Fund Democracy
Consumer Federation of America
Consumer Action
National Association of Personal Financial Advisors

May 5, 2010

FILED ELECTRONICALLY

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
Department of Labor
200 Constitution Avenue
Washington, DC 20210

Re: Investment Advice – Participants and Beneficiaries

Dear Mr. Wong,

We are writing on behalf of Fund Democracy, the Consumer Federation of America, Consumer Action and National Association of Personal Financial Advisors in response to the Department's request for comments on its proposed regulation regarding investment advice provided by fiduciaries to participants in participant-directed individual account plans (collectively, "401(k) plans"). We support the Department of Labor's efforts to correct deficiencies in the rules adopted in January 2009 and applaud its new, improved restrictions on conflicted advice provided to 401(k) plan participants.

The Pension Protection Act of 2006 ("PPA") created two safe harbors from ERISA's conflict of interest provisions. The first permits advice provided by conflicted advisers as long as the adviser's fees do not vary on the basis of beneficiaries' investment selections. This is known as the fee-leveling requirement. The second permits advice generated by a computer model that satisfies certain requirements that are intended to ensure that the advice is unbiased. We recognize that these safe harbors, especially the fee-leveling provision, expand the opportunities for advisers to provide beneficiaries with conflicted advice and appreciate the Department's efforts to minimize the risk to beneficiaries. On the whole, the proposed rule achieves a reasonable balance between the express requirements of the Act and the beneficiary-protection provisions of ERISA.

Nonetheless, we believe that there are significant areas where the proposal can be improved, which are summarized below:

- <u>Fee-Leveling</u>. The Department has made it clear that the fee leveling requirement is not limited to the individual who advises the beneficiary, but also applies to the fiduciary adviser and its other personnel. We believe that there remains some ambiguity, however, regarding whether a variation in a fiduciary adviser's compensation must have been *expressly designed* to result from beneficiaries' investment selections in order for that variation to run afoul of the fee-leveling requirement. Congress made it clear that the adviser's fees may not vary based on the investment selection, regardless of whether that variation is intentional. The Department should revise the rule to reflect this position.

- Off-Model Advice. The Department also should clarify that any advice that is not specifically generated by the computer model must comply with the fee-leveling provision in order to qualify for a safe harbor. Congress did not create the fee-leveling safe harbor only to allow it to be circumvented by providing off-model advice. All off-model advice should be subject to fee-leveling.

- Generally Accepted Investment Theories. The Department should clarify that computer models are required to incorporate generally accepted investment theories beyond theories that relate to the investment returns of asset classes. Moreover, the Department should provide further guidance regarding generally accepted investment theories that computer models are required to include. For example, computer models should incorporate theories based on the persistence of asset class investment returns, the nature of active management risk, the predictive power of fees, and the role of diversification.

- Unauthorized Exclusion of Investment Options from Computer Models. The Department should not permit computer models to exclude recommendations relating to the acquisition, holding or sale of investment options comprising employer stock, asset allocation funds or annuities. First, this exclusion is not consistent with Congress's express requirement that computer models "take into account all investment options under the plan." Second, a computer model that excludes these options cannot satisfy Congress's requirement that computer models apply generally accepted investment theories. Third, a computer model cannot make a reasonable recommendation without the recommendation itself taking all investment options into account, especially if the beneficiary already has allocated all or part of his assets to one or more of the excluded options.

The remainder of this letter is organized as follows:

I. Fee-Leveling and Compensation to Affiliates

A significant deficiency in the rule adopted in January 2009 was that it permitted an adviser's employer to receive compensation that varied based on the investment option selected by a beneficiary. As previously stated by the Department regarding the now-rescinded January 2009 rule:

> [U]nlike the statutory exemption, the final class exemption, like the proposal, applies the fee-leveling limits solely to the compensation received by the employee, agent or registered representative providing the advice on behalf of the fiduciary adviser, as distinguished from compensation received by the fiduciary adviser on whose behalf the employee, agent or registered representative is providing such advice.[1]

We and other commentators noted that this position directly contradicted Congress's intent to reduce advisers' financial incentives to recommend investments based on the best interests of his employer rather than the best interests of the beneficiary.[2] The rule would have permitted an adviser's employer to be paid on a sliding scale based on the profits generated by the investment options selected, the employer's executives and the adviser's immediate supervisor to be paid bonuses on the same basis, and the adviser to be paid a fixed salary – without the arrangement violating the fee-limiting provision.

The record of sales abuses in the mutual fund industry shows that, in such circumstances, advisers' employers will find ways to reward the advisers for recommending the investment options that maximize the employer's profits and its

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[1] *Investment Advice—Participants and Beneficiaries,* 74 F.R. 3822 (Jan. 21, 2009).

[2] *See* Testimony of Mercer Bullard on behalf of Fund Democracy and the Consumer Federation of America before the Subcommittee on Health, Employment, Labor and Pensions, Committee on Education and Labor, U.S. House of Representatives (Mar. 24, 2009) ("CFA/Fund Democracy Testimony"); Letter from Senator Jeff Bingaman, Senator Charles E. Grassley, and Senator Edward M. Kennedy to Bradford Campbell, Assistant Secretary of Labor, Employee Benefits Security Administration (Oct. 6, 2008) ("By not considering fees received by affiliates, the proposed regulation opens the door to conflicted advice.") *available at* http://www.dol.gov/ebsa/pdf/cmt-10170824-ex.pdf.

executives' income.[3] As stated by members of the U.S. Senate, advisers will be rewarded for providing conflicted advice through stock options, positive evaluations, pay raises and other means that cannot practicably be traced to the advisers' selection of investment options but that nonetheless will produce conflicted advice.[4]

The Department's current proposal corrects this problem by clearly establishing that:

> the receipt by a fiduciary adviser of any payment from any party (including an affiliate of the fiduciary adviser), or used for the benefit of such fiduciary adviser, that is based, in whole or part, on investments selected by participants or beneficiaries would be inconsistent with the fee-leveling requirement of the statutory exemption.[5]

The text of the proposed rule further clarifies that the prohibition also applies to a fiduciary adviser's receipt of differential economic benefits from affiliates. The rule states that the direct or indirect receipt of any kind of compensation from an affiliate would be inconsistent with the rule if it were "based in whole or in part on a participant's or beneficiary's selection of an investment option."[6]

II. Fee-Leveling and Adviser's Intent

We have some remaining concerns, however, regarding the extent to which a causal relationship between the compensation and the investment selection must be intentional to run afoul of the fee-leveling provision. The Department states that it intends to prohibit "any provision of financial or economic incentives by an affiliate . . . to favor certain investments." The Department's use of the terms "incentives" and "favor," along with the rule's phrase "that is based . . . on," however, might be interpreted (incorrectly, we believe) to apply only when the additional benefit received by the fiduciary adviser can be shown to have been specifically intended by the adviser or its affiliates to be triggered by an investment selection.

For example, if an affiliate realized higher profits from some investment options than from others (*e.g.*, an investment in a stock fund rather than a bond fund), and the

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[3] *See* CFA/Fund Democracy Testimony, *supra*, at 5 - 10.

[4] *See* Letter from Senators Bingaman, Grassley, and Kennedy, *supra* (advisers' affiliates "may be held under the same holding company or corporate parent as the fiduciary adviser – and their fortunes may rise and fall together. In this case, the investment adviser could have a powerful incentive (including holdings in company stock options, opportunities for promotion, and informal *quid pro quo* arrangements stemming from ongoing business arrangements) to recommend investment options that provide greater benefit to an affiliate.").

[5] *Investment Advice—Participants and Beneficiaries,* 75 F.R. 9360 (Mar. 2, 2010).

[6] We recommend that the Department expressly rescind the position taken in its January 2009 adopting release that "negligible" compensation that varies based on the investment option selected satisfies the fee-leveling provision. Congress did not include any carve-out for negligible compensation.

fiduciary adviser recommended that beneficiaries invest in those options, then the fee-leveling requirement would not be satisfied if the financial performance of the affiliate directly or indirectly benefited the fiduciary adviser. It should not be necessary to show any level of intent regarding the causal relationship between the fiduciary's benefit and beneficiaries' investment selections. The mere fact that the investments selected positively affected the fiduciary adviser's finances should be sufficient.

This non-intent-based standard is reflected in the statute, which states that the fiduciary adviser's fees may "not vary depending on the basis of any investment option selected." This passive language arguably contrasts with the rule's more active "that is based . . . on" phrasing and, in particular, the Department's explanatory references to "incentives" and "favoring." When an administrative agency chooses to use phrasing in rulemaking and interpretive guidance that differs from related statutory phrasing, courts often assume that the agency's choice was intentional and that the different phrasing means something different. In this case, a court might view the Department's decision to use different phrasing as interpreting the statute to require that some degree of intent accompany a variance in fees that results from beneficiaries' investment selections.

While we agree that the mere fact that an affiliate's fees may vary based on the selection of investment options should not, by itself, be viewed as inconsistent with the fee-limiting provision, we do not agree that this variance may be permitted to affect the finances of the fiduciary adviser, whether or not the variance appears to be produced by express design. What appears to be chance is too often the hidden residue of design. We therefore recommend that the Department revise the rule's phrase quoted above to reflect the text of the statute that it implements and refer to any compensation "that varies depending on the basis of any investment option selected." We also urge the Department to clarify that it is the effect of the investment selection, not the intent of the investment recommendation, that determines whether the fee-leveling standard has been met.

A narrow reading of the fee-leveling provision is important to the protection of beneficiaries because, as the Department is aware, the conflicts of interest permitted by the PPA cannot be entirely eliminated. An adviser will feel an inherent affinity for investment products sponsored by his employer's affiliates, regardless of whether any related financial benefit to the adviser can be identified. Moreover, the financial services industry has demonstrated a resilient capacity to circumvent conflict-mitigation rules and incentivize advisers to favor higher-fee options offered by affiliates. The only way to achieve reasonable assurance that an adviser will not have an economic incentive to recommend higher-fee investment options to participants is to require the maximum possible economic separation of the adviser's employer from the affiliate that sponsors the options. The structure and amount of the adviser's compensation must be completely segregated from the economic performance of any affiliate whose fees vary depending on the investment option selected.

III. Off-Model Advice

We have significant concerns regarding the Department's interpretation of the computer model exemption. As the Department is aware, the computer model exemption is not subject to the fee-leveling provision. This means that incentives paid to advisers with respect to any advice provided under the guise of a computer model are exempt from ERISA's conflict-of-interest provisions. Unfortunately, the PPA makes the exemption available for any "arrangement" that "uses" or provides advice "under" or "pursuant to" a computer model.[7] It also refers to the permissibility of off-model advice if requested by the beneficiary.[8] These provisions could be interpreted to permit such expansive off-model advice that the computer model exemption could be used to completely bypass the fee-leveling provision.

In contrast, the PPA mandates that "the only investment advice provided under the program is the advice generated by the computer model." 29 U.S.C. § 1108(g)(3)(D)(i). This statutory text is reflected in the rule's proviso that the computer model exemption is only available "if the only investment advice provided under the arrangement is advice that is generated by a computer model." We believe that these provisions correctly reflect the permissible scope of the computer model exemption. The computer model exemption must be read consistent with Congress's intent to apply fee-leveling to off-model advice. To interpret the computer model exemption to permit non-fee-level advice would eviscerate the fee-leveling provision.

We urge the Department to state expressly in its adopting release that *any* investment advice that is not specifically produced by the computer model must satisfy the fee-leveling provision to be exempt from ERISA's general conflict-of-interest provisions. This clarification should include the understanding that the following reference in the PPA reference to off-model advice --

> Nothing in the preceding sentence shall preclude the participant or beneficiary from requesting investment advice other than that [produced by the computer model]

-- refers to advice provided under the fee-leveling provision or is subject to ERISA's conflict-of-interest provisions. The fee-leveling provision demonstrates Congress's intent that advice provided by conflict-susceptible advisers, in contrast with presumably conflict-free computer models, should be exempt only if subject to fee-leveling. The Department should make it clear that arguably inartful legislative drafting cannot be read to unravel an entire statutory scheme.

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[7] 29 U.S.C. §1108(g)(2)(A)(i) ("an arrangement . . . which . . . uses a computer model") & 3(b) ("advice provided under the investment advice program provided pursuant to a computer model").

[8] *See* 29 U.S.C. § 1108(g)(3)(D) ("Nothing in the preceding sentence shall preclude the participant or beneficiary from requesting investment advice other than that described in subparagraph (A)").

IV. Generally Accepted Investment Theories

We are also concerned about the Department's interpretation of the computer model exemption's generally accepted investment theories ("GAIT") requirement. We interpret the PPA's requirement that computer models "appl[y] generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time," 29 U.S.C. § 1108(g)(3)(B)(i), to mandate that the models apply *all* GAITs, rather than to limit GAITs to those that are related to the role of past asset class investment performance.[9] In other words, computer models must apply GAITS beyond those that relate to the use of the past investment performance of asset classes. This reading is required by the inclusion of other aspects of GAITs in subparagraphs (ii), (iii) and (v) of section 1108(g)(3)(B), which make it clear that the GAITs referenced in subparagraph (i) are not limited.

One reason that we are concerned about this issue is the rule's proviso that "nothing herein shall preclude any investment advice from being based on generally accepted investment theories that take into account additional considerations." Proposed Rule 408(g)-1(b)(4)(i)(A). This phrasing could be interpreted to mean that the incorporation of GAITs is somehow optional or that a model could incorporate only theories relating to historical risks and returns.[10] While we agree that the PPA cannot be read to make plan sponsors responsible for ensuring that a computer model incorporates every conceivable GAIT, we believe that the model must reflect certain additional considerations, especially to the extent that such considerations are stated or implied in the statute itself. For example, the statute requires that the model use information such as a beneficiary's age and life expectancy, *see* 29 U.S.C. § 1108(g)(3)(B)(ii), which would require that the model incorporate GAITs relating to the appropriateness of different mixes of asset classes depending on these factors.

V. Mandatory GAITs in Computer Models

We also believe that there are certain GAITs that a computer model must incorporate under the safe harbor. First, we believe that it is a GAIT that a properly diversified investment portfolio should be based on the risk and return characteristics of different asset classes. This is implied by the statute's express inclusion of the

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[9] The suggestion by some that computer models be permitted to ignore even the most settled GAITs, *see*, *e.g.*, Letter from The SPARK Institute, Inc. to the Employee Benefits Security Administration (Apr. 29, 2010)(*SPARK Letter) available at* http://www.sparkinstitute.org/content-files/File/SPARK%20Inst%20%20Comment%204-29-10%20FINAL.pdf, directly contradicts Congress's express command that the computer models "apply" GAITs and is flatly inconsistent with the Department's longstanding role in incorporating substantive investment theory into its rules regarding the operation of 401(k) plans. *See* Letter from Fund Democracy, Consumer Action and Consumer Federation of America to the Employee Benefits Security Administration at pages 3 – 11 (May 3, 2010).

[10] We note that the rule uses the term "historic" returns, presumably because that is the term used in the statute. We recommend that the rule use the term "historical," however. Although the rule itself may be "historic," the returns that it references are not.

"historic[al] returns of different asset classes over defined periods of time"[11] as a necessary component of a computer model that "applies generally accepted investment theories." The Department appears to agree, as reflected in its statement that "[a]sset classes, in contrast [with investment options within a single asset class], can more often be distinguished from one another on the basis of differences in their historical risk and return characteristics." It would be preferable for the Department to make its position more explicit.

Second, we agree with the Department in the converse view: the performance of investment options *within* a single investment class is not persistent and therefore could not form the basis of a computer model's recommendations. The rule requires that a computer model 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." It is not clear, however, what purpose the term "inappropriately" serves in this context. As stated by the Department,

> [w]hile some differences between investment options within a single asset class, such as differences in fees and expenses or management style, are likely to persist in the future and therefore to constitute appropriate criteria for asset allocation, other differences, such as differences in historical performance, are less likely to persist and therefore less likely to constitute appropriate criteria for asset allocation.

We believe that it is more than "less likely" that distinguishing among investment options based on their performance could be appropriate. If the Department envisions that such distinctions could be appropriate, it should identify exactly what those circumstances might be.

Third, we strongly recommend that the Department extend the logical conclusion of its position on the persistency of single investment option performance and recognize the GAIT that active management entails investment risks that are not present with respect to passive investment management, and that a plan that offered only active management options violates this component of GAITs. This position is implicit in the Department's recognition of GAITs as they relate to persistency of the performance of asset classes. The reason that it would inappropriate to distinguish investment options, rather than asset classes, on the basis of performance is that, within a given asset class, the performance of investment options is unpredictable.[12] In other words, the performance of investment options entails the risk that performance will be much lower

[11] We believe that the term "returns" in context refers not just to raw investment returns, but to the broader concept of investment returns considered in the context of the risks taken to achieve those returns. It is generally accepted investment theory that raw investment returns by themselves mean little without taking risk into account.

[12] Remarkably, it appears that there are members of the financial services industry who reject established science regarding the relative predictability of the investment performance of an asset class compared with that of funds within an asset class. We note that their conclusory position lacks any empirical basis. *See*, *e.g.*, *SPARK Letter*, *supra* note 9.

than the performance of the asset class. To the extent that a passive investment option mirrors an asset class, the persistence of the performance of the investment option, in contrast with that of an actively managed investment option within the same asset class, will be persistent.

In our view, a computer model that did not incorporate active management risk would not satisfy Congress's mandate that computer models reflect GAITs. If a plan includes actively managed investment options and asset-class-matching passive investment options, then the model must set forth the additional active management risk entailed by the active management option in providing recommendations. Indeed, we believe that a plan sponsor has a fiduciary duty not to require that beneficiaries assume active management risk by excluding passive investment management options from its menu of investment options. It is inconsistent for the Department to provide a safe harbor for plans that offer three distinct investment options while ignoring the importance of offering a passively managed version of each.

Indeed, there is a strong case to be made that, even assuming that some active managers can beat market – already a largely discredited view – there is no evidence that those managers can be identified prospectively, especially by beneficiaries, plan sponsors, plan administrators or investment consultants. If that proposition does not qualify as a GAIT, then at a minimum the Department must recognize the ineluctable logic of its own position *vis a vis* the persistence of asset class performance and reject the view that computer models can pretend that active management risk does not exist. Any computer model that does not recognize and incorporate active management risk violates Congress's requirement that computer models apply GAITs and increases the risk that beneficiaries will be directed into actively managed funds because they are more profitable to an adviser's affiliates.

Fourth, we believe that fees have independent predictive value. In other words, holding all other factors constant, lower fees are positively correlated with higher performance. This is not to say that, between any two funds, it is a GAIT that fees therefore are dispositive as to the superior recommendation. What is generally accepted is that fees, unlike past investment performance, have a scientifically proven correlation with performance. This assertion is a truism in that it simply stands for the proposition that, for any two investment options with identical gross performance and other characteristics, the investment option with lower fees is extremely likely to generate superior performance net of fees in the future. A computer model therefore *must* distinguish investment options based on their fees (within a given asset class) in order to satisfy the requirement that it apply GAITs.

Fifth and finally, we believe that it is a GAIT that an investment portfolio should be diversified. It is a corollary GAIT that an investor should not hold a significant concentration of assets in the securities of a single private issuer, especially when that issuer is also the investor's primary source of employment income. This corollary is codified with respect to assets of defined benefit plans, of which no more than 10 per cent may be invested in the plan sponsor's stock.[13] The Department requires that plans offer at least three distinct investment options, and it has estimated that beneficiaries have lost more than $85 billion in their plans due in part to inadequate diversification. *See* Proposal at Part G. Thus, diversification is not only a GAIT, but also established federal policy. Any computer model that did not recognize the conflict between concentrated holdings in employer stock and GAITs could not satisfy the statutory requirements for the computer model exemption.

VI. Unauthorized Exclusions from Computer Models

A. Accounting for All Investment Options

Our final concern is that the Department's rule violates Congress's plain requirement that computer models "take into account all investment options under the plan." This means that, if employer stock, asset allocation funds or annuities are offered as investment options in a plan, the computer model must take them into account. This statutory text leaves no regulatory discretion to the Department to remove these options from incorporation into a qualifying computer model.

Nonetheless, this is precisely what the Department appears to have done. The Department acknowledges in the rule that a computer model must "take into account all designated investment options" only to reverse course and permit the omission of "recommendations relating to the acquisition, holding or sale of an investment option that:"

> (i) Constitutes an investment primarily in qualifying employer securities;
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> (ii) Constitutes an investment fund, product or service that allocates the invested assets of a participant or beneficiary to achieve varying degrees of long-term appreciation and capital preservation through equity and fixed income exposures, based on a defined time horizon (such as retirement age or life expectancy) or level of risk of the participant or beneficiary, provided that, contemporaneous with the provision of investment advice generated by the computer model, the participant or beneficiary is also furnished a general description of such funds, products or services and how they operate; or
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> (iii) Constitutes an annuity option with respect to which a participant or beneficiary may allocate assets toward the purchase of a stream of retirement income payments guaranteed by an insurance company, provided that, contemporaneous with the provision of investment advice

[13] *See* 29 U.S.C. § 1107(a). As of December 31, 2000, 62 percent of Enron Corporation's 401(k) assets were invested in Enron stock. *See* Patrick Purcell, *The Enron Bankruptcy and Employer Stock in Retirement Plans*, Congressional Research Service Report for Congress at 3 (Mar. 22, 2002) *available at* http://fpc.state.gov/documents/organization/9102.pdf.

> generated by the computer model, the participant or beneficiary is also furnished a general description of such options and how they operate.

It is not possible for a computer model to "take into account" all options without incorporating all options in its recommendations. Making "recommendations" is precisely how computer models "take into account" various investment options. By not making recommendations regarding certain investment options, computer models will not be taking into account all investment options as required by Congress.

Even if the Department had the authority to exclude recommendations regarding these investment options, it would be imprudent to do so. As a general matter, any computer model that comported with GAITs could only provide recommendations that accounted for a beneficiary's full range of investments. Ignoring an equity allocation, such as an investment in employer stock, a contractual income stream (such as a fixed annuity), or an asset allocation fund would be inconsistent with GAIT's mandate that asset allocations be based on a beneficiary's entire portfolio.

To illustrate, consider the recommendation that a GAIT-compliant computer might generate for a 50-year-old beneficiary. A computer model might appropriately recommend a 60/40, equity/debt asset allocation on the assumption that the 60 percent allocated to equities would be invested in a diversified pool of stocks. If the beneficiary already had 40 percent of his account invested in employer stock, a computer model that ignored this holding might recommend a 60/40 allocation, which would leave the beneficiary with an overall 76 percent equity allocation of which more than half would be concentrated in a single stock. The recommendation would not be consistent with GAITs, yet it arguably would be consistent with the rule because taking the employer stock into account could reasonably be considered to be making a "recommendation relating to" the holding of the employer stock and therefore excludable under the Department's position.

The Department seems to disagree with this interpretation of its proposal. It states that, while a computer model is permitted to exclude "recommendations relating to" the three excluded investments, a computer model nonetheless "must take into account the fact that the participant or beneficiary has such an investment."[14] While this is a possible interpretation of the rule's text, it is not sufficiently clear. If the model took the employer stock "into account," one could reasonably argue that the model would be making at least an implicit "recommendation[] relating to the acquisition, holding or sale" with respect to the stock. At a minimum, the text of the rule needs clarification.

Even if the Department's interpretation holds as a matter of law, however, it cannot work as a matter of practice. To illustrate, assume again the 50-year-old beneficiary described above. If the computer model made a recommendation regarding the non-employer-stock investment options that "took into account" the 40 percent, employer stock holding but made no recommendation about holding the stock, then GAITs would militate that the risk of the 60/40 allocation be reduced to accommodate the

[14] *Investment Advice—Participants and Beneficiaries,* 74 F.R. 3822 (Jan. 21, 2009).

heightened risk presented by the high employer stock concentration. The recommended debt percentage would be substantially increased to reflect both the pre-existing stock allocation and the concentration of that allocation in a single company's stock. But requiring a model to make this adjustment without requiring that it also incorporate some GAIT-based evaluation of the 40 percent employer stock allocation commits a fraud on the beneficiary. The model will have produced a recommendation that standing alone, without any contextual explanation, makes no sense. Moreover, for a purportedly GAIT-compliant model to remain silent on the *inadvisability* of a 40 percent allocation to employer stock makes a mockery of GAITs. It allows GAITs to be used as covers for a contra-GAIT asset allocation.

We believe that there is no practical space between "taking into account" an allocation to employer stock and making a "recommendation" regarding the "acquisition, holding or sale" of employer stock, an asset allocation fund or an annuity. It is distinction without a difference. Either the rule provides that GAIT-compliant advice be given or it does not. A computer model cannot be said to provide a recommendation that is GAIT-compliant if the impact of a beneficiary's allocation to an excludable option is not incorporated into the recommendation. With respect to beneficiaries' current investment in plan investment options, the Department concedes that this factor is "fundamental to meaningful investment advice" but does not even require that computer models incorporate this factor when making recommendations. While we agree that it would be impracticable to require models to incorporate all non-plan allocations (although advisers must ask for information about them), it would be imprudent not to require models to incorporate all of a beneficiary's investments within a plan.

The way in which employer stock, asset allocation options and annuities are "taken into account" by computer models should be left to the experts who design the models. The Department should not attempt detailed engineering of the particular content of computer models by deciding on its own that certain types of options need not be the subject of recommendations. The providers of these models are well aware of the nuances of managing a wide range of plan investment options. They are in the best position to determine the most effective means of implementing Congress's mandate that the models comport with GAITs and, in one way or another, "take into account" all investment options consistent with the nature of the options. The Department should not substitute its particular views regarding the capacity or appropriateness of computer models to incorporate particular investment options into the models' recommendations beyond providing direction regarding the fundamental GAITs that the models must reflect.

B. Employer Stock

It is particularly important that computer model recommendations incorporate allocations to employer stock. One of the most fundamental GAITs is that a diversified pool of investments *not* include a heavy concentration in the stock of a single company, much less of one's employer. The fate of the many Enron employees who bet both their income security and retirement security on a single company is a reminder of why employees should never hold more than a small percentage of their portfolios in their employer's stock.[15] For a computer model to comply with GAITs, it would have to advise that investments in employer stock above a certain percentage range is imprudent and recommend that the beneficiary consider additional diversification. If the beneficiary insisted on an over-concentration in employer stock, a GAIT-compliant model must be able to incorporate that allocation into the recommendation it provides as to the beneficiary's remaining assets.

It is with regard to employer stock that employers have a direct conflict of interest with their employees and the protections of ERISA are most important.[16] Management benefits when employees hold large blocks of stock because the employees provide a more stable, friendly shareholder base. Employee ownership of stock is commonly considered an effective defense against acquisitions and a way to maintain a higher share value that pumps up executive compensation.[17] These concerns are reflected in anti-fraud securities regulation that is specifically targeted at companies' conflict of interest when purchasing their own stock.[18] Research shows that beneficiaries' over-concentration in employer stock driven partly by the implied endorsement of this

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[15] As of December 31, 2000, 62 percent of Enron Corporation's 401(k) assets were invested in Enron stock. *See* Patrick Purcell, *The Enron Bankruptcy and Employer Stock in Retirement Plans*, Congressional Research Service Report for Congress at 3 (Mar. 22, 2002) *at* http://fpc.state.gov/documents/organization/9102.pdf; *Enron Employee Ride Stock to Bottom*, CNN.com (Jan. 14, 2002) *at* http://archives.cnn.com/2002/LAW/01/14/enron.employees/. Twelve percent of employees whose plans offer employer stock have at least 60 percent of their plan assets invested in that option. *See* Jason Zweig, *Wall Street Lays Egg With Its Nest Eggs*, Wall St. J. (Sep. 28, 2008).

[16] It is ironic that this conflict of interest is actually the Department's *justification* for this exclusion. In its 2008 proposal, the Department explained that the exclusion was necessary so as not to "discourage arrangements based on utilization of a computer model." *Investment Advice—Participants and Beneficiaries*, 73. F.R. 49895 at text accompanying note 10 (Aug. 22, 2008). In other words, the Department recognized that employers would put their own interests ahead of their employees' interests and decline to offer a computer model if doing so would expose employees' over-investment in employers' stock as ill-advised. It is patently inconsistent with the public interest to permit models to give distorted recommendations in order to protect the self-interest of employers. The Department justifies its position on the ground that quarterly benefits statements refer to the dangers of over-investing in the securities of one company, but that disclosure makes no reference to the special conflict of interest when the employer's securities are at issue or the special vulnerability to investments in employers' stock to which the behavioral finance literature shows employees are susceptible. *See generally* Shlomo Benartzi, Richard Thaler, Stephen Utkus and Cass Sunstein, *Company Stock, Market Rationality, and Legal Reform*, Chicago Working Paper Series No. 218 (July 2004) ("*Company Stock*"); James Choi, David Laibson & Brigitte Madrian, *Are Empowerment and Education Enough? Under-Diversification in 401(k) Plans* at 24 (2005) *available at* http://www.brookings.edu/es/commentary/journals/bpea_macro/forum/200509bpea_laibson.pdf.

[17] *See generally* Joshua Rauh, *Own Company Stock in Defined Contribution Pension Plans: A Takeover Defense?* 81 J. Fin. 379 (2006).

[18] *See* Exchange Act Rule 10b-18 (anti-manipulation rule applicable to companies' purchase of their own stock); *see also* Purchases of Certain Equity Securities by the Issuer and Others, Exchange Act Release No. 61414 (Jan. 25, 2010) ("an issuer may have an incentive to manipulate the price of its securities").

allocation by their employers.[19] Federal law prohibits defined benefit plans from investing more than 10 percent of their assets in employer stock to combat precisely the employer's conflict of interest that the Department's proposal ignores as to individual beneficiaries. The incidence of high concentrations of employer stock ownership in defined contribution plans is a significant threat to millions of Americans' financial security.[20] It is unclear why the Department would contradict the express requirement of the statute that computer models account for all investment options when the risk to beneficiaries in this respect is so great.

It is unconscionable that computer models could be permitted to ignore the risks of investing in employer stock. Any rationally designed model that addressed employer stock would strongly recommend against it comprising more than 10 or 20 percent of a beneficiary's portfolio.[21] Allowing qualified computer models to remain silent on this issue sends the implicit message that it is not an area of concern and fails to reflect the GAITs that the models are required to apply. The employer stock exclusion disregards the express requirements of the statute, exceeds the Department's authority, and creates the impression of being designed to elevate the interests of employers over the interests of plan beneficiaries.

C. Asset Allocation Options

We also strongly disagree with the Department's proposal to permit computer models to exclude asset allocation funds from recommendations. The Department states, with respect to asset allocation options, that,

> where an investment fund, product or service is itself designed to maintain a particular asset allocation taking into account the time horizons (retirement age, life expectancy) or risk level of a participant, such fund should not be required to be included in the computer modeled investment advice.

Whether a particular option it designed to take into account a beneficiary's time horizon is not the issue as to the recommendations generated by a computer model. Neither an investment option nor an asset allocation is itself a recommendation or even investment advice. An asset allocation within an investment option exists independent of the beneficiary for whom the investment option might or might not be appropriate. It is

[19] *See* Shlomo Benartzi, *Excessive Extrapolation and the Allocation of 401(k) Accounts to Company Stock*, 56 J. Fin. 1747 (2001) (finding that "employees interpret the allocation of the employer's contributions as implicit investment advice").

[20] *See Company Stock*, *supra* note 15 (11 million plan participants hold more than 20%, and 5 million over 60%, of their balances in employer stock).

[21] *See id.* ("Encouraging or forcing employees to invest in a single stock, as opposed to a diversified fund such as a mutual fund, violates the first principle of investing—diversify!").

the role of the computer model to advise the beneficiary regarding the appropriateness of the investment option, not to advise the investment option sponsor on its asset allocation.

Consider a stock fund that holds a 70/30 allocation of large and small cap U.S. stocks. A computer model would provide a recommendation that took account of the fact that this option represented both large and small cap stocks and recommend a portfolio on that basis. If a fund held a 70/30 allocation between stocks and bonds, a computer model that viewed this allocation as appropriate for a 30-year-old would take that allocation into account while recommending that it be revisited as the beneficiary aged. In the same vein, if the fund changed its asset allocation to match the aging of the beneficiary (*i.e.*, it operated as a target-date fund), then the computer model presumably would recommend that option as an appropriate investment for the period of the beneficiary's employment. In each case, the computer model's function is the same: to advise the beneficiary regarding the investment option or options that would be most appropriate for the beneficiary, regardless of the extent to which the recommendation itself combined different options to create the right degree of diversification and risk.

If, in the last example, the beneficiary had already purchased a fixed annuity, then the computer model might vary its recommendation regarding the appropriateness of the target-date fund. The annuity would make the beneficiary's overall retirement portfolio more conservative. The computer model therefore might recommend a more aggressive target-date fund. If, in addition to the annuity, the beneficiary held 10% of his retirement assets in employer stock, then the computer model might recommend a more conservative target-date fund and/or one with a heavier international emphasis (assuming that the employer was a U.S. company). In this last example, the computer model's role is the same with respect to all three plan options that the Department proposes to exclude as it would be with respect to any other type of option. It is not the model's role to evaluate the particular investments inside an investment option as such, but to evaluate their role *vis a vis* each beneficiary based on the information about the beneficiary that is incorporated into the model.

The relevant *advisory* issue is not whether a particular asset allocation option's internal allocation is appropriate, but whether the particular option is appropriate for the beneficiary. The fact that the option's asset allocation may be fixed says nothing about the advisability of the allocation for a particular beneficiary. The Department must be acutely aware of this fact based on its current review of target-date funds. Target-date funds for any give target retirement year have been found to use an extraordinarily wide range of asset allocations.[22] Just as a GAIT-compliant recommendation cannot be made without reflecting a beneficiary's employer stock allocation, a GAIT-compliant recommendation cannot be made without reflecting the particular characteristics of an asset allocation fund. The Department's logic would allow a model either to ignore a 65-year-old's investment in a 2050 target-date fund, or to adjust other investments to reflect the target-date fund but without making any recommendation as to the target-date fund

[22] *See* Remarks of SEC Chairman Mary Schapiro before the Solutions Forum on Fraud, Washington, DC (Oct. 22, 2009) ("In 2008, target date funds for 2010 suffered losses of as little as 4 percent to as much as 40 percent.").

itself. This example illustrates why Congress required that computer models take all investment options into account.

D. Annuities

We also object to the Department's position on annuities. With respect to annuities, the Department states that:

> where, in connection with an in-plan annuity option, with respect to which a participant may allocate a portion of his or her assets toward the purchase of an annuitized retirement benefit and those allocated assets are no longer available for investment at the time of the advice, the participant or beneficiary has, in effect, decided to treat those assets as no longer available for investment and, accordingly, such assets should not, in the view of the Department, be required to be modeled for purposes of buy, hold or sell recommendations.

Our first objection is that the exclusion covers investment options that, in practice, are not annuities. The exclusion applies to an investment options whereunder a beneficiary "may allocate assets toward the purchase of a stream of retirement income payments guaranteed by an insurance company." This description would include, for example, a variable annuity, which interpretation is supported by the Department's phrase "toward the purchase" (rather than "to purchase") and the fact that the Department appears to have been responding to a request to accommodate "annuity purchase programs that serve as both *accumulation* and distribution options" (emphasis added).

With respect to a variable annuity, the term "accumulation" generally refers to a period during which the purchase amount is invested in fixed, underlying investments. The investments are commonly mutual funds that are virtually indistinguishable from mutual funds offered by plans outside of an annuity wrapper. These investments are designed to be held, in theory, until the retirement date, when the beneficiary has the option of purchasing a fixed annuity. In fact, purchasers of variable annuities rarely convert their investments to an actual "stream of retirement income payments." One study found that less then 0.8% of variable annuity purchasers actually converted to a fixed income annuity.[23] As this data suggests, the use of the term "annuity" in "variable annuity" is more a reflection of salesmanship than reality.[24]

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[23] *See* Jeffrey Brown, *Rational and Behavioral Perspectives on the Role of Annuities in Retirement Planning*, NBER Working Paper 13537 (2007) (less than 0.8% of variable annuities were converted to fixed life annuities, citing Dan Beatrice and Matthew Drinkwater, *The 2003 Individual Annuity Market: Sales and Assets*, LIMRA International (2004)).

[24] Sales abuses are more common with respect to variable annuities than any other retail investment product, especially with respect to senior citizens. *See* Letter from AARP, North American Securities Administrators Association, Fund Democracy and Consumer Federation of America to Chairman Christopher Dodd and Ranking Member Richard Shelby, Committee on Banking, Housing and Urban Development, U.S. Senate (Feb. 2, 2010) (discussing abusive sales practices in sale of variable annuities to seniors), *see also Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free*

Our second objection is that, even accepting the Department's reasoning, it seems to apply only where the fixed annuity has already been purchased. The Department refers to the annuity assets as being "no longer available for investment" because the beneficiary has "decided to treat those asset as no longer available for investment." This is not the case, however, when the issue is a recommendation as to whether to *acquire* a fixed annuity, yet the exclusion applies to a recommendation relating the "acquisition" of a fixed annuity, not just relating to the holding or sale of the annuity. If a fixed annuity is a plan investment option, a computer model certainly should be required to have considered the annuity in generating its recommendations.[25]

Admittedly, recommendations as to holding or selling, as opposed to acquiring a fixed annuity are different because there may be punitive costs associated with a sale if a sale is even permitted. As with employer stock and asset allocation options, however, an allocation to a fixed annuity, irrevocable or not, still cannot be ignored when generating a GAIT-compliant recommendation regarding other plan investments. The computer model must include an analytical framework for evaluating the risk-return characteristics of a fixed annuity and then apply that framework in generating a recommendation as to other plan investments that is GAIT-compliant considering the allocation to the fixed annuity.

As to asset allocation, employer stock and annuity options alike, the purpose of the computer model is to help the beneficiary make choices among plan options that make the most sense for the particular beneficiary. This requires that the model's recommendations incorporate all plan options in its analysis.

VII. Conclusion

In conclusion, we wish to re-emphasize the choice that Congress made in ERISA to prohibit conflicted advice by prohibiting fiduciaries from receiving fees for both

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Lunch" Seminars, Securities and Exchange Commission, North American Securities Administrators Association and Financial Industry Regulatory Authority at 21-22 (2007); FINRA Investor Alert, "Should You Exchange Your Variable Annuity?" (last updated Mar. 2, 2006) (citing abusive sales practices); Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June 2003); FINRA Investor Alert, "Variable Annuities: Beyond the Hard Sell" (last updated May 27, 2003); NASD Regulatory and Compliance Alert, "Advertising of Bonus Credit Variable Annuities" (Summer 2000) (warning against misleading sales practices); NASD Notice to Members 99-35, "The NASD Reminds Members of their Responsibilities Regarding the Sales of Variable Annuities" (May 1999); NASD Notice to Members 96-86, "NASD Regulation Reminds Members and Associated Persons that Sales of Variable Contracts are Subject to NASD Suitability Requirements" (Dec. 1996). If variable annuities are singled out for special treatment, they should be subject to greater scrutiny rather than less.

[25] This confusion may reflect the common misperception that a fixed annuity is not an "investment." This misperception is partly based on the illusion of the insurance guarantee. The holder of a fixed annuity is a creditor of the insurance company that sells it, which exposes the holder to the risk of that the insurer will fail to the extent that the annuity is not covered the applicable state guaranty fund. A fixed annuity may very well be a relatively *safe* investment, but it is no less an investment than any other kind of investment option for purposes of generating recommendations regarding the optimal allocation of a beneficiary's retirement assets.

investment products and for providing advice about those products. The fee-leveling and computer model safe harbors must be understood as exceptions to this statutory scheme that should be interpreted narrowly, especially when considering the creativity demonstrated by many financial services firms in employing sales practices that are designed to maximize their profits rather than investors' best interests. With the growth of defined contribution plans and the increasing importance of participants' individual decision-making role, it has never been more critical that the investment advice that participants receive be free of conflicts of interest.

We are encouraged by the significant improvements that the Department has made to the conflict advice rule and greatly appreciate your consideration of our comments.

Sincerely,

Mercer Bullard
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Fund Democracy, Inc.

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Ken McEldowney
Executive Director
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Ellen Turf
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