agreement or understanding with a plan fiduciary [overlay manager] such that this advice may be considered in connection with making investment decisions with respect to plan assets and will be individualized [by overlay manager] to the needs of the plan. Thus, it appears that the breadth of the new proposal could cause it to extend to model portfolio providers. This result is possible because "individualized" would now modify the advice received by the client under the proposed definition rather than the advice provided by the potential advisor under the existing definition. Moreover, by eliminating the modifier "mutual" before "agreement" or "understanding," it effectively eliminates the ability for the client, overlay manager, and model portfolio provider to agree that the model portfolio provider is not intended to be an investment advisor or fiduciary to the client. Instead, it would create a fiduciary relationship based on the subjective perception of the client alone.

C. Model Portfolio Providers Do Not Appear to Be the Intended Targets of the Rule

EBSA has cited its concerns with respect to a variety of services that are currently provided to plans, but which do not invoke fiduciary status. Specifically, EBSA has identified the following types of service providers that it is intending to cover as fiduciaries with the proposed definition: (1) consultants who provide investment advice, but not regular investment advice; (2) persons who expressly hold themselves out as fiduciaries, but still fail one of the five elements of the current definition; and (3) appraisers who currently avoid fiduciary status as a result of prior EBSA guidance. We note that EBSA has not identified any abuse from model portfolio providers or from investment sub-advisers to plan investment managers or other fiduciaries. In the absence of any identified practice that potentially harms plans and IRAs, we believe that EBSA should refrain from extending the reach of the definition of "fiduciary" to include model portfolio providers.

D. Proposed Definition Would Create Fiduciary Relationship Even Where No Advisory Relationship May Exist Under the Advisers Act

The proposed definition would effectively create fiduciary and advisory relationships between plans and model portfolio providers where none would likely exist under the Investment Advisers Act of 1940. SEC rules and guidance generally define the adviser-client relationship based on the question of for whom the advice is tailored. For example, in two separate rules defining who the client is, for purposes of determining whether an individual stakeholder or beneficiary of a corporate or other entity, or the corporate or other entity itself, is the client, Advisers Act Rules 203(b)(3)-1 and 222-2 provide that the individual is the client if the advice is individualized to the needs of the individual, and that the entity is the client if the advice is individualized to the needs to the entity, rather than the individual stakeholders or beneficiaries.

In the contexts of sub-advisers, the SEC staff has also provided guidance to support the principal that a sub-adviser that provides advice to an adviser to the client which is not individualized to the client's needs, need not consider the eligibility of the client for "qualified client" status in order to receive performance based fee, but instead only the eligibility of the client's adviser.[3] Based on the available SEC guidance as described above, the managed accounts industry has generally taken the position that model portfolio providers should not be considered as having an investment advisory relationship with end clients.

The proposed rule, by reaching model portfolio providers, would instead create fiduciary status under ERISA and the prohibited transaction liability under the Internal Revenue Code onto relationships where no advisory relationship may exist under the Advisers Act. This result would create inconsistent standards and should be avoided or at a minimum should be analyzed more thoroughly in the context of Executive Order 12866, as it creates a potential conflict with the activities of another agency.

E. Increased Costs, Reduced Availability of Customization, and Distortion of Competition

We are concerned that the costs and risks to model portfolio providers incurred by complying with the requirements for fiduciary status would be significant and would potentially cause a significant number of model portfolio providers to decide not to participate in model-based programs with respect to ERISA plans and IRA accounts. While we note that EBSA has identified this risk generally in the proposing release[4], we believe that the effect could be more pronounced in the UMA segment of the separate accounts industry because of the lower fees that many model portfolio providers receive compared to fees received by asset managers in SMAs. In other words, a baseline of costs, risk, and compliance burden will apply that will be higher relative to the fees typically received by model portfolio providers and that these costs are more likely to deter model portfolio providers from participating with respect to ERISA plans and IRAs.

The proposing release does not seem to contemplate these costs in particular, based on EBSA's method for estimating the potential number of new fiduciaries. Specifically, EBSA has based its estimate on its reviews of Schedule C, in which plans above a certain size report service providers, and it has used an estimate of the number of service providers reported on these forms to estimate the number of new fiduciaries.[5] This methodology ignores the potential to create new

[3] *See*, Copeland Financial Services, Inc. (available September 21, 1992); Kempner Capital Management, Inc. (available Dec. 7, 1987); Lazard Freres Asset Management (February 12, 1996); *see also* BNY ConvergEx Group, LLC (Publicly Available September 21, 2010) (no advisory relationship between broker and adviser's clients where broker provides research to adviser).

[4] Proposing Release at 65,260.

[5] Proposing Release at 65,272, section 4.

fiduciaries that are not included on Schedule C as service providers, such as model portfolio providers. In addition, we note that other types of potential service providers would not be listed on Schedule C, including specifically managers of private funds. We therefore believe that the regulatory impact analysis in the proposing release is insufficient and should be reconsidered to the extent the final rule includes model portfolio providers or other potential fiduciaries not likely to be listed on Schedule C.

We also believe that the effect the rule could have on model portfolio providers and other potential fiduciaries could affect the competitiveness of these types of firms versus other products, such as registered investment companies. The increase in relative costs to model portfolio providers, when contrasted with the effective exclusion of investment managers to registered investment companies pursuant to Section 3(21)(B) of ERISA, would put separate account-based services and products at a competitive disadvantage. Thus, an asset manager would face significantly higher costs and risk in offering its investment strategy through a UMA than as a sub-adviser to a registered investment company.

Separate account-based products provide opportunities for greater customization for ERISA plans and IRA accounts in terms of diversification, avoiding concentrated risks, and proxy voting. By treating model portfolio providers as fiduciaries, the proposed rule could effectively deny these opportunities for many smaller plans and result in few investment options for them outside of registered investment companies and ETFs. Plans and IRAs could consequently be deprived the option of choosing managed accounts and the potential for enhanced customization that they provide. EBSA has not apparently considered the cost and burden that applying the definition of "fiduciary" would have on model portfolio providers and other vendors to other fiduciaries. We urge EBSA to re-analyze the potential impact of the updated definition with regard to the foregoing concerns.

F. Proposed Exception for Model Portfolio Providers

While we are concerned that expanding the definition of "fiduciary" as proposed may have significant unintended consequences for plans and IRAs and that this action should be reconsidered, at a minimum we believe that EBSA should include in the final rule an exception that provides that a person will not be deemed a fiduciary or an investment advisor solely because the person is a model portfolio provider or other non-discretionary sub-adviser who provides non-personalized services to another fiduciary, where the plan or IRA client has agreed that such person is not a fiduciary to the plan or IRA.

EBSA has already proposed two relevant exceptions which appear to reflect similar principles as in this proposal: (1) in proposed (c)(2)(i) for the counterparty of a transaction with the plan in situations where the counterparty has disclosed the potential for conflicts and does not represent fiduciary status; and (2) another in proposed (c)(2)(ii) for a person providing information and educational materials including "asset allocation models" provided without the individualized needs of the plan. The additional exception we propose is based on similar concepts as the exceptions already included in the proposed definition – namely, the lack of individualized advice in (c)(2)(ii)(B) and the express acknowledgement of the plan or IRA that the purported fiduciary is not acting as an investment adviser to the plan in (c)(2)(i).

II. Expansive Reach of “Fiduciary” Inhibits Flow of Information to Investment Managers and, Indirectly, to Plans and IRAs

Aside from the specific concerns we have regarding the applicability of the proposed definition on model portfolio providers, we have additional concerns about the unintended consequences that the proposed definition expansion may have on advisory services and plans generally. Because we anticipate that many other commenters will express similar concerns, we will address them only briefly.

A. Restricting Incidental Advice and Other Information to ERISA Plans and IRAs

The proposed definition makes fiduciary status dependant on the giving of investment advice in addition to other services, and in doing so, it makes the communication of advice the critical factor. For service providers seeking to avoid the costs and burden of fiduciary status, where their services consist primarily of other services, the proposed definition would create a significant deterrent to providing any information. For example, a manager to a private fund is likely to be unwilling to provide additional information that might otherwise be communicated and be useful to a plan fiduciary to value the private fund or to incorporate the private fund into an allocation with other assets.

B. Appraisal Restriction is Overly Broad

As proposed, making all appraisers fiduciaries would likely deter certain parties – such as issuers and transaction counterparties – from providing any assistance in valuing hard-to-value assets. The proposing release seems to contemplate that ERISA plans would retain third-party appraisers to perform these services. However, we doubt that there are sufficient numbers of appraisal service providers with the expertise to provide appraisals for many hard-to-value assets. EBSA should carefully consider the means by which ERISA plans would be able to obtain reliable valuation and appraisal information if the burden and costs of becoming fiduciaries result in the lack of ERISA plans having access to critical valuation data.

C. Limitation for Counterparty Disclosing Adverse Interest

While we support the exception from the definition of “fiduciary” outlined in (c)(2)(i) for advice provided by a counterparty of transaction, where the counterparty can demonstrate that the recipient of the advice knows that the counterparty is acting as principal and that its interests are adverse, it is impractical if not impossible to obtain sufficient document for each transaction. We believe EBSA should provide a more feasibly implemented means of disclosing a potential adverse interest.

III. Conclusion

The proposed definition of “fiduciary” would significantly expand its scope and would cover service providers and non-service providers, imposing new and burdensome requirements. Many of the new fiduciaries created by enacting the proposed definition would likely face significant costs relative to their revenue from continued participation, making it cost-prohibitive for many asset managers to participate in model-based programs available to ERISA plans and

IRAs. This deterrent effect could be repeated in other areas and deprive ERISA plans and IRAs of valuable services and information. The effects may reach well beyond EBSA's intended focus on consultants and appraisers. We therefore urge EBSA to reconsider the proposed definition and to consider the unintended consequences that enacting such a broad rule would have, both on model portfolio providers and generally. At a minimum, we believe that EBSA should consider an additional exclusion as described above and that it should analyze the costs and effects of the expanded definition with a view toward understanding its potential effect on firms that are not service providers today but that could be covered by the proposed definition.

Sincerely,

John A. Ehinger Jr.
Member, Legal and Regulatory Affairs Committee
Money Management Institute

CC: Christopher Davis, President, Money Management Institute