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Submitted Electronically
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, DC 20210

Re: 2010 Investment Advice Proposed Rule

Ladies and Gentlemen:

The Investment Company Institute is pleased to submit comments on the Department of Labor's February 2010 proposal to implement the investment advice provisions of the Pension Protection Act.

Congress included investment advice provisions in the PPA, a bipartisan piece of legislation, in order to increase opportunities for plan participants and IRA holders to obtain professional investment advice, while providing meaningful protection for those investors. The PPA investment advice exemption allows participants access to advice from financial services firms engaged in providing services and investments to their plans and IRAs, provided conditions of the exemption are met.

The need for investment advice for participants in defined contribution plans and IRA account holders is well recognized, as the Department has itself noted.[1] According to a 2007 GAO report, only 47 percent of ERISA plans offered some form of investment advice to participants.[2] In contrast, 80 percent of households owning mutual funds outside of employer-sponsored plans purchased their funds

[1] 74 Fed. Reg. 3822, 3822 (Jan. 21, 2009).

[2] U.S. Government Accountability Office, GAO-07-355, *Employer-Sponsored Health and Retirement Plans: Efforts to Control Employer Costs and the Implications for Workers*, at 36 (Mar. 2007), available at www.gao.gov/new.items/d07355.pdf.

using a professional financial adviser.[3] These data suggest that investment advice is much less widely available for retirement plans.

In finalizing a PPA investment rule the Department's guiding principle should be to facilitate the creation of new investment advice arrangements, with appropriate safeguards, as Congress intended. If the final rules make the PPA exemption unworkable, it will not be used, Congress' intent will be thwarted, and the Department's estimate for the increase in advice offered to participants will be incorrect.

Our comment letter makes the following points:

- The final rule should remove or modify substantially the proposed requirement that suggests that computer models cannot consider historical performance in distinguishing among investment options in an asset class. Historical performance is considered routinely by third party evaluation services and other professional advisers in evaluating investment managers and products, and its relevance is recognized in the PPA exemption itself and a number of the Department's rules. The investment advice rule should reflect well-established practice.

- The Department should not embark on a process to determine or define the generally accepted investment theories under which plan assets should be invested. While the Department has framed its questions in terms of the computer model, any attempt to establish the parameters of generally accepted investment theories necessarily would affect the investment of assets of any plans subject to ERISA, or even advice provided outside of ERISA. Since ERISA was enacted over three decades ago, the Department consistently and wisely has refused to get into the business of opining on how plan assets should be invested and it should not do so now.

- The final rule should clarify the fee leveling condition in two respects – (1) to state that any compensation that a fiduciary adviser receives when a participant implements an investment recommendation cannot vary based on the investment (removing the suggestion that the adviser cannot receive *any* compensation based on an investment) and (2) to reiterate that bonus programs based on the organization's overall profitability, when participant investments constitute a negligible portion of the calculation of profitability or revenue, do not violate the level fee condition.

[3] Sabelhaus, Bogdan, and Bass, "Characteristics of Mutual Fund Investors, 2009," *ICI Fundamentals*, vol. 18, no. 8 (Dec. 2009), Figure 8, available at www.ici.org/pdf/fm-v18n8.pdf.

- The final rule should clarify that an advice program is *not required to seek* from participants all of the information that the PPA says *may* be included in the relevant information about participants that the program takes into account.

- The final rule should retain the provision of the proposal that preserves Department guidance on programs not relying on the PPA exemption.

- The final rule should clarify that IRAs that offer a wide range of investment options would be treated under the rule as similar to brokerage windows in 401(k) plans.

Our comment letter is divided into three parts. First, we discuss our recommendation with respect to the treatment of past performance. Second, we respond to the Department's questions about generally accepted investment theories. The final section of our letter sets out our recommendations for clarifications to the rule.

We want to emphasize that a number of Institute members who do not have any current plans to use the PPA exemption expressed to us the concerns described in the first two sections of our letter regarding the effect that the Department's final rule could have on the investment of plan assets in other circumstances.

I. The Rule Should Not Require that Computer Models Ignore Historical Performance of an Investment Fund or Manager

The proposal would require that computer models not "[i]nappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future." In explaining its reasoning for the new condition, the Department asserts in the preamble that while some differences in fees or management style between investment options within a single asset class are likely to persist in the future, differences in historical performance are less likely to persist and therefore less likely to constitute appropriate criteria for asset allocation. The Department distinguishes past performance of investments and asset classes, stating that asset classes can more often be distinguished from one another on the basis of differences in their historical risk and return characteristics.

The Department apparently intends the new requirement to mean that a computer model generally should ignore the relative historical performance of any investment but may consider the historical performance of the asset class in which the fund invests. If a plan were to offer two or more funds whose investment objective put them in the same asset class, however defined, it appears under the Department's proposed rule that the *only factor* the computer could use to distinguish among the

options would be the fees of each option.[4] We have several objections to the requirement and the Department's rationale for it.

First, one of the most important factors that investment professionals use to evaluate an investment or its manager is historical performance. The Department's own record in the long notice and comment process for the investment advice regulation shows that existing computer models currently take into account the historical performance of a plan's investment options in making recommendations. One computer model provider told the Department that it considers the "manager performance" among other factors to determine how an investment's assets may perform in the future.[5] Another similarly stated that its computer model offered in the IRA market collects information on the "returns, holdings, risk, volatility, and expenses" of the investments offered by the IRA provider.[6]

In our experience, while financial professionals may place different weight on the predictive value of the historical performance of an investment fund or manager, virtually no financial professional *ignores* historical performance. When defined benefit plans or other institutional investors hire an investment manager, the investment performance of that manager is one of the important factors considered, although not the only one. It is routine for pension plans to consider an investment manager's investment performance when engaging that manager and to review periodically the manager's performance – not just the performance of the asset class(es) in which the manager invested plan assets. Courts have uniformly held that plan fiduciaries' consideration of historical performance as part of the selection and monitoring of plan investments is an appropriate part of a prudent process.[7]

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[4] We have not been able to identify any other factor that has the necessary likelihood of future persistence that the proposal seems to require.

[5] *See* Comment Letter from Financial Engines to Office of Regulations and Interpretations (February 12, 2007), available at www.dol.gov/ebsa/pdf/Jones021307.pdf.

[6] *See* Comment Letter from Morningstar to Ivan Strasfeld, Director of Exemption Determinations (February 20, 2007), available at www.dol.gov/ebsa/pdf/Bliss022007.pdf.

[7] *See, e.g.*, *Tibble v. Edison Int'l*, 639 F. Supp. 2d 1074, 1117 (C.D. Cal. 2009) (finding that the plan fiduciary appropriately relied on a fund's ten-year performance rating at the time the fund was selected); *New Orleans Employers Int'l Longshoremen's Ass'n, AFL-CIO Pension Fund v. Mercer Inv. Consultants*, 635 F. Supp. 2d 1351, 1377 (N.D. Ga. 2009) (considering a manager's favorable past performance as a "relevant consideration" in deciding whether to continue to retain an investment manager for the plan); *Dupree v. Prudential Ins. Co. of Am.*, 2007 WL 2263892, at *9, *47 (S.D. Fla. 2007) (finding "appropriate due diligence and procedural prudence in selecting proposed investments" where plan fiduciaries considered a variety of factors including the investment manager's track record). The SEC requires that mutual funds disclose, in proxy and registration statements, the fund board's consideration of factors enumerated by the SEC, including past performance, in approving the management fee of the fund's adviser. *See Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies,* SEC Release Nos. 33-8433, 34-49909, and IC-26486 (June 23, 2004), available at www.sec.gov/rules/final/33-8433.htm. The factors the SEC lists derive from the *Gartenberg* factors, which were recently affirmed by the Supreme Court. *See Jones v. Harris*, _ U.S. _, 2010 U.S. LEXIS 2926 (March 30, 2010).

When an investment adviser of a mutual fund recommends a subadviser to the fund's board of directors, the adviser typically discusses the subadviser's track record managing similar assets in the same style, and the board's ongoing oversight generally involves a review of the subadviser's risk-adjusted performance.[8] The PBGC uses active managers for part of its portfolio, and requires that the prospective manager provide in the RFP process detailed information about the manager's performance history.[9] Similarly, the Treasury Department's process for hiring managers for TARP assets included an evaluation of the applicant's performance track record managing similar assets.[10]

Second, a requirement that the computer model generally must ignore past performance of investment options would be inconsistent with the PPA exemption itself. The best evidence that Congress would not agree that historical performance of an investment is irrelevant to the decision to invest in that option is that, *in this PPA exemption*, Congress required that participants be told "the past performance and historical rates of return of the investment options available in the plan."[11] If Congress thought that only the historical performance of the fund's asset class was relevant to the investment decision, it would have required disclosure of that information instead.

Third, a rule that effectively requires those providing investment advice or evaluating investment options to ignore the past performance of an investment is a misapplication of the relevant financial literature and could have a number of unintended consequences. The recommendation that past performance be ignored in computer models seems based on the "efficient markets hypothesis" of financial markets, which suggests that it is difficult to "beat the market," i.e. to sustain a rate-of-return over and above the market without taking on additional risk. Put differently,

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[8] *See* Independent Directors Council, *Board Oversight of Subadvisers* (Jan. 2010), available at www.ici.org/pdf/idc_10_subadvisers.pdf.

[9] *See, e.g.*, Request for Proposal for Fixed Income Investment Managers (PBGC01-RP-10—0003), available at https://www.fbo.gov/spg/PBGC/CMO/PD/PBGC01-RP-10--0003/listing.html.

[10] *See, e.g.*, Application for Treasury Investment in a Legacy Securities Public-Private Investment Fund, available at www.treas.gov/press/releases/reports/legacy_securities_ppif_app.pdf.

[11] ERISA section 408(g)(6)(A)(ii). Disclosure of investment performance is required in many similar circumstances. The Securities and Exchange Commission requires disclosure of past performance in mutual fund prospectuses, in the summary information at the beginning of the prospectus. The Department's section 404(c) regulation requires participants be provided, upon request, information on an investment option's "past and current investment performance." The Department's participant disclosure proposal includes a similar requirement—disclosure of the historical performance of the investments available to participants in a participant-directed plan. The mutual fund star rating system used by Morningstar – the largest provider of independent mutual fund ratings – takes into account, among other factors, the "risk- and cost-adjusted return" of a fund. See *The Morningstar Ratings for Funds*, available at corporate.morningstar.com/US/documents/MethodologyDocuments/FactSheets/MorningstarRatingForFunds_FactSheet.pdf. Similarly, Morningstar's fund "fact sheets" include information on past performance.

investors typically earn above-average rates of return only by taking on additional risk. Similarly, underperformance generally reflects a reduction in risk relative to the market.

Even if one accepts the view of financial markets as perfectly efficient,[12] it does not mean that financial advice should ignore past performance when selecting investments. To the contrary, past performance is an essential element of evaluation. All academic studies that evaluate investment funds rely on fund performance, including those that have found that fund performance is heavily influenced by the underlying riskiness of a fund's portfolio.[13] To exclude performance from the evaluation process would eliminate one of the most important tools for identifying the riskiness of an investment and how its returns are correlated with other investments in a portfolio. These are essential pieces of information for a financial adviser to consider when building a portfolio to meet an investor's financial goals given his or her risk tolerance.

In addition, while past performance is essential for understanding an investment's risk/return profile, it is also helpful for assessing investments *within* a given asset class. There is no generally accepted, nor even widely accepted, definition of "asset class." For example, the mutual fund research firm Morningstar places in its "Large-Blend" category funds that invest anywhere between 50 percent and 100 percent of their assets in domestic stocks, with the balance in international stocks, cash, bonds, or other investments. The range of funds in this asset class will have widely different risk/return profiles. Moreover, the funds or portfolios one rating firm would place in one asset class, other firms could place in another. For example, Morningstar and Lipper have similar asset class categories for their domestic equity funds, yet they often classify the same fund in different categories.[14] As a result, funds within a given "asset class" do not necessarily all have the same risk/return profile. The primary way to establish and understand the differences in such profiles, and thus to evaluate properly the appropriateness of a given fund for a particular investor, is on the basis of past performance.

A rule that effectively requires those providing investment advice to ignore the past performance of an investment could also have a number of unintended consequences. One might be to hamper those financial advisers who tend to prefer index funds. Indexes have different risk/return

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[12] Some eminent economists have voiced skepticism that financial markets are efficient. *See, e.g.*, Shiller "From Efficient Market Theory to Behavioral Finance," Cowles Foundation Discussion Paper, no. 1385 (Oct. 2002).

[13] *See, e.g.*, Barras, Scaillet, and Wermers, "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas," *The Journal of Finance*, vol., LXV, no. 1 (2010); Carhart, "On Persistence in Mutual Fund Performance," *The Journal of Finance*, vol., LII, no. 1 (1997).

[14] Using March 2009 data from Strategic Insight Simfund, Morningstar classifies 319 mutual funds as Large-Blend, while Lipper categorizes only 51 percent of these funds as Large-Blend. Similarly, the percent that the two firms consistently categorized for other asset classifications is 49 percent for Large-Growth, 56 percent for Large-Value, 57 percent for Mid-Blend, 55 percent for Mid-Growth, 46 percent for Mid-Value, 69 percent for Small-Blend, 68 percent for Small-Growth, and 66 percent for Small-Value.

characteristics even among indexes that seek to track the same sector of the market.[15] Denying a financial adviser information about a particular index fund's actual performance would prevent the adviser from having the tools to differentiate among index funds.

Another unintended consequence of a rule to ignore past performance is that a financial adviser would not be able to assess a fund that had historically provided a significant sub-market return to investors in the fund for the given risks of the fund. Without information about the performance of the fund, no assessment can be made to exclude such funds from consideration. Similarly, this means that plan fiduciaries apparently could not remove from the menu of a 401(k) plan an investment option that has under-performed relative to its peers—a routine and important practice in fiduciary oversight of plans.

Finally, if the Department concludes that past performance of an investment provides *no useful information* about the possible future performance of the fund, we do not see how the Department could conclude that the past performance of the asset class in which the fund generally invests would provide useful information, given the relationship between risk and performance. We believe that performance is essential in assessing the risk/return trade-offs for both asset classes and investments, even if neither provides a guarantee of future performance, adjusted or unadjusted for risk.[16]

Finally, the task of evaluating whether a computer model properly takes into account historical performance belongs with the independent expert, not the Department. The proposal would require that a computer model not "inappropriately" distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future. We agree that there are situations in which it may not be appropriate to consider historical performance, for example, if the computer model failed to take into account any information except the historical performance of the investment option, or took into account only short-term performance when longer term performance information was available, or took into account historical performance after an investment fund had changed its fundamental investment objective or strategy. In addition, historical performance should be taken into account net of fees.

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[15] *See* Reilly and Brown, *Investment Analysis and Portfolio Management*, 9th Edition, South-Western Cengage Learning, Mason Ohio (2009), pp. 127-148; and Israelsen, "Variance Among Indexes," *Journal of Indexes* (May/June 2007).

[16] Historical performance also helps investment professionals assess the performance *volatility* of an investment, which is essential in matching investments with a participant's tolerance for large short-term swings in performance. After seeking comment on how the volatility of mutual fund performance might be disclosed effectively, the SEC adopted the requirement that mutual funds provide a bar chart showing a fund's performance in each of the last ten years. *See Registration Form Used by Open-End Management Investment Companies*, SEC Release Nos. 33-7512, 34-39748, and IC-23064 (March 13, 1998), available at www.sec.gov/rules/final33-7512r.htm.

We agree with the Department that a computer model's first task should be to provide proper asset allocation and diversification, not simply to pick the investment option or options on the plan's menu that have provided the best historical performance or have the lowest fees. We also believe it is the job of the *eligible independent expert* to examine the computer model carefully and certify that the computer model applies generally accepted investment theories, utilizes prescribed objective criteria to provide asset allocation portfolios comprised of the investment options available under the plan, and is not inappropriately weighted with respect to any investment option. Under the PPA rules, an independent expert may not certify a computer model that acted in a way outside generally accepted investment theories in how it took into account historical performance. Congress gave that job to the independent expert, not the Department.

For all of these reasons, we recommend that the Department delete the new criteria in the proposal requiring advice programs to ignore factors within an asset class that cannot confidently be expected to persist in the future. Alternatively, we recommend that the criteria be revised simply to follow the PPA language,[17] and require the computer model not be inappropriately weighted with respect to any investment option.

II. Request for Comment on Computer Model Investment Theory

In the proposal, the Department asks for comment on a series of questions related to the PPA requirement that advice generated by a computer model be based on generally accepted investment theories. The questions presented suggest that the Department may seek to define generally accepted investment theories and that the final rules might describe in detail the types of information that a computer model should (and should not) consider in making recommendations, and the conclusions that the computer model must draw from that information. We believe strongly that the Department should not embark on a process to micromanage the investment theories behind investment advice computer models or substitute its judgment for the investment professionals that design and certify these computer programs.

First, an exercise to define generally accepted investment theories would have implications far beyond computer models under the PPA exemption. It necessarily would be viewed as the government setting standards on how all employee benefit plan assets should be invested. Any such standards would also seem to apply to the methodology used by plan fiduciaries to select investments for a plan menu in a participant-directed plan or to designate an investment manager for a defined benefit plan under ERISA section 402(c)(3). Computer models that rely on Advisory Opinion 2001-09A ("SunAmerica") also would need to be reevaluated, because that Advisory Opinion described the

[17] *See* ERISA section 408(g)(3)(B)(v).

computer model as using "generally accepted principles of Modern Portfolio Theory." Every qualified default investment alternative under the QDIA rules and every educational material relying on Interpretative Bulletin 96-1 would need to reevaluated, since both pieces of guidance refer to "generally accepted investment theories."[18]

Second, the goal of the PPA investment advice exemption is to increase access to investment advice by 401(k) participants and IRA holders. Regulating the output of computer advice based on the Department's current view of what is and is not generally accepted investment theory would place computer advice programs in a straightjacket that would discourage their effective use. The Department acknowledges this point in its regulatory impact analysis, stating that a narrow view on what information computer models can consider "may inhibit innovations in investment advice that utilizes additional information, which could reduce the economic benefits of the statutory exemption."[19]

ERISA requires that fiduciaries "diversify the investments of the plan so as to minimize the risk of large losses"—an expression of the core principle of Modern Portfolio Theory.[20] ERISA also requires that fiduciaries discharge their duties with care, skill, prudence and diligence. Since 1974 the Department's guidance has focused on these two ERISA principles: diversification and a prudent process. The Department's basic regulation under ERISA section 404(a) requires fiduciaries to give appropriate consideration to facts that the fiduciary knows or should know are relevant to a particular investment and act accordingly, and to consider, among other factors, the composition of a portfolio with regard to diversification and the current return of portfolio.[21] Similarly, the regulation under ERISA section 404(c) requires that a plan offer at least three investment alternatives, each of which is diversified, each of which has materially different risk and return characteristics, and which when combined tend to minimize the overall risk through diversification.[22] The Department has never before sought to define what investments or types of investments might or might not be appropriate under these standards.[23]

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[18] 29 C.F.R. § 2509.96-1; 29 C.F.R. § 2550.404c-5. It is unclear that the implicit reach of the government's effect on generally accepted investment theories would stop there. Investment advisers generally regulated by the SEC or state securities commissions may feel compelled to follow the views underlying the Department's rule.

[19] 75 Fed. Reg. 9360, 9363 (March 2, 2010).

[20] ERISA § 404(a).

[21] 29 C.F.R. § 2550.404a-1.

[22] 29 C.F.R. § 2550.404c-1.

[23] In fact, the Department expressly refused to do so in its basic regulation under ERISA section 404(a), specifically stating in the regulation's preamble that "the Department does not consider it appropriate to include in the regulation any list of

Third, the questions posed in the preamble suggest the Department believes that investment advice should favor passively managed investment options. For example, the Department asks whether the computer model should "all else equal[24] . . . ascribe different levels of risk to passively and actively managed investment options." We are unable to determine what "different levels of risk" means in this context. The risk/return characteristics of an investment fund are tied to the assets in which the fund invests, which is true whether or not those assets are chosen by reference to a pre-determined index. To the extent that the Department is suggesting a computer model should favor a passively managed fund over an actively managed fund[25] simply because the former is passively managed, we strongly disagree.

Mutual funds were the first to make index investing broadly available to individual investors more than three decades ago, and today there are hundreds of index mutual funds and exchange-traded funds available in the market. Index funds are appropriate for many investors in many situations, but are not necessarily a "one-stop" solution for retirement investing. As noted above, index funds vary widely in their choice of index, which leads to widely varying risks and returns. No one index fund is right for all investors in all markets. Furthermore, there is no single definition or methodology for creating an index. Indexing can be price-weighted, value-weighted, unweighted, style driven, and fundamental.[26] All of these methodologies have varying and, in some cases, significant components of active security selection embedded in them.

Both actively and passively managed funds routinely are used as plan investments. As of year-end 2009, index mutual funds represented $223 billion, or about 11 percent, of all mutual fund assets held in defined contribution plans.[27] (Conversely, 89 percent of the $2.1 trillion in mutual funds in defined contribution plans in all investment categories are held in actively managed funds.) Index funds are more commonly used in certain investment categories. In 2009, of assets held in 401(k) plans in large-cap blend domestic equity mutual funds, index funds represented 59 percent, up from 34 percent in 1999.

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investments, classes of investments, or investment techniques that might be permissible under the 'prudence' rule." *See Investment of Plan Assets under the "Prudence" Rule*, 44 Fed. Reg. 37,221, 37,225 (June 26, 1979).

[24] Actively and passively managed funds are not "equal"—by definition an actively managed fund invests in something other than an index.

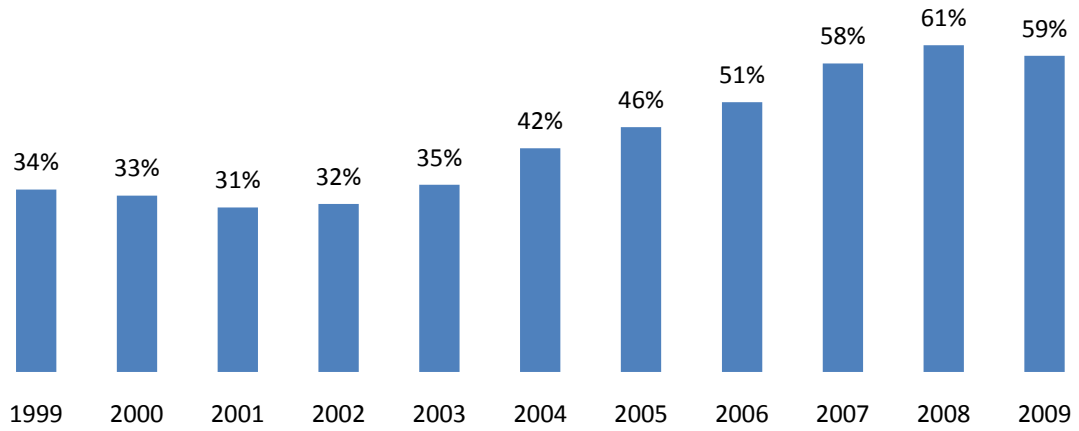
[25] The Department has never made this suggestion before. Indeed, in at least one case, the Department has provided special advantages for an actively managed investment—venture capital operating companies (VCOC), which are exempt from the plan asset "pass through" rules. 29 C.F.R. § 2510.3-101.

[26] *See* Reilly and Brown, *Investment Analysis and Portfolio Management*, 9th Edition, South-Western Cengage Learning, Mason Ohio (2009), pp. 131-137.

[27] *See* Brady, Holden and Short, "The U.S. Retirement Market, 2009," *ICI Fundamentals*, vol. 19, no. 3 (May 2010; forthcoming).

Share of 401(k) Assets in Large-Blend Domestic Equity Index Funds Has Risen

Percentage of 401(k) assets in large-blend domestic equity funds, year-end, 1999-2009



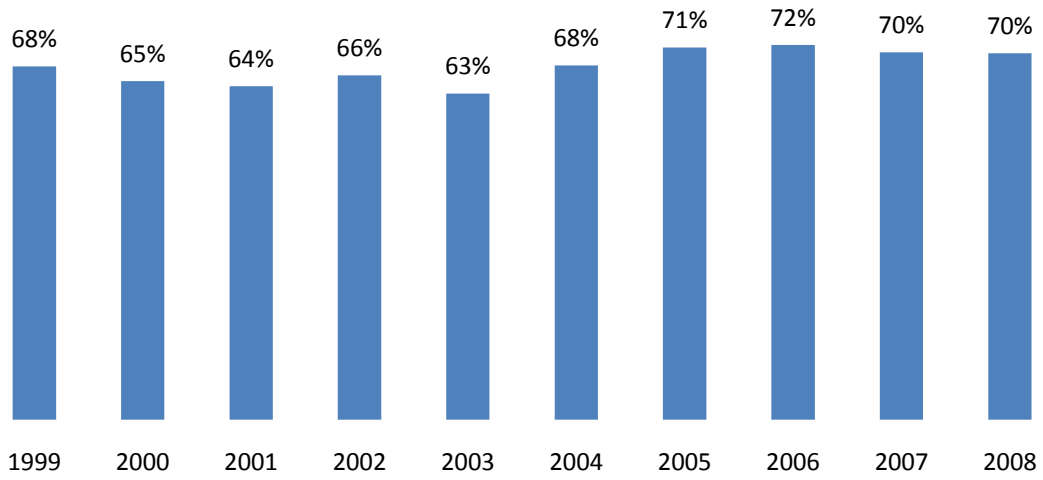
Source: Investment Company Institute

Employers recognize the benefits of both forms of investing when they select menus of investment options for 401(k) plans. A survey by the Profit Sharing/401k Council of America found that 70 percent of plans offered a domestic equity index investment option in 2008.[28] We think it sets a dangerous precedent for the government to usurp the role of fiduciaries by placing its thumb on the scale for one kind of investment.

[28] Profit Sharing/401k Council of America, *52nd Annual Survey of Profit Sharing and 401(k) Plans, Reflecting 2008 Plan Experience* (2009). Respondents in this study also commonly used actively managed funds. In fact, respondents reported higher use of actively managed funds in every category where the survey offered that choice. (The survey did not ask about indexing in certain investment categories like real estate funds.)

The Majority of Plans Offer Index Funds as Investment Choices

Percentage of 401(k) plans offering domestic equity index investment funds, 1999-2008



Note: Figure reports percentage of plans offering the investment option indicated for participant contributions. In the PSCA data, "investment fund" includes mutual funds, collective trusts, and separately managed accounts.
Source: Profit Sharing/401k Council of America

It may be that the Department is concerned about the *costs* associated with a particular management style. If that is the case, the regulation *already addresses this concern*, by requiring a computer model take into account investment and other fees attendant to an investment.[29] We agree that fees and expenses should be a factor that a computer model (and any other investment advice program or any plan fiduciary investment decision) takes into account. But we disagree that the Department's rules should systematically favor one investment style over another.

More than $8 trillion was invested in defined contribution plans and IRAs at year-end 2009, and another $2.1 trillion was invested in private defined benefit plans. A Department regulation that effectively requires plans to use passive investments could affect the efficient operation of the securities markets, which depend on active traders to incorporate all available information into securities prices. In the case of mutual funds in defined contribution plans alone, this could call into question the investment of *89 percent of those assets*. Moving a significant portion of $8 trillion into a passive

[29] Although index funds are often lower cost, fees of index funds are not uniform. *See* Collins, "Are S&P 500 Index Mutual Funds Commodities?" *ICI Perspective* vol. 11, no. 3 (Aug. 2005), available at www.ici.org/pdf/per11-03.pdf.

investment style also could create significant arbitrage opportunities at the expense of retirement investors.[30]

Before implementing any rule that favors one style of investing, the Department should be required to engage in a regulatory impact assessment of the effect of the regulation not only on plan participants but on the functioning of the securities markets. Further, the Department should catalog all of the guidance since the enactment of ERISA that may need to be reevaluated, and determine how many decisions by fiduciaries and others based on that guidance would be impacted.[31]

Finally, the questions posed by the Department could take it on a long detour away from the primary objective of this proposal, which is to finalize, after nearly four years, the regulations implementing the new PPA exemption. It is important that this matter be settled so that the industry can begin making judgments as to whether to design advice programs under the PPA exemption. A long inquiry into whether the Department should essentially pre-design these computer programs will simply delay the final regulations for some time. And none of this is necessary, because Congress provided that every computer model must be certified by an independent expert and audited annually.

III. Recommendations for Clarifications

A. The Department should clarify that the fee-leveling condition prohibits compensation that <u>varies</u> based on the investment selected by the participant, not compensation that is paid because a participant made an investment.

The proposal revised the fee-leveling condition to read:

> No fiduciary adviser (including any employee, agent, or registered representative) that provides investment advice receives from any party (including an affiliate of the fiduciary adviser), directly or indirectly, any fee or other compensation (including commissions, salary, bonuses, awards, promotions, or other things of value) that is based in whole or in part on a participant's or beneficiary's selection of an investment option.

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[30] There is considerable evidence already that index changes create arbitrage opportunities for non-index investors, and pushing a large portion of the markets into indexes could possibly magnify these opportunities. *See, e.g.*, Quinn and Wang, "How is Your Reconstitution?" *Journal of Indexes*, 4th Quarter (2003); Chen, Noronha, and Singal, "Index Changes and Losses to Index Fund Investors," *Financial Analysts Journal*, vol. 62, no. 4 (2006); and Cai and Houge, "Long-Term Impact of Russell 2000 Index Rebalancing," *Financial Analysts Journal*, vol. 64, no. 4 (2008).

[31] A partial list of Department guidance based solely on the examples given throughout this comment letter: 29 C.F.R. § 2509.96-1; 29 C.F.R. § 2510.3-101; 29 C.F.R. § 2550.404a-1; 29 C.F.R. § 404c-1; 29 C.F.R. § 2550.404c-5; proposed regulation 29 C.F.R. § 2550.404a-5; and Advisory Opinion 2001-09A.

The preamble explains that the revision brings the regulation in line with Field Assistance Bulletin 2007-1 and clarifies that the limitation applies both to the entity that is retained to render advice and to any employee, agent, or registered representative of the entity.

We support the Department's goal of providing clarity about the fee-leveling condition. As rewritten, however, the new language suggests that any payment that is received by a fiduciary adviser *because* a participant selected an investment option would be prohibited. This is because the rewritten standard prohibits compensation that "is based in whole or in part" on the participant's selection of an investment. The statute, the Field Assistance Bulletin, and the previous versions of the regulation focus on the fact that compensation not *vary* depending on the investment option selected.

It is clear that the receipt of payment from investments was contemplated by Congress, because Section 408(g)(6) requires fiduciary advisers to disclose "all fees or other compensation that the fiduciary adviser or any affiliate thereof is to receive (including compensation provided by any third party) . . . in connection with the sale, acquisition, or holding of the security."

The Department should clarify the description of the fee-leveling condition by including a reference, following the statutory language, to the fact that the fees received by the fiduciary adviser may not "vary" based on the investment option selected.[32]

B. The Department should reiterate that bonus programs based on an organization's profitability or revenue, where the participants' investment constitutes a negligible portion of the calculation of profitability or revenue, would not violate the fee-leveling requirement.

In the preamble to the January 2009 final regulation, the Department addressed bonus programs and concluded that whether any particular compensation or bonus program meets the fee-leveling condition depends on the details of the program, which would be subject to the independent audit. The Department stated that "it is conceivable that a compensation or bonus arrangement that is based on the overall profitability of an organization may be permissible to the extent that it can be established that the individual account plan and IRA investment advice and investment option components were excluded from, or constituted a negligible portion of, the calculation of the organization's profitability."[33]

The Department should reiterate this statement in the preamble to the final regulation. Many firm-wide bonus programs are broad based and look to a number of factors and often require, at a

[32] For example the language could be revised to read " ... any fee or other compensation (including commissions, salary, bonuses, awards, promotions, or other things of value) that varies based in whole or in part on a participant's or beneficiary's selection of an investment option."

[33] 74 Fed. Reg. 3822, 3826 (Jan. 21, 2009).

minimum, that the overall firm be profitable. In a large financial asset management firm with many affiliates and many billions of dollars in assets under management, the investments selected by a particular participant or plan may have a negligible effect on profitability. If a firm-wide bonus program is so structured (which the annual audit would review) it would not create any improper incentive for an employee of a fiduciary adviser to favor the investments of the fiduciary adviser's affiliates.

C. The Department should clarify that an advice program is not required to seek from participants all the information the PPA says may be included in relevant participant information.

The proposal requires that computer model and fee-leveling arrangements request and take into account, to the extent provided, "information relating to age, time horizons (e.g., life expectancy, retirement age), risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences of the participant." We believe this requirement could serve to disqualify from consideration many prudent and appropriate investment advice programs that for very sound reasons do not take every one of these factors into account. While some highly customized (and, therefore, more expensive) programs ask participants for information on all of these factors, many advice programs do not ask for all of this information. For example, a computer program that provides advice based on the information that is automatically in the recordkeeping system of the plan has the advantage of avoiding requiring the participant to locate and input correctly information such as other assets or sources of income. It would not be consistent with the goal of increasing the availability of advice programs to force plan sponsors into only two choices – offer no advice program at all, or offer a more costly advice program that is highly individualized to every participant.

The requirement to seek information on all these items is not compelled by the statutory language. Section 408(g)(3)(B)(ii) simply requires that a computer model utilize "relevant information about the participant, which *may* include age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments" (emphasis added). Moreover, Congress did not specify any information that should or might be considered under a fee-leveling arrangement, leaving the fiduciary adviser – appropriately – to follow the ERISA general prudence standard in Section 404.

D. We recommend that, as proposed, the Department preserve in the final regulation Department guidance on advice or educational programs not relying on the PPA exemption.

We applaud the Department for maintaining, in the proposal, the position first expressed in Field Assistance Bulletin 2007-1 that enactment of PPA did not invalidate or otherwise affect prior

guidance issued by the Department concerning investment advice.[34] Clarifying this point is very important for those advice programs (and educational programs under Interpretative Bulletin 96-1) that are currently providing advice and education to participants. We recommend that the Department retain this statement in the final rule.

E. The Department should clarify that IRAs that allow investment in a wide range of securities are treated like self-directed brokerage windows in 401(k) plans.

A number of requirements in the proposed rule refer to or are based on the plan's "designated investment options." For example, a computer model advice program must take into account, with certain exceptions, all of the plan's designated investment options, and the required disclosure to participants must include the past performance and historical rates of return of designated investment options. The proposal does not provide a specific exception in the case of IRAs.

The Internal Revenue Code permits IRAs to invest in virtually anything other than collectibles and life insurance.[35] And many providers of IRAs permit IRA holders to invest in a very wide range of investments. Congress recognized the problem presented by IRAs, and instructed the Department to consider if there are any computer models which take into account the full range of investments, including equities and bonds, in determining options for the investment portfolios of the IRA beneficiary. The Department concluded that a computer model would take into account the "full range" of investments if it takes into account "all of the generally recognized asset classes that are necessary for an account beneficiary to construct a diversified investment portfolio."[36]

The exemption will be unworkable for IRAs if every potential IRA investment is considered a "designated investment option" under the rule. There is, however, a relatively easy way to address this problem. The proposal provides that a plan's designated investment options do not include brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan. The Department should clarify that an IRA that provides the IRA beneficiary with access to a wide range of investments is treated like a self-directed brokerage account and would therefore not have any "designated investment options."[37]

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[34] *See* Proposed Regulation 2550.408g-1(a)(3).

[35] Internal Revenue Code §§ 408(e), (m).

[36] U.S. Department of Labor, Report to Congress, available at www.dol.gov/ebsa/pdf/reporttocongress.pdf.

[37] By "wide range" of investments we do not necessarily mean the same standard as the "full range" described in the PPA. Instead we mean an IRA that offers access to a large number of securities similar to brokerage windows or mutual fund windows in 401(k) plans. Many providers, in contrast, offer IRAs with a limited menu of investments. In these cases, it should not be a problem for those investments to be treated as "designated investment options."

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The Institute is committed to finding ways to help participants and IRA investors gain access to quality investment advice and has supported the Department's nearly four-year process to implement the PPA investment advice exemption. We look forward to continuing to work with the Department to implement the PPA's goal of expanding opportunities for investment assistance. If you have any questions, please contact the undersigned at 202.326.5826 or Michael Hadley at 202.326.5810.

Sincerely,

Mary Podesta
Senior Counsel – Pension Regulation

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