



January 29, 2007

Office of Exemption Determinations  
Employee Benefits Security Administration  
Room N-5700  
U.S. Department of Labor  
200 Constitution Avenue, NW.  
Washington, DC 20210

Attn: IRA Investment Advice RFI.

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DALBAR appreciates the opportunity to submit comments in response to the request for information relating to the feasibility of the application of computer model investment advice programs for Individual Retirement Accounts and similar types of plans (IRAs) as required by the Pension Protection Act of 2006 (PPA).

The PPA restricts the use, under the exemption<sup>1</sup>, of a computer model investment advice program to provide investment advice to an IRA beneficiary. In this regard, section 601(b)(3)(C)(i)(I) of the PPA provides that a computer model investment advice program will not apply to an IRA unless and until the Secretary of Labor determines under section 601(b)(3)(B) or (D) of the PPA that there is a computer model investment advice program described in section 601(b)(3)(B) of the PPA. Section 601(b)(3)(A) requires that the Secretary of Labor, in consultation with the Secretary of the Treasury, solicit information as to the feasibility of the application of computer model investment programs for IRAs.

These comments and answers to the specifically requested information are intended to assist in the determination of the feasibility of granting such an exemption for computer model investment advice program for IRAs.

It is evident that IRA investments, as they exist today, are not optimized to provide the most secure retirement for IRA beneficiaries. Many long term IRAs are held in short term instruments such as money market funds, stable value and other low yielding vehicles. Additionally, IRAs are often burdened with fees that materially reduce the beneficiaries' investment returns.

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<sup>1</sup> Section 601(b) of the PPA similarly amended the Code by adding new Code sections 4975(d)(17) and 4975(f)(8). Section 4975(d)(17) of the Code provides conditional exemptive relief from the prohibitions described in section 4975(c) for certain transactions in connection with the provision of investment advice (as described in Code section 4975(e)(3)(B)) to a participant or beneficiary of a plan, if the requirements of section 4975(f)(8) are met.

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These comments recognize the need to help IRA investors to upgrade investments to improve retirement security and also attempts to answer the question of whether computer model investment advice program can accomplish this while protecting the beneficiary from biased and self-serving advice.

## SUMMARY OF COMMENTS

The following is a summary of comments offered:

- **Weaknesses of Current Models:** Current models exist but have an inherent bias that favors investments for which the model provider is compensated. Removing this bias would create a negative incentive for these providers to offer the model, thus causing them to cease offering the models.
- **Employer Sponsored Plans Are Different:** Unlike the IRA, employer sponsored plans have a fiduciary who is responsible for prudent selection of the investment options that are available to participants. This limited subset of investments makes the computer model investment advice practical. Conversely, IRAs literally have millions of investment options with no fiduciary that is responsible for narrowing the selection of investments that are offered to the beneficiary.
- **Low Usage:** Computer model investment advice programs have had very low usage and can be expected to serve only a very small percentage of IRA beneficiaries in the foreseeable future.
- **Cost Considerations:** While an unbiased model is technologically possible the cost of data accumulation and ongoing updating of millions of investment options would be impractical and cost prohibitive. Narrowing the available options to only those investments currently in IRA accounts would lower costs, but not sufficiently to make such a model practical.
- **Providing Exemption:** Providing an exemption for a biased model would fail to protect IRA beneficiaries and invite abuse. An alternative approach to improving the investments in IRAs is suggested here.

## ABOUT DALBAR

DALBAR was founded in 1976 and has served as the independent expert to financial firms in several areas of business. Financial firms use DALBAR for its unbiased ratings and evaluations and consultation in their pursuit of excellence. DALBAR measures and evaluates how well investors are served, consistent with various financial regulatory requirements in the areas of:

- **Personal Financial Advice** (Due diligence and certification of personal financial advisers)



- Technology (Web based, Automated phones, e-business)
- Phone Centers (Service and sales)
- Written Communications (Required disclosures, sales materials, education materials)

Financial services firms recognize DALBAR's evaluations, recommendations and awards as standards of excellence in these areas.

### ALTERNATIVE APPROACH

While the exemption for computer model investment advice programs for IRAs is not advised, two alternatives can and should be considered to help IRA beneficiaries to improve investment returns.

- First is to help beneficiaries that have access to an employer sponsored plan to transfer the IRA assets into such plans in order to take advantage of the fiduciary advice and qualified default investment advice available.
- The second is to help IRA beneficiaries who do not have access to an employer sponsored plan by permitting a qualified default investment alternative (QDIA) for IRAs. Such a QDIA for IRAs would use identical rules as the QDIA for employer sponsored plans and would be periodically certified by an independent expert.

Legislative and regulatory changes described below should be proposed that support each of these alternatives in place of an exemption for the IRA computer model investment advice program.

### Access to Employer Sponsored Plans

IRA beneficiaries should be encouraged to consolidate IRA assets into employer-sponsored plans by establishing regulation that:

- Provides employees with notice of the availability and desirability of transferring IRA assets into the employer-sponsored plan:
  - Potential for higher returns and improved capital preservation
  - Convenience of having retirement investments in one place
  - Potential elimination of IRA fees and expenses
- Establishes standards for ease and timeliness to complete transfers of IRAs into an employer-sponsored plan.
- Imposes no limits on transfers of IRA assets derived from sources unrelated to current employment.



- Permits tax-free transfer of a spouse's IRA assets into and out of the employer sponsored plan of either spouse.
- Permits both Roth and regular IRA transfers to maintain their respective tax status.
- Extends hardship withdrawal and loan provisions, if available in the plan to IRA assets.

Employers should be encouraged to accept IRA assets from employees and spouses into the employer-sponsored plan by regulation that:

- Provides an exemption from fiduciary obligation for assets that were contributed from sources that are unrelated to current employer.
- Requires that IRA assets transferred into the employer-sponsored plan go into the most comparable investment options currently available in the plan and are subject to change, if/when these options change.
- Creates an exemption to prohibited transaction rules so as to permit plan providers to solicit the transfer of IRA assets into employer-sponsored plan and offer to reduce fees for employers based on the value of IRA assets transferred.
- Permits employees to transfer IRA assets out of an employer-sponsored plan, net of appreciation or loss, at any time without burden to the employer (burdens such as approval of plan trustee).

### QDIA for IRA Beneficiaries

Qualified default investment alternatives (QDIA), identical to those permitted in employer-sponsored plans, will benefit a far greater number of IRA beneficiaries than will computer model investment advice programs. DALBAR's research has shown that only a very small percentage<sup>2</sup> of individuals actually use these models.

An exemption should be created for IRA plan providers to offer a QDIA to IRA beneficiaries. Recommending the QDIA to an IRA beneficiary should not be a prohibited transaction.

An exemption to the prohibited transaction rules for QDIA for IRAs should:

- Require institutions that offer IRAs to make a QDIA available to all IRA beneficiaries.

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<sup>2</sup> The 2003 DALBAR report, "Effectiveness of Online Advice Tools in 401(k) Plans" shows that only 1/10<sup>th</sup> of 1% of participants that have the availability of computer advice models within employer sponsored plans have ever completed and used the results of these programs. Recognizing this, plan providers now provide access to these models through telephone call centers.



- Notify all beneficiaries of the availability of the QDIA and permit transfer of assets from current holdings to the QDIA at no cost.
- Require periodic certification of QDIA by an independent expert to establish that each QDIA:
  - Has produced investment returns that are in line with comparable QDIAs.
  - Charges fees that are reasonable in comparison to services provided by comparable institutions.
  - Does not unduly favor investments that produce higher compensation to the provider of the QDIA.
  - Complies with the QDIA requirements under ERISA section 404(c)(5).

### ANSWERS TO REQUEST FOR INFORMATION

- (1) Are there computer model investment advice programs for the current year and preceding year that are, or may be, utilized to provide investment advice to beneficiaries of plans described in section 4975(e)(1)(B)-(F) (and so much of subparagraph (G) as relates to such subparagraphs) (hereinafter "IRA") of the Code:

Computer model investment advice programs that can be used for IRAs do currently exist. For the most part these models offer generic guidance, which has proven to be ineffective in helping participants to make prudent investment choices. Models give generic guidance specifically for the purpose of appearing to be delivering investment education, thus avoiding the fiduciary responsibility of providing advice.

The models that give specific advice are offered by certain institutions:

- That use them as incentives to persuade beneficiaries and prospective IRA investors to use that institutions own IRA offering.
- That offer advice to individuals, where the advice is incidental to the primary purpose of executing transactions or holding assets.
- Whose primary business is advising participants in an employer sponsored plan, where the employer acts as a fiduciary for the benefit of the participants.
- That are investment clubs and provide this advice as a service to members.



The motivation of these institutions in providing computer model investment advice are in conflict with the unbiased advice that is the premise for creating a prohibited transaction exemption. Creating an exemption in any of these circumstances would appear to defeat the purpose of the PPA provisions.

[Do such models]:

- a. Apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;

Investment theories used by these models vary widely, from the generally accepted to proprietary and copyrighted algorithms. All models of which we are aware include consideration of historic returns over various periods.

- b. Utilize relevant information about the beneficiary, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments;

Available models generally include these factors. There are also models designed to achieve a single investment goal (such as maximum current income or maximum short term appreciation), which do not include the factors listed.

- c. Operate in a manner that is not biased in favor of investments offered by the fiduciary adviser or a person with a material affiliation or contractual relationship with the fiduciary adviser;

We are unaware of any models that are not biased. All known models directly or indirectly favor either the provider of the model, an affiliated person, a person having a contractual relationship with the fiduciary adviser or a particular category of investments such as mutual funds, bank deposits, insurance products, brokerage accounts, etc.

- d. Take into account the full range of investments, including equities and bonds, in determining the options for the investment portfolios of the beneficiary;

We are unaware of any model that takes into account the full range of investments. Such a model would require the inclusion of millions of investment options where accurate data would be cost prohibitive to collect and maintain.

Investments available to models are typically those for which the provider of the model receives some form of compensation. Where certain models may include widely held investments to attract prospective customers, none seek to include a full range of investments.





- e. Allow the beneficiary, in directing the investment, sufficient flexibility in obtaining advice to evaluate and select investment options.

Most current models that operate outside of employer-sponsored plans provide the ability for the beneficiary to accept or reject its results. Many permit specific investments to be added or removed.

- (2) If currently available computer models do not satisfy all of the criteria described above, which criteria are presently not considered by such computer models? Would it be possible to develop a model that satisfies all of the specified criteria? Which criteria would pose difficulties to developers and why?

Criterion c. (unbiased model) is not considered by current models because it removes the incentive to build the model in the first place. Model builders typically create and operate models to attract assets to investments for which they are compensated. It is possible to develop a model that is unbiased but there would be no economic incentive to do so. Beneficiaries are unlikely to pay a sufficiently high fee to compensate a fiduciary adviser for developing and deploying such a model and institutions are not likely to forego the compensation to qualify for the proposed exemption.

Criterion d. (full range of investments) is not considered by current models because of the high cost of accumulating and maintaining complete data on all publicly available investments that could be used in determining investment options for a beneficiary. If requirements were lowered to include only those investments currently existing in IRA accounts, the scope would be materially reduced but not sufficiently to be practical. Instead, the range of investments in current models are limited to those for which the model provider is compensated or has other interests.

- (3) If there are any currently available computer model investment advice programs meeting the criteria described in Question 1 that may be utilized for providing investment advice to IRA beneficiaries, please provide a complete description of such programs and the extent to which they are available to IRA beneficiaries.

As indicated earlier, we are unaware of the existence of any models that meet all the criteria in Question 1.



- (4) With respect to any programs described in response to Question 3, do any of such programs permit the IRA beneficiary to invest IRA assets in virtually any investment? If not, what are the difficulties, if any, in creating such a model?

By definition, "virtually any investment" for IRAs would have to include all deposits products from every deposit institution, every mutual fund, every insurance product, every stock, every bond, all options, every ETF, all rights and warrants, every commodities contract, every managed account and every brokerage account. Including all of these investments in a computer model is simply not feasible.

Difficulties in permitting "virtually any investment" include that the cost of acquiring current and historical information needed for each investment and keeping this information current. An additional difficulty is the willingness of the issuers or other parties to supply the needed information in a form that would permit use by the computer model.

- (5) If computer model investment advice programs are not currently available to IRA beneficiaries that permit the investment of IRA assets in virtually any investment, are there computer model investment advice programs currently available to IRA beneficiaries that, by design or operation, limit the investments modeled by the computer program to a subset of the investment universe? If so, who is responsible for the development of such investment limitations and how are the limitations developed? Is there any flexibility on the part of an IRA beneficiary to modify the computer model to take into account his or her preferences? Are such computer model investment advice programs available to the beneficiaries of IRAs that are not maintained by the persons offering such programs?

Are models available that use a subset of investment universe?

Models that use limited subsets are available and used widely as described in the answer to Question 1.

Who is responsible for development of limitations? How are limitations developed?

The interested party defines the limitations of subsets. In the case of employer sponsored plans this is the responsibility of the plan sponsor. Where there is no employer, the subset is defined by the institution that offers the investment product or service.

The determination of the number of investments to include in a subset is determined by cost and the likelihood of loss of business to competitors.

The most obvious subset for purposes of a prohibited transaction exemption is to use only investments that currently exist in IRA accounts. This would enable any IRA beneficiary to use the model.





Implementing such a subset would require reporting of all IRA holdings and considerable information about each holding in a way that would be accessible to the computer model.

Is there flexibility for IRA beneficiaries to account for preferences?

Models are designed to capture assets and therefore permit the users flexibility to avoid losing the opportunity to capture assets.

Are subset models available from SOURCES other than providers of IRA?

Models are available from persons that do not offer IRAs as described in the answer to Question 1.

(6) If you offer a computer model investment advice program based on nonproprietary investment products, do you make the program available to investment accounts maintained by you on behalf of IRA beneficiaries?

We offer no such programs.

(7) What are the investment options considered by computer investment advice programs? What information on such options is needed? How is the information obtained and made part of the programs? Is the information publicly available or available to IRA beneficiaries?

Models vary greatly in the investment options considered and information required. This depends on the investment theory that is employed and the degree of precision that the model seeks to achieve. Information used by models are derived primarily from three sources:

- Provided by the user
- Purchased or otherwise obtained from public sources
- Proprietary data

(8) How should the Department or a third party evaluate a computer model investment advice program to determine whether a program satisfies the criteria described in Question 1 or any other similar criteria established to evaluate such programs?

Given the large number of theories that now exist and will be developed in the future, the only practical method of evaluating whether a model satisfies the criteria in Question 1 is to conduct a sufficiently large number of tests of each model and examine the results.

These evaluations involve using controlled tests in a variety of typical investor situations for a number of different models. DALBAR suggests testing approximately 100 different scenarios uniformly applied to each model. Scenarios should include hypothetical beneficiaries with:



- Current IRA investments ranging from deposit and guaranteed products to highly speculative investments.
- Ages ranging from new to the workforce through retirement.
- Economic situations from minimum wage to affluent.
- Risk tolerance from risk averse to high-risk takers.
- Varying skills, comprehension, interest and knowledge of investments.

Results from each model should then be evaluated on the basis of the:

- Skew in investment recommendations to determine if there is an unsubstantiated bias for any investment source(s).
- Consistency of investment recommendations to determine if investment selections are consistent with the investment theory used.
- Variance from the results produced by other models and whether significant variances are explained by the investment theory.
- Usability for various audiences to determine if the model can be understood and operated by a large segment of the population.
- Burden of using the model evaluates the time and information requirements from the user to estimate the percentage of users likely to complete the program.

Analysis of these results include comparison to available models to identify models that are not up to a benchmark of what is available.

- (9) How do computer model investment advice programs present advice to IRA beneficiaries? How do such programs allow beneficiaries to refine, amend or override provided advice?

The models that gain the highest levels of usage simply provide the beneficiary with a suggested portfolio and automatically executes the required transactions after the beneficiary accepts the result.

Usage is generally very low for models that attempt to educate beneficiaries or provide generic results that require additional effort by the beneficiary.

Overriding the results of models that create a suggested portfolio is usually permitted at the time that the beneficiary is asked to accept the model's results.

Thank you for your consideration of these comments in developing the response to the Congress

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10



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President