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

Submitted via email to [e-ORI@dol.gov](mailto:e-ORI@dol.gov)

**Re: 2010 Investment Advice Proposed Rule**

Ladies and Gentlemen:

We appreciate this opportunity to comment on the Department's proposed rule implementing the Pension Protection Act (PPA) investment advice exemption (the "Proposed Rules" or "Rules"). The Charles Schwab Corporation is a leading provider of financial services, with more than 300 offices and 7.8 million client accounts, 1.5 million corporate retirement plan participants, 768,000 banking accounts, and \$1.49 trillion in client assets. We applaud the Department's efforts to finalize a rule implementing the PPA investment advice exemption and support the overall expansion of access to professional investment advice.

We write to request that the Department provide clarification of certain aspects of the Proposed Rules' fee-leveling, disclosure, and computer model requirements to help assure the usefulness and effectiveness of the Rule. Providing clarity in the areas noted below will facilitate industry compliance with the Rule and aid in the expansion of retirement savers' access to professional investment advice.

## **FEE-LEVELING ARRANGEMENTS**

### Application to Wrap-fee Programs

The proposing release for the Rules cautions that receipt of varying compensation by the fiduciary adviser from its affiliate or receipt of varying compensation by any party “that is used for the benefit of” the fiduciary adviser would be inconsistent with the fee-leveling requirement. Both the Proposed Rule and Field Assistance Bulletin 2007-1, however, make clear that “an affiliate of a fiduciary adviser may receive fees that vary depending on investment options selected.”

To avoid confusion, Schwab believes it is important for the Department to clarify that it does not intend to rule out traditional wrap-fee advisory programs as a permissible fee-leveling arrangement under the Proposed Rule, provided that there is no variable compensation paid to or received by the fiduciary adviser based on the recommended investments.

A wrap-fee arrangement refers to a bundle of advisory and brokerage services, including trade execution and custody, provided for a single fee. One common arrangement is for a broker-dealer sponsor of the program to provide the brokerage services while an affiliated investment adviser (e.g. the fiduciary adviser where advice is provided to a retirement plan account) provides the investment advice (to plan participants or IRA beneficiaries), with each entity receiving a portion of the bundled wrap fee. It is also common in wrap-fee programs for the overall fee to be paid to the broker-dealer sponsor, which then passes on to the advisory affiliate its share of the fee – a share fully disclosed and agreed to by the recipient of the advice.

It would be helpful for the Department to clarify that, so long as the portion of the wrap fee paid to the fiduciary adviser does not vary according to investment option, then neither the fact that payments flow from the broker-dealer to its affiliated fiduciary adviser, nor the fact that the affiliated, non-fiduciary broker-dealer may receive variable compensation on the underlying investments would render the wrap-fee approach ineligible under the Proposed Rule.

### Inter-Affiliate Arrangements

Financial services organizations commonly contract with affiliates to perform administrative, client service and other functions pursuant to inter-affiliate agreements. For example, a fiduciary adviser might contract with one or more of its affiliates to provide payroll, facilities, marketing, technology, research, and other support services. We request that the adopting release for the final rule clarify that the performance of these types of non-fiduciary services on behalf of a fiduciary adviser, pursuant to an inter-affiliate agreement, will not result in making the service provider affiliate a fiduciary adviser for purposes of the fee-leveling condition. This clarification is consistent with the policy goal of enabling fiduciary advisers affiliated with large financial

institutions to provide advice for a level fee at a reasonable cost and will provide the industry with certainty in connection with common business practices. It also is consistent with prior DOL guidance that an entity which is not otherwise a plan fiduciary does not become a fiduciary merely because it is affiliated with an entity that engages in fiduciary activities.

### Dual Employee Status

The fee-leveling condition applies both to the fiduciary adviser and its employees, agents and registered representatives. In many financial services organizations it is common for individuals to perform more than one role or even to maintain an employment relationship with more than one affiliate. For example, the representative of a registered investment adviser may also be under the partial supervision of an affiliated bank for purposes of enabling the representative to discuss the bank's products and services (a banking requirement). The fact that a representative engages in non-fiduciary adviser activities from time to time should not prevent that representative from also delivering "eligible investment advice" in compliance with the Proposed Rule. To assist firms in understanding the scope of the fee-leveling provisions and to enable compliance, we ask the Department to clarify that a fiduciary adviser's "employees, agents and registered representatives" include such individuals only when acting on behalf of the fiduciary adviser in providing investment advice.

### Advice Based on "Generally Accepted Investment Theories"

Fiduciary advice may cover the full range of stocks, bonds, mutual funds, exchange-traded funds, and other investments. Participants or beneficiaries, making their own investment decisions, may have a few positions in their account, or dozens of positions. A requirement of Proposed Rule (b)(3)(i)(A) is that "any investment advice is based on generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time. . . ." It would be helpful for the Department to recognize when adopting the final rule that, because a beneficiary can choose to accept or ignore the fiduciary's advice, investment holdings in the account might not reflect generally accepted investment theories despite receiving fiduciary advice based on generally accepted investment theories.

## **DISCLOSURE REQUIREMENTS**

The Proposed Rule would require prior written disclosure to a plan participant or IRA beneficiary of, among other items, "[t]he past performance and historical rates of return of the designated investment options available under the plan." As written, this requirement could levy an impossible task on fiduciary advisers offering a wide range of investment options. IRAs held at broker-dealers, for example, may offer a full range of "designated investment options" that includes thousands of stocks, bonds, mutual funds, and exchange traded funds. The fiduciary adviser seeks to customize client portfolios from among those thousands of investment options.

It is simply not feasible to continuously track and publish performance results for each recommendable security. (This is in contrast to performance of client accounts, which can be tracked and compared to applicable benchmarks.) The Department should eliminate this requirement from the final rule, or at least clarify that “past performance and historical rates of return” means at an asset class level rather than individual investment level.

For fiduciary advisers who are registered with the Securities and Exchange Commission, many of the disclosures required by the Proposed Rules are also required under or overlap with SEC rules promulgated under the Investment Advisers Act of 1940. To avoid unnecessary duplication or confusion to IRA beneficiaries who would already be receiving the SEC’s ADV Part II disclosure, we ask that the Department clarify that fiduciary advisers may provide the Fiduciary Adviser Disclosure under the Proposed Rules integrated (e.g., in the same disclosure brochure) with the fiduciary adviser’s disclosures under the Investment Advisers Act. Firms, of course, would need to supplement their ADV Part II disclosures to meet the additional requirements of the Proposed Rule.

## COMPUTER MODELS

### Generally Accepted Investment Theories and Use of Historical Performance

The request for comments asks, among other things, whether it is appropriate to “recommend a fund with superior performance over an alternative fund in the same asset class with average performance but lower fees.” Schwab believes that it may be appropriate, depending on other factors. For example, under generally accepted investment theories (a term used throughout the Proposed Rules), historical performance of a mutual fund is an important factor, but not the only one, used to make investment decisions. The absolute level of performance, standing alone, may not be an accurate measure of the manager’s skill, especially if the fund’s investment style (e.g., large-cap growth) happens to have been either in or out of favor in the market over the particular time period. For this reason it is generally accepted to consider risk-adjusted performance or risk- and style-adjusted performance in lieu of absolute performance in the investment decision making process. Research shows that performance is just one of several factors that should be considered. Expenses, of course, should be considered, but assets under management, cash flows, and the degree of active management are also important.<sup>1</sup>

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<sup>1</sup> See, for example: Chen, Joseph, Harrison Hong, Ming Huang, and Jeffrey D. Kubik. 2004. “Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization.” *American Economic Review*, vol. 94 (December): 1276-1302.

Peterson, James D., Paul A. Pietranico, Mark W. Riepe, and Fran Xu. 2001. “Explaining the Performance of Domestic Equity Mutual Funds.” *The Journal of Investing*, vol. 10, no. 3: 81-91.

Cremers, Martijn and Antti Petajisto. 2009. “How Active is Your Fund Manager? “A New Measure That Predicts Performance.” *Review of Financial Studies*, vol. 22, no. 9: 3329-3365.

Historically well-performing funds in their categories may result not from chance (one possibility mentioned in the request for comments), but from superior investment management approaches based on quantitative or qualitative models. Although there is a healthy debate regarding the role of luck versus skill in investment management, studies have shown that some managers have enough security selection skill to more than cover their costs of trading and that the superior skill persists.<sup>2</sup>

The Proposed Rules state that a computer model must 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.” For the reasons stated above, this should not preclude the appropriate use of historical performance as one valuable factor used to distinguish among investment options. Such a prohibition could have the effect of forcing fiduciary advisers using computer models to recommend nothing but index mutual funds and exchange traded funds, as the cost advantage enjoyed by these investments – only one factor in investment selection, as reflected in the multiple investment selection criteria laid out in the Proposed Rules themselves – is perhaps the only factor that can be confidently expected to persist in the future. Our experience tells us that many investors at various stages of saving for retirement have a desire for at least part of their portfolio to outperform a benchmark, and active management is the only way to do that. Therefore, the Proposed Rules should enable fiduciary advisers to help these investors identify active funds that give them the best opportunity to achieve their goals.

#### Impact on Third-Party Advice Arrangements

Schwab’s experience shows that participants using computer model-generated advice generally tend to achieve better investment performance with respect to their 401(k) plan assets than those participants that do not receive advice. Computer model-generated advice today is typically provided by third parties. By preserving prior “regulations, exemptions, interpretive or other guidance issued by the Department,” we applaud the Proposed Rules’ preservation of this relatively low cost access to advice that would otherwise be unavailable to many participants.

We note, however, that the regulatory exemption provided by the Proposed Rules, including qualification for the safe harbor, may create a negative implication for plan fiduciaries that a third party computer model (which does not require an exemption) provides less comfort than advice arrangements under the PPA. This may result in plan fiduciaries disfavoring less expensive and fully permissive third party arrangements. That would be unfortunate. The additional audit, certification, and disclosure provisions of the Proposed Rules contemplate an affiliated fiduciary adviser and so are intended to address the additional potential conflicts of interest that result. With the additional requirements comes the additional expense for a PPA

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<sup>2</sup> See, for example: Kosowski, Robert, Allan Timmermann, Russ Wermers, and Hal White. 2006. “Can Mutual fund “Stars” Really Pick Stocks? New Evidence from a Bootstrap Analysis.” *The Journal of Finance*, vol. 61, no. 6: 2551-2595.

computer model arrangement compared to a third party computer model arrangement. This cost will be passed along to the plan sponsor, the plan or the participants.

We therefore encourage the Department to make clear that fiduciaries offering third party computer model advice arrangements will have the same protections as fiduciaries offering PPA computer model arrangements.

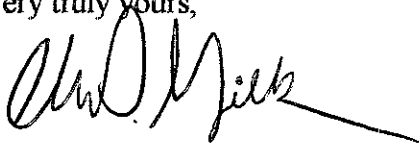
**ANNUAL AUDIT**

Proposed Rule (b)(6) requires that an annual audit be performed by an independent auditor, defined as an auditor who “does not have a material affiliation or material contractual relationship with the person offering the investment advice arrangement . . . .” To enable fiduciary adviser firms to select from a full range of qualified independent auditors, it would be helpful for the Department to clarify that the “material contractual relationship” condition focuses on whether an existing contractual relationship is material for the audit firm. This will make sure that condition does not disqualify from consideration auditors who perform other important independent audit engagements for the fiduciary adviser or sponsor of the investment advice arrangement.

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Thank you for considering these comments in developing the final rules. We would be happy to answer any questions you may have about our comments.

Very truly yours,



Christopher Gilkerson