Retirement Security: The Importance of an Independent Investment Adviser

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before the

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Chairman Andrews, Ranking Member Kline, members of the Subcommittee, thank you for the opportunity to appear before you to discuss the importance of an independent investment adviser. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Associate Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Fund Democracy has attempted to achieve this objective in a number of ways, including filing petitions for hearings, submitting comment letters on rulemaking proposals, testifying on legislation, publishing articles, lobbying the financial press, and creating and maintaining an Internet web site for the posting of information. I also have served as an expert witness for plaintiffs and defendants in a variety of securities cases and am a senior adviser with financial planning firm Plancorp, Inc.

This testimony is also provided on behalf of the Consumer Federation of America. The CFA is a nonprofit entity with approximately 300 nonprofit members from throughout the nation with a combined membership exceeding 50 million people. The CFA is an advocacy, research, education, and service organization. As an advocacy group, it works to advance pro-consumer policy on a variety of issues before Congress, the White House, federal and state regulatory agencies, state legislatures, and the courts. Its staff works with public officials to promote beneficial policies, to oppose harmful policies, and to ensure a balanced debate on important issues in which consumers have a stake.

EXECUTIVE SUMMARY

The Pension Protection Act's conflicted advice exemption and the Department of Labor's interpretation and extension of the exemption will promote the providing of conflicted advice to pension plan participants, and participants will pay higher fees and experience inferior investment returns as a result. There is a need to facilitate the providing of expert financial advice to plan participants, but there is no excuse for exempting *conflicted* advice that will harm participants and leave them less prepared for a financially secure retirement. The exemption will have the effect of suppressing the providing of *independent* advice to participants while encouraging participants to rely on advisers whose incentives are to maximize their own compensation at the expense of participants. At a time when Americans confidence in our financial system has been severely damaged, it is imperative that Congress act promptly to protect our retirement security.

The problem with the conflicted advice exemption cannot be adequately addressed through administrative action alone; legislative action is necessary. Congress should repeal the statutory conflicted advice exemption. As an alternative, Congress should ensure that the Department of Labor: (1) withdraws its class exemption, which exacerbates the problem of conflicted advice created by the statutory exemption, and (2) clarifies and corrects its interpretation of the statutory exemption to reflect the exemption's plain meaning. Additionally, policy makers should seek to promote the providing of independent advice to the exclusion of conflicted advice. Congress should enact legislation or direct the Department to adopt a class exemption that creates an employer safe harbor that is available solely for independent investment advice.

I. INTRODUCTION

Defined contribution plans have become the most important source of retirement security for middle-income Americans, yet many of them will enter retirement with inadequate savings. Some projections predict that DC plans will replace only 22 percent of annualized career earnings and that 37 percent of workers will reach retirement age with a zero plan balance.[1] Inadequate retirement income for middle-income workers poses systemic risks to our political and economic systems. At the same time that the actuarial viability of Social Security and Medicare are crumbling, inadequate DC plan savings threaten to increase retired Americans' dependence on such welfare programs. The regulation of private pensions is in dire need of a substantial overhaul.

One promising development has been the recent emphasis on increasing participants' access to professional financial advice. Older participants may invest too aggressively, especially after a run-up in the markets, to provide the retirement security that they need.[2] Many workers on the brink of retirement invested excessively in equities, for example, and recent market downturns have severely compromised their retirement security. In some cases, they have done so pursuant to professional advice provided by conflicted managers.[3] On the other hand, younger participants often invest too conservatively, leaving their plan balances barely able to keep pace with or even at risk of losing ground to inflation. This is a significant risk today, with many workers seeking to escape the carnage in the equity markets in a flight to safety.[4] This strategy, the functional equivalent of buying high and selling low, will exacerbate the adverse effects of current market volatility. Because it can help participants avoid these costly errors, expert financial advice is a crucial component of a successful DC plan.

Unfortunately, employers fear liability for providing advice to employees, and reducing this liability risk has been viewed as essential to ensuring that participants have the guidance they need to make prudent investment decisions. This does not mean, however, that employers should have no responsibility for exercising reasonable care in selecting advisers for their employees. And it is no

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[1] *See Private Pensions: Low Defined Contribution Plan Savings May Pose Challenges to Retirement Security, Especially for Low-Income Workers*, GAO-08-08 (Nov. 2007) *available at* http://www.gao.gov/new.items/d088.pdf.

[2] *See* Christine Dugas, *401(k) Losses: Older Investors' Retirement Funds Hit Hard*, USA Today (Oct. 31, 2008) *available at* http://www.usatoday.com/money/perfi/retirement/2008-10-30-retirement-401k-funds-stocks-savings_N.htm.

[3] *See* discussion of Transition 2010 Fund *supra,* at text accompanying notes 39 - 45.

[4] *See generally* Mercer Bullard, Geoffrey Friesen & Travis Sapp, *Investor Timing and Fund Distribution Channels* (Dec. 2007) (discussing adverse effects of market-timing investment performance) *available at* http://ssrn.com/abstract=1070545.

excuse for protecting employers from liability when they choose to provide employees with *conflicted* advice that benefits advisers rather than participants. Yet the Department of Labor has become increasingly permissive regarding the providing of conflicted advice over the last decade. The codification of the Department's positions in the Pension Protection Act of 2006 ("PPA"), coupled with the Department's misinterpretation and expansion of the Act, expressly permit advisers to steer unsophisticated participants to investment products that maximize advisers' compensation rather than products that help participants' achieve financial security in retirement.

The effect of legal protections for conflicted advice is quite predictable. The securities industry has long been plagued by sales abuses that result in investment recommendations that are designed to profit financial services firms rather than serve the interests of investors. Pension consultants routinely are compensated by the money managers that they recommend to pension plans. The law prohibits any *quid pro quo* for such payments, but proving that a *quid pro quo* exists is next to impossible. Once a culture of pay-to-play has become widely accepted, it becomes impracticable to regulate it or to do business without participating in it.

The conflicted advice exemption not only will permit and promote conflicted advice; it also will suppress independent advice in the DC plan marketplace. Private pension plan service providers will bundle investment products, computer models and individualized financial advice in a single package. The cost of (conflicted) advice will be included in a bundled fee. This will require that independent advisers charge a separate fee that service providers will argue results in the participant's paying twice for financial advice. In fact, the double payment will actually occur when the participant pays once for conflicted advice and then again for higher fees paid for products that the conflicted adviser recommends.[5] Employers are likely to rely on the conflicted advice exemption, however, and limit advisory services only to those that produce conflicted recommendations. Rather than promote the providing of independent financial advice to participants, the exemption will promote conflicted advice, higher fees and lower investment returns.

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[5] *See* Mercer Bullard & Edward O'Neal, *The Costs of Using a Broker to Select Mutual Funds*, Institute for Higher Education Law & Governance Monograph Series, University of Houston Law Center (07-03) (discussing "broker penalty" incurred when investors pay both for advice and higher fund fees) *available at* http://www.zeroalphagroup.com/studies/113006_Zero_Alpha_Group_Fund_Democracy_Index_Funds_Report.pdf; *see also* Daniel Bergstresser, John Chalmers, and Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* (Oct. 1, 2007) (investors paying to purchase funds through intermediaries experience lower returns, consistent with inefficiencies created by conflicts of interest) *available at* http://ssrn.com/abstract=616981.

II. BACKGROUND

For decades, assets in defined contribution plans have been growing relative to defined benefit plans.[6] America's workers have often been made poorer as a result. Defined contribution plans place substantial responsibility on plan participants and expose them to significantly greater investment risk than defined benefit plans.[7] Whereas defined benefit plans generally are managed by professionals, and the promised benefits are federally insured, self-directed defined contribution plans are managed by participants who may know very little about investing and who bear the cost of misguided investment decisions.

In some respects, the regulation of defined contribution plans has exacerbated the risk to participants. For example, participants are permitted to invest 100 percent of their accounts in employer stock, notwithstanding that this allocation violates fundamental investment principles.[8] Permitting participants to invest 100 percent of their retirement assets in the stock of a single issuer when that issuer is also the participant's sole source of earned income is irresponsible. Yet many employers permit and effectively encourage their employees to invest in this manner.[9]

One of the unfortunate byproducts of the shift from defined benefit to defined contribution plans has been the introduction of sales abuses that have long been prevalent in the retail financial services market to the 401(k) market.[10] This

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[6] From 1997 to 2007, defined benefit plan assets increased from $1.8 trillion to $2.4 trillion, while defined contribution assets (including 401(k), 403(b) and 457 plan assets) increased from $1.7 trillion to $4.5 trillion. *The U.S. Retirement Market, 2007*, 17 Research Fundamentals at 2 (July 2008) *available at* http://www.ici.org/stats/mf/fm-v17n3.pdf.

[7] *See 401(k) Losses, supra* note 2 (quoting Karen Ferguson, Pension Rights Center: "All the risks and responsibilities are on the individuals in 401(k) plans").

[8] In 2007, 9.9% of 401(k) assets held by participants *in their sixties* were allocated to employer stock. *See* 2008 ICI Fact Book, at 93 (2008) *available at* http://www.ici.org/stats/mf/2008_factbook.pdf.

[9] 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). More than 60 percent of Enron's 401(k) assets, worth more than $1.3 billion in early 2001, were invested in Enron stock. *See Enron Employee Ride Stock to Bottom*, CNN.com (Jan. 14, 2002) *at* http://archives.cnn.com/2002/LAW/01/14/enron.employees/. The inadvisability of permitting participants to bet their retirement on a single company's stock contrasts with the prohibition against defined benefit plans' investing more than 10 percent of plan assets in the employer's securities.

[10] This is not to say that conflicts of interest are absent in the defined benefit context. *See Defined Benefit Plans: Conflicts of Interest Involving High Risk or Terminated Plans Pose Enforcement Challenges*, GAO-07-703 (June 28, 2007) *available at* http://www.gao.gov/new.items/d07703.pdf.

has been particularly true of abuses related to the distribution of mutual funds, which comprise more than half of all 401(k) assets.[11]

For decades, federal securities regulators have tolerated a system of undisclosed kickbacks to brokers who sell mutual funds. Quite simply, these kickbacks create economic incentives for brokers to recommend funds that pay them the highest compensation, as opposed to the funds that are best suited for their clients. If a broker sells a client 100 shares of IBM stock, he receives the same compensation that he would receive for selling 100 shares of Dell stock. But in the mutual fund world, the broker can choose from among funds that will pay him nothing to those that will pay him 8.5 percent of the invested amount. The financial incentives to provide conflicted advice are substantial.

There have been half-hearted attempts to rein in such abusive sales practices, but these practices are more entrenched today than ever. In the mid-1990s, complaints were made about brokers who routinely received incentive payments to recommend in-house funds. This practice led to the publication of the Tully Report, which set forth industry best practices for neutralizing brokers' conflicts of interest in selling mutual funds.[12] Before the ink was dry on the Report, brokers had developed ways to end-run the Report's standards. Branch chiefs, rather than line brokers, were compensated based on sales of particular funds, and contests were staged whereby brokers received noncash incentive payments as a way to circumvent restrictions on cash payments.[13]

Another abuse involved mutual funds' directing fund trades to brokers based not on the quality of execution provided, but on sales of fund shares.[14] These directed brokerage arrangements were known to regulators. Mutual funds routinely disclosed their directed brokerage arrangements in the depths of their registration statements while investors received no disclosure of their brokers' incentives to recommend funds that paid for distribution through directed brokerage.[15] Only when adverse publicity surrounding directed brokerage arrangements became too intense did regulators finally ban this practice.

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[11] In 2007, mutual funds comprised $1.674 trillion of $3.047 in total 401(k) assets. 2008 ICI Fact Book, at 92 (2008) *available at* http://www.ici.org/stats/mf/2008_factbook.pdf.

[12] *Report of the Committee on Compensation Practices* (Apr. 10, 1995) *available at* http://www.sec.gov/news/studies/bkrcomp.txt.

[13] *See* NASD Notice 05-40 (2005) (never-adopted proposal to amend non-cash compensation rule to prohibit non-cash sales contest with respect to sales of mutual fund shares).

[14] *See* NASD Rule 2830 (2008) (rule amended in 2005 to prohibit broker-dealers from selling mutual fund shares if fund or its adviser has directed brokerage to the broker-dealer for the purpose of promoting the sale of fund shares).

[15] Last year, the SEC settled charges against traders and senior executives at a major fund firm that had accepted gifts and other benefits from broker-dealers to which the funds sent brokerage

Hidden incentive payments to brokers continue to plague the industry. Mutual funds frequently make payments for shelf space (also known as revenue sharing)[16] to increase fund sales, and regulators do not require that brokers disclose this conflict of interest to their clients. Remarkably, undisclosed revenue sharing payments are still permitted today, with the only restraint on them coming from state regulators who have been willing to bring state claims against funds and their distributors who engage in such abusive sales practices.[17]

Similar abuses also have plagued the pension consultant business. In 2005, the SEC published a staff study on conflicts of interest in the pension consultant industry that painted an appalling picture of rampant conflicts of interest and inadequate disclosure to plans and participants.[18] The staff found, for example, that more than half of the inspected pension consultants "provided products and services to both pension plan advisory clients *and* money managers and mutual funds on an ongoing basis," with compensation received from money managers in some cases comprising "a significant part of [the consultant's] annual revenue." More than half of the consultants were affiliated or had relationships with broker-dealers through which they received undisclosed compensation. These relationships raised concerns that:

- "plan assets may not be receiving 'best execution' because their trades are directed to the broker that provides these rebates,"
- "plans may overpay for the pension consultant's services because the directed

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business. *See In the Matter of Fidelity Management and Research Co.,* Admin. Proc. File No. 3-12976 (Mar. 5, 2008)(finding that fund manager executives and traders received "approximately $1.6 million in travel, entertainment and gifts" and that the "traders allowed the receipt of travel, entertainment and gifts to influence their selection of brokers to handle transactions for Fidelity's clients.") *available at* http://www.sec.gov/litigation/admin/2008/ia-2713.pdf.

[16] The term "revenue sharing" has acquired a variety of meanings. In the retail mutual fund context, it generally refers to a form of distribution payments to brokers, although it can be used to include payments for administrative services as well. In the pension context, the term has been used primarily to refer to payments for administrative services, such as a fund's payments to plan administrator to compensate it for recordkeeping, although it can include distribution payments.

[17] *See*, *e.g.*, *California v. American Fund Distributors, Inc., et al*., Case No. BC 330774 (Cal. Atty Gen.); *In the Matter of American Express Financial Advisors, Inc.*, INV04-122 (N.H. Bureau of Sec. Reg.); *In the Matter of Morgan Stanley DW*, E-2003-53 (Mass. Sec. Div.). (In the interest of full disclosure, I provided expert consulting services and testimony to the prosecution in connection with California and Massachusetts matters.)

[18] *Staff Report on Examinations of Select Pension Consultants*, Office and Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (May 16, 2005) *available at* http://www.sec.gov/news/studies/pensionexamstudy.pdf. Following the publication of this report, the SEC and the Department published: *Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries* (June 1, 2005) *available at* http://www.sec.gov/investor/pubs/sponsortips.htm.

brokerage arrangements may not be capped to terminate when fees due a pension consultant have been paid in full," and

- "these arrangements may provide an incentive for a pension consultant to recommend an active trading strategy, because the pension consultant or its affiliated broker may receive more money in commission payments."

The SEC's inspections ultimately led to at least two enforcement actions.[19]

The actual effect of such conflicted arrangements is difficult to prove. In 2007, the GAO found that pension consultants with significant undisclosed conflicts of interest with their defined pension fund clients had annual returns that were 1.3 percentage points lower than for other consultants.[20] What is particularly troubling about these abuses and the abuses uncovered by the SEC is that they have been foisted on presumably sophisticated plan fiduciaries. Unsophisticated participants are even less likely to be able to discern and defend against abusive sales practices that the conflicted advice exemption permits.

As indicated by the SEC's and GAO's report on pension consultants, these practices have now infected the 401(k) market, although ERISA provides some additional investor protections that are lacking in the securities context. In contrast with brokers' and securities regulators' position that providing personalized investment advice does not create a fiduciary relationship or otherwise trigger a duty to disclose revenue sharing payments,[21] ERISA expressly classifies persons

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[19] *See In the Matter of Callan Associates*, Admin. Proc. File No. 3-123808 (Sep. 19, 2008) (pension consultant failed to disclose payments from broker-dealer in connection with trades by consultant's pension clients) *available at* http://www.sec.gov/litigation/admin/2007/ia-2650.pdf; *In the Matter of Yanni Partners, Inc.*, Admin. Proc. File No. 3-12746 (Sep. 5, 2007)(pension consultant misled pension clients regarding undisclosed payments from money managers that it recommended) *available at* http://www.sec.gov/investor/pubs/sponsortips.htm; *see also SEC Charges Merrill Lynch With Misleading Pension Consulting Clients*, SEC Press Release (Jan. 30, 2009)("Merrill Lynch failed to disclose its conflicts of interest when recommending that clients use directed brokerage to pay hard dollar fees, whereby the clients directed their money managers to execute trades through Merrill Lynch") *available at* http://www.sec.gov/news/press/2009/2009-13.htm.

[20] *See Conflicts of Interest*, *supra* note 10.

[21] *See*, *e.g.*, Letter from Mary Schapiro, Vice Chairman and President, NASD, and Elisse Walter, Executive Vice President, NASD to Annette Nazareth, Director, Division of Market Regulation, and Meyer Eisenberg, Acting Director, Division of Investment Management, U.S. Securities and Exchange Commission (Apr. 4, 2005) (lobbying on behalf of FINRA for a suitability standard rather than a fiduciary standards for brokers) *available at* http://www.sec.gov/rules/proposed/s72599/nasd040405.pdf. Ms. Schapiro is currently SEC Chairman, and Ms. Walter is an SEC Commissioner. The fiduciary advisers who are covered by the PPA exemption include brokers who are not registered investment advisers. *See* 29 U.S.C. § 1108(g)(11)(A)(iv).

who exercise discretion over any aspect of a plan or provide advice to participants as fiduciaries.[22]

Another advantage of ERISA is that ERISA fiduciaries, including persons who advise plan participants, are generally prohibited from receiving additional compensation from plan product providers.[23] The prohibited transaction provisions of ERISA are generally designed to prevent plan fiduciaries from being paid by parties on both sides of a plan transaction.[24] For example, if a plan fiduciary receives a fee for providing investment advice to plan participants,[25] then the fiduciary cannot be compensated in connection with products that the fiduciary recommends. This prohibition is violated when a plan fiduciary advises participants to invest in a way that results, directly or indirectly, in additional compensation to the fiduciary. Thus, whereas in the securities context conflicted fees not only are permitted but also are allowed to be hidden from investors, ERISA prohibits the payments of conflicted fees in the first place. The need for disclosure should not even arise.

The Department of Labor has chipped away at ERISA's statutory protections, however. For example, the Department has permitted plan fiduciaries to receive payments from third parties provided that the amount of the payments is applied to offset (reduce) payments to the fiduciary by the plan. In theory, requiring a matching fee offset eliminates the economic incentive that otherwise would exist for the fiduciary to favor the third party that paid the highest fees. This is the approach taken in the *Frost Bank* opinion, where the Department permitted a plan fiduciary that sponsored plan investment products to receive additional compensation for advising participants as long as the additional compensation was applied to offset other compensation paid to the fiduciary by the plan.[26]

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[22] 29 U.S.C. § 1002(21)(A).

[23] *See* 29 U.S.C. § 1106; *401(k) Plan Sponsor Practices*, GAO-08-774, at 6 ("Fiduciaries cannot receive money or any other consideration for their personal account from any party doing business with the plan related to that business.") *available at* http://www.gao.gov/new.items/d08774.pdf.

[24] *But see Changes Needed to Provide 401(k) Plan Participants and the Department of Labor with Better Information on Fees*, GAO-07-21 (Nov. 2006) (discussing payments between pension plan service providers); *Conflicts of Interest*, *supra* note 8 (GAO report regarding undisclosed compensation arrangements in defined benefit context).

[25] *See* 29 C.F.R. § 2510.3-21(c) (2007) (defining "investment advice").

[26] *See* Advisory Opinion 97-15A (May 22, 1997); *see also* Advisory Opinion 2005-10A (May 11, 2005) (commonly cited as *COUNTRY Trust Bank*, permitting fiduciary bank providing custodial, advisory and other services to receive IRA fees from mutual funds affiliated with bank if fees are offset); *see generally* Interpretive Bulletin 96-1, 29 C.F.R. sec 2509.96-1 (provision of certain educational materials to plan participants does not constitute investment advice under ERISA).

The Department again weakened ERISA's fiduciary foundation in its *Sunamerica* opinion.[27] *Sunamerica* permits a plan fiduciary to receive additional compensation for providing investment advice to beneficiaries *without* any fee offset. The only provision in *Sunamerica* that limits the fiduciary's incentive to recommend products that will generate the highest profits for the fiduciary is the requirement that the advice result from guidance produced by a computer-based model designed by an independent party. As discussed below in connection with the PPA's computer model exemption, this restriction in *Sunamerica* provides little protection against advisers' making recommendations that are designed to further their best interests rather than the best interests of participants.

The PPA and related Department positions have substantially expanded *Frost Bank* and *Sunamerica* by permitting conflicts of interest to infect a wide range of recommendations provided to plan beneficiaries. The PPA exempts two types of "eligible investment advice arrangements" from ERISA's prohibited transaction provisions.[28] The first type requires that the adviser's fees "not vary depending on the basis of any investment option selected."[29] The second type requires the use of "a computer model under an investment advice program meeting the requirements of [PPA section 601(a)(1)] in connection with the provision of investment advice by a fiduciary adviser to a participant or beneficiary."[30] As discussed below, these exemptions, especially as interpreted and further expanded by the Department, have opened the door wide for plan fiduciaries to provide advice to participants that is motivated not by participants' best interests, but by fiduciaries' incentive to maximize their own compensation.[31]

III. FEE-LEVELING EXEMPTION

Section 601(a)(1) of the PPA permits a fiduciary to be compensated for providing investment advice to beneficiaries as long as the fiduciary's fees do "not vary depending on the basis of any investment option selected." This restriction appears sound on its face. If the fiduciary's compensation is unaffected by the

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[27] *See* Advisory Opinion 2001-9A (Dec. 14, 2001).

[28] *See generally* Jon Shimabukuro, *Investment Advice and the Pension Protection Act of 2006*, Congressional Research Service (Mar. 11, 2009) *available at* http://aging.senate.gov/crs/pension24.pdf.

[29] 29 U.S.C. § 1108(g)(2)(A)(i).

[30] 29 U.S.C. § 1108(g)(2)(A)(ii).

[31] *See* 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.

advice he provides, then, in theory, he has no economic incentive other than to continue to keep his beneficiary clients satisfied with his services.

But the reality is more complex. As noted in a comment letter submitted to the Department by Fund Democracy and the Consumer Federation of America, there are too "many firms that profit not by the quality of their products but by the ingenuity of their sales practices."[32] Mutual fund salesmen are compensated for selling fund shares, and part of their job is to find ways to incentivize advisers to recommend the salesmen's funds. If the salesmen and advisers are employed within the same organization, the salesmen's job becomes that much easier.

The Department's class exemption permits not only an adviser's affiliates but also the adviser's ***employer*** to receive increased fees as a result of the adviser's investment option recommendations. As stated by the Department:

> [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.[33]

The Department's distinction between the adviser and his employer for fee-limiting purposes defies reason. Its position would permit 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 and its executives' profits. 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. [34] Effectively amending the fee-leveling exemption not to

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[32] Letter from Mercer Bullard, President and Founder, Fund Democracy, and Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Fred Wong, Office of Regulations and Interpretations, Employee Benefits Security Administration (Oct. 6, 2008) *available at* http://www.dol.gov/ebsa/pdf/cmt-10070811.pdf.

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

[34] *See* Letter from Senators Bingaman, Grassley, and Kennedy, *supra* note 31 (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

apply to the adviser's employer effectively renders the statutory exemption's fee-leveling requirement meaningless.[35]

The Department's liberal interpretation of the statutory exemption is also overbroad. An adviser awill 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. The financial services industry argues "that it would be unreasonable to require financial institutions to avoid their own products when providing services to plans,"[36] but what is truly unreasonable is permitting product sponsors to act as advisers to participants and be paid for recommending their own products. It is difficult enough designing rules that will prevent product sponsors from providing financial incentives to *independent* advisers to recommend the sponsors' products. As discussed above, this is accepted practice in the retail mutual fund context. It is impossible to prevent such arrangements when the product sponsor and adviser are part of the same organization.[37] Investment advice provided pursuant to the fee-leveling provision cannot eliminate advisers' incentives to increase their affiliates' profits.

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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.").

[35] It appears that the Department correctly interprets the statutory fee-leveling exemption to prohibit an adviser's employer to receive unlevel fees. *See* Field Assistance Bulletin No. 2007-01 (Feb. 2, 2007) ("both the individual and the entity [individual's employer] would be treated as fiduciary advisers and subject to the limitations of [the fee-leveling provision]."). It has been suggested, however, that because the definition of "fiduciary adviser" refers to a person who provides investment advice "***and*** is an affiliate of an investment adviser" (emphasis added), the fee limiting provision applies only to the person and not the employer. This misinterprets the fee-limiting provision. First, the reference here is to the person as an "affiliate," not the employer. Second, the person providing the advice would qualify to do so only in his capacity as an affiliate the employer, *i.e.*, the definition of "fiduciary adviser" incorporates by its terms the person's status as an affiliate and thereby any fees received within that status would be fees received by the fiduciary adviser. Third, if the employer were not a fiduciary adviser, the fee-limiting provision would never limit fees because the fees paid by the plan would not be received by the "fiduciary adviser" as long they were received by the employer, and the fees received by the person would be received as employment compensation for providing services to the employer (there would be no contractual privity between the person and the plan). Fourth, as described above, such a split-fiduciary-adviser interpretation is absurd as a practical matter because it would completely eviscerate the practical effect of the fee-limiting provision. It is my opinion that an independent-minded federal court would find that the split-fiduciary-adviser interpretation contradicted the plain meaning of the fee-limiting provision.

[36] *ERISA Advisory*, Steptoe & Johnson (Feb. 3, 2009) *available at* http://www.steptoe.com/publications-5869.html.

[37] *See* Letter from Representative George Miller, Chairman, House Committee on Education and Labor & Representative Rob Andrews, Chairman, House Subcommittee on Health, Education, Labor, and Pensions, to Bradford (Oct. 8, 2008) ("the Department's proposal would not prohibit advisers from making recommendations that are more beneficial to its affiliates") *available at* http://www.dol.gov/ebsa/pdf/cmt-10150802.pdf.

The only truly effective remedy for this problem is the repeal of the PPA's conflicted advice provisions. Congress specifically mandated an exemption for fee-leveling arrangements. The Department has no choice but to implement the express intent of the statute. Nonetheless, the fee-leveling exemption leaves significant room for interpretation, and the Department has the authority to narrow substantially participants' potential exposure to conflicted advice. By interpreting the fee-leveling provision to prohibit advisers from receiving *any direct or indirect benefit* as a result of the investment option selected, the adverse effects of the exemption could be significantly mitigated.

To a limited extent, the Department has adopted this approach. For example, the Department's proposed exemption states that "[a]ny fees or other compensation (including salary, bonuses, awards, promotions, commissions or other things of value) received, directly or indirectly" that vary depending on the investment option selected would be inconsistent with the fee leveling provision. These broad terms could limit the extent to which the financial fortunes of an affiliate that offered an investment option could affect an adviser's incentives. The Department should be applauded for taking steps to ensure that any financial benefit received by an adviser on account of his investment recommendations, including "trips, gifts and other things that while having a value, are not given in the form of cash," would violate the fee-leveling requirement.

Unfortunately, very little ingenuity will be needed to circumvent these restrictions on selling compensation. The Department has expressly authorized bonus programs that result in the adviser's compensation being increased depending on the investment options selected. The Department stated that an adviser's bonus program could be based on the overall profitability of an organization that included both the adviser and an affiliate whose fees varied depending on the selected investment option if the investment option and advice "constituted a negligible portion of" the calculation of the adviser's bonus. This position might appear to be a reasonable and necessary accommodation of the structure of the financial services firms, but it will assuredly undermine the fee-leveling requirement. Once a bonus program is permitted to provide "negligible" benefits to advisers who recommend an affiliate's products, it will provide more than negligible benefits that will be impossible to monitor. If a structure is permitted through which some form or selling compensation can be paid to an adviser, it will be used by some to provide incentives that affect the adviser's recommendations to the detriment of participants.

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 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.[38] Even this approach is inadequate, for at some point the industry's ingenuity will find ways to incentivize advisers to favor higher-fee options. But the only way to eliminate an adviser's financial incentive to favor his affiliate's higher-fee options is through the repeal of the statutory exemption.

IV. COMPUTER MODEL EXEMPTION

Section 601(a)(1) of the PPA permits conflicted advisers to be compensated for providing investment advice to participants as long as the adviser uses "a computer model under an investment advice program meeting the requirements of [PPA section 601(a)(1)] in connection with the provision of investment advice by a fiduciary adviser to a participant or beneficiary." Unlike the fee-leveling exemption, the computer-based model exemption does not prohibit advisers from receiving increased fees as the result of steering participants to the investment options that are most profitable for the advisers' affiliates. The computer model thereby enables advisers to circumvent the fee-leveling provision simply by providing conflicted advice within the context of a computer-generated asset allocation recommendation. What the fee-leveling provision purports to prohibit, the computer model exemption effectively encourages.

The Department's class exemption expressly authorizes advisers to exercise broad discretion to advise participants within the "context" of computer-generated recommendations. Under this standard, advisers will easily be able to make recommendations designed to serve their affiliates' interests rather than participants' interests within the scope of computer-generated recommendations. For example, the affiliate's equity funds may have higher expense ratios and generate higher levels of profitability than its bond funds, which the adviser therefore would have a greater incentive – and could be paid higher fees – to recommend. Alternatively, the affiliate may prefer that the adviser recommend a new fund with a small asset base in order to generate economies of scale and increase profitability. New funds often reflect hot investing trends that collapse soon after the fund has gathered significant assets, such as occurred during the Internet investment boom of the late 1990s. The current computer model exemption provides ample leeway for an adviser to steer participants to funds for the benefit of affiliates. Nothing in the exemption expressly prohibits the adviser from receiving higher fees for doing so.

[38] In other words, it would not be sufficient to require "fee leveling," because the conflict of interest for the affiliate arises not out of the size of the fee, but the profitability of the investment option. One investment option may have higher fees than another, but the lower-fee investment option may be more profitable and therefore be preferred by adviser's affiliate. Advisers' compensation therefore must be completely unaffected by the economic performance of the affiliate that provides the investment option, regardless of whether the fees for different investment options are "level."

For example, a computer model that produced an age-appropriate asset allocation recommendation for investments in equity funds generally would qualify under the exemption. These models will not even be required to be created by an independent party, as mandated in *Sunamerica*. Rather, they can be designed by the same fiduciary who stands to benefit from the freedom the model provides to the adviser to make conflicted recommendations to participants. The adviser would be free to recommend the equity funds offered by the plan that would be most profitable to the fund's sponsor. The adviser also would have an incentive to recommend actively managed funds over passively managed funds, because the former are more profitable to their sponsors. The exemption would not prevent the adviser from receiving increased compensation as a result of these recommendations because the fee-leveling provision would not apply.

The fatal flaw in the computer model exemption is illustrated by the structure and recent performance of certain target-date funds. A target-date fund used as a plan investment option creates the functional equivalent of a computer model exemption. The target-date fund's asset allocation reflects, in effect, the fund manager's "advice" to beneficiaries regarding the appropriate mix of investments for a participant who plans to retire at the stated target date. Such "advice" is not subject to ERISA's prohibited transaction provisions, because mutual fund managers generally are excluded from being treated as plan fiduciaries with respect to fund assets.[39] The fund manager therefore is permitted to charge a fee (although many do not) at the target-date fund level for asset allocation advice and a second fee at the level of the underlying equity and bond funds in which the target-date fund invests. If some of these underlying funds generate higher profits for the adviser, the adviser has an incentive to allocate a higher percentage of assets to the more profitable funds.

The following example of an actual target-date fund illustrates the potential problem with the computer model exemption. The Transition 2010 Fund's target equity allocation as of mid-2008 was 65 percent, with an additional 5 percent allocated to a commodity fund "designed for aggressive investors seeking total return over the long term." In contrast, the average target equity allocation for all target-date 2010 funds was 45 percent as of the end of 2008.[40] All of the assets of the Transition 2010 Fund are invested in affiliated underlying funds managed by the same manager, and all of them are higher-priced, actively managed funds.[41] The

[39] *See* 29 U.S.C. § 1002(21)(B).

[40] This figure is based on a search by Craig Israelsen of Target Date Analytics using the Morningstar Principia database as of December 31, 2008, of all funds with a 2010 target date. The figure reflects the simple average of the actual percentage of equity holdings of the funds as of December 31, 2008. Dr. Israelsen is a professor at Brigham Young University in Provo, Utah.

[41] It is unclear how an employer could fulfill its fiduciary duty in selecting plan investments without offering passively managed options. Under any reasonable understanding of a fiduciary standard, requiring that plan participants assume active management risk, not to mention the burden of higher

expense ratio of the Transition 2010 Fund's Class Y shares (the share class that a plan would purchase) is 1.25 percent, which includes expenses of 0.59 percent charged by the underlying affiliated funds. The expense ratios of the underlying funds are as follows:[42]

Equity & Commodity		Fixed Income	
Capital Appreciation	0.69%	International Bond	0.54%
Main Street	0.49%	Core Bond	0.49%
Value	0.54%	Champion Income	0.64%
MidCap	0.84%	U.S. Government	0.64%
Small- & MidCap Value	0.76%		
Global	0.70%		
Main Street Opportunity	0.69%		
Commodity Strategy Total Return	0.86%		
Average:	0.70%	Average:	0.58%

As indicated in this table, the average expense ratio for the underlying equity & commodity funds is 0.70%, which is 0.12 percentage points higher than the average expense ratio for the fixed income funds. Although the profitability of a particular fund depends on a variety of factors, equity funds generally are more profitable than bond funds, all other factors being equal. Thus, the manager of the Transition 2010 Fund may have a financial incentive to allocate a higher percentage of assets to its more profitable equity funds, which is precisely what the manager has done in this case. The 70 percent equity/commodity allocation is 78 percent higher than the average 45 percent equity allocation for all 2010 funds.[43] Perhaps this difference

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fees, violates an employer's fiduciary duty to the plan and its participants. *See DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 418 (4th Cir. 2007)(404(c) safe harbor "does not apply to a fiduciary's decisions to select and maintain certain investment options within a participant-driven 401(k) plan;" citing Department sources); *see also* Kenneth French, *The Cost of Active Investing* (Apr. 12, 2008) (estimating annual cost of active management to be 0.67%); Ross Miller, *Measuring the True Cost of Active Management by Mutual Funds* (Aug. 2005)(finding that actively managed funds' "active expense ratios" are more than six times higher than their published expense ratios of 1.15%).

[42] All of the expense ratios, including the 1.25 percent expense ratio for the 2010 Fund, reflect fees after a fee waiver. If the fund manager were to eliminate the waiver, the expense ratios would be higher. All of the expense ratios are based on Class Y shares.

[43] This reflects a failure of securities regulation. A fund with the name "Transition 2010 Fund" implies an allocation that is substantially more conservative that 70 percent equity/commodity, yet the SEC has chosen not to require that funds that choose a name that strongly implies a particular allocation or investment style to stick to that allocation or style. Pursuant to a request from consumer advocates, the SEC adopted a misleading fund names rule in 2001, but the rule fell far short of providing reasonable assurances that fund names that strongly implied a particular investment objective or style would stick to it. *See generally Enhancing Investor Protection and the Regulation of the Securities Markets*, hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, at 28 – 32 (Mar. 10, 2009) (testimony of Mercer Bullard discussing misleading target-date funds) *available at*

reflects the fund manager's sincere view that a 64-year-old on the brink of retirement should have an aggressive, 70 percent equity/commodity allocation.[44] It would be practicably impossible to prove otherwise without a "smoking gun" document stating that the purpose of the allocation was, in fact, to increase the manager's profits.[45] Nonetheless, that may be the conflicted manager's actual goal.

As this example illustrates, the kind of asset allocation generated by a computer model will afford advisers significant discretion to steer participants to the funds that are most profitable for fund managers, rather than most suitable for participants. And nothing in the exemption expressly prohibits the adviser from receiving a higher fee for doing so. The idea that limiting the adviser's discretion to the scope of recommendations generated by a computer model will neutralize his incentive to provide conflicted advice is an illusion. ***The practical effect of the computer model exemption is to permit the adviser to circumvent the fee-limiting provision simply by providing the conflicted advice in the context of a computer model.***[46]

http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=faf91bea-ca58-4bc1-873d-33739dbb4f76&Witness_ID=c99e77ff-e9a6-4763-9095-cfb7ebb3a555.

[44] Overly aggressive equity allocations in target-date funds were fully discussed at last month's Senate Special Committee on Aging hearing: *Boomer Bust? Securing Retirement in a Volatile Economy*. The written and oral statements and testimony for this hearing are *available at* http://aging.senate.gov/hearing_detail.cfm?id=309027&. *See also Enhancing Investor Protection, supra* note 41, at 28 – 32 (discussing misleading target-date funds). The same conflict of interest exists in the 529 plan market, where allocations of assets needed within 1 or 2 years have often been substantially invested in stocks. *See* Jason Zweig, *Did Your College Savings Plan Blow Up on You?*, Wall. St. J. (Mar. 20, 2009)("'In some states, the asset allocation for the 16- to 18-year-olds looks as if it was designed by the 5-year-olds.'"); *Enhancing Investor Protection, supra,* at 30.

[45] It should be noted that the Investment Company Act prohibits a fund manager from reallocating assets among funds in a way that increases the fund manager's fees without first obtaining shareholder approval. Over the objections of Fund Democracy and other investor advocates, however, the SEC has routinely permitted funds to increase their fees in this way without shareholder approval. *See Exemption from Shareholder Approval for Certain Subadvisory Contracts*, Investment Company Act Rel. 26230 (Oct. 23, 2003)(proposing permanent exemption and discussing numerous exemptions granted on case-by-case basis) *available at* http://www.sec.gov/rules/proposed/33-8312.htm#P42_4370; Letter from Mercer Bullard, President and Founder, Fund Democracy, and Barbara Roper, Director of Investor Protection, Consumer Federation of America to Jonathan Katz, Secretary, U.S. Securities and Exchange Commission (Jan. 8, 2004) (opposing proposed permanent exemption from requirement that fee increases be subject to shareholder approval) *available at* http://www.funddemocracy.com/Multi-Manager%20Comment%20Letter.pdf.

[46] *See* Letter from Senators Bingaman, Grassley and Kennedy, *supra* note 31 ("the Department explicitly ignores that requirement that only the computer-generated advice can be provided, and instead states that computer-generated models merely provide a 'context' for other forms of advice.").

The investor protection provisions of the class exemption are not adequate to prevent abuses. The class exemption requires, for example, that the basis for the advice provided be explained to the beneficiary and documented, to include an explanation as to "why the advice includes an option(s) with higher fees than other options in the same asset class(es) available under the plan."[47] While this requirement appears to address the problem of conflicted advice provided within the scope of a computer model recommendation, it has little practical utility. The adviser need only "explain" and "document" that the higher fee options are expected to generate higher risk-adjusted returns after taking into account the additional fees. The disclosure and documentation provision is virtually unenforceable. Proving that a preference for a higher fee investment option actually resulted from the receipt of incentive compensation from the higher-fee option's sponsor is not practicable.[48]

Another difficulty with the explanation requirement is that it is triggered at the time that the conflicted advice is provided. Rather, the adviser's conflicts should be fully disclosed at the inception of the advisory relationship. As pointed out by Chairman Miller and Chairman Andrews, once the relationship is underway, participants will already have established the kind of dependence on the advisor that will neutralize the effect of any subsequent cautionary conflict disclosure.[49] Finally, it is unclear, if the explanation is to be documented, why that documentation cannot be provided to the participant at the time of the recommendation (or at the inception of the relationship), rather than merely being filed up to 30 days later. Under the Investment Advisers Act, investment advisers are required to provide

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[47] 29 § 2550.408g–1 (d)(6)(ii)(A)(2) (as proposed).

[48] The Department's failure to adopt final rules regarding plan fee disclosure further exacerbates the problem of conflicted advice because participants cannot easily discern differences among fees charged by different options or make comparisons to fee benchmarks. *Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans*, 73 F.R. 43013 (July 23, 2008). One significant omission it the Department's pending proposal is that it lacks any requirement for meaningful comparisons to fee benchmarks. *See Hidden: 401(k) Fees: How Disclosure Can Increase Retirement Security*, Hearing before the Special Committee on Aging, U.S. Senate (Oct. 24, 2007)(testimony of Mercer Bullard) *available at* http://aging.senate.gov/events/hr182mb.pdf; Letters from Mercer Bullard, President and Founder, Fund Democracy, and Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Office of Regulations and Interpretations, Employee Benefits Security Administration (July 24, 2007 and Sep. 8, 2008) *respectively available at* http://www.funddemocracy.com/401k%20fee%20letter%20final.pdf and http://www.dol.gov/ebsa/pdf/cmt-09090810.pdf.

[49] *See* Letter from Miller and Andrews, *supra* note 37 ("30-day notice period fails to ensure that participants have critical information about possible conflicts of interest before they make investment decisions"); *cf.* Letter from Fund Democracy, Consumer Federation of America, Consumer Action and Consumers Union to Secretary, U.S. Securities and Exchange Commission (Apr. 21, 2004) (disclosure provided by brokers to mutual fund investors regarding brokers' receipt of incentive compensation "should be provided prior to the engagement, as it is for investment advisers") *available at* http://www.funddemocracy.com/confirmation%20comment%20letter.pdf.

clients with a brochure at the inception of the relationship that identifies, among other things, the adviser's compensation arrangements.

With respect to plans that permit investments other than those designated by the plan, conflicted advisers will have even broader discretion to receive incentive compensation for advising participants to invest in higher fee investment options. The exemption permits advisers to receive higher fees for pushing higher fee options as long as the participant, before receiving the conflicted advice, is:

> furnished with material, such as graphs, pie charts, case studies, worksheets, or interactive software or similar programs, that reflect or produce asset allocation models taking into account the age (or time horizon) and risk profile of the beneficiary, to the extent known.[50]

In other words, the adviser can avail himself of this lower standard when recommending non-designated options without the guidance even having to satisfy the already malleable requirements for a qualifying computer model.[51]

Another deficiency in the computer exemption is that it is not required to take employer securities into account if such securities are a plan investment option.[52] Any computer model that purported to take employer securities into account and that complied with the requirement that the model apply "generally accepted investment theories"[53] would recommend a zero allocation to employer securities. If the model were modified to accommodate a participant who insisted on investing some part of his account in employer securities, it would recommend that the investment be limited to no more than 10 or 20 percent of the account. Permitting computer models to exclude employer stock serves the employer's interests by obscuring the imprudence of a participant's investing in employer stock. One purpose of encouraging the use of an objective computer model should be to inform participants about the inadvisability of such investments.

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[50] 29 § 2550.408g–1(d)(3)(ii) (as proposed).

[51] If there are plan-designated options, the advice must be preceded by a qualifying computer-based model, but the non-designated options still need only be preceded by information that complies with this lower standard. *See id*. In the case of IRAs, the lower standard applies only if the "types or number of investment choices reasonably precludes the use of [qualifying] computer model," whereas in the non-IRA context it appears that the lower standard is available even if a computer-based could reasonably have been used. *Id*.

[52] 29 § 2550.408g–1(b)(4)(i)(F)(*2*)(*i*) (as proposed).

[53] *See* 29 U.S.C. § 1108(g)(3)(b)(i); 408g(b)(4)(i)(A)). There is no generally accepted investment theory that would accommodate a material investment of retirement plan assets in securities issued by a person's employer. Such an investment could only be justified if it reflected the express, informed (if ill-advised) decision of the plan participant.

In addition, it is not clear what the Department means regarding the requirement that the computer model "take into account the fact that the participant or beneficiary has such an investment when giving advice with respect to the participant's or beneficiaries remaining assets or investments." If a model takes into account a participant's plan holdings in employer securities, it should generate a recommendation that these holdings be reduced or eliminated. The Department's discussion creates the very different impression, however, that a model could satisfy the "generally accepted investment theories" requirement and simply treat the investment in employer stock as just another equity investment to be counted toward the participant's equity allocation. The Department should correct this misleading impression and clarify that computer models must take into account employer stock options and holdings in a way that is consistent with the "generally accepted investment theories" requirement. While the model must be designed to accommodate participants who *insist* on making significant investments in employers' stock, the adviser should be required also to present the recommendation that the model would produce without taking the participant's preferences for employer stock into account.

V. CONCLUSION

The PPA's conflicted advice exemption and the Department's interpretation and extension thereof will have the effect of promoting conflicted investment advice to pension plan participants. To some extent, this can be corrected by administrative action. The Department should withdraw its class exemption and correct its misinterpretation of the statutory exemption, which would greatly mitigate the potential adverse effects of conflicted advice. The elimination of the incentives to provide conflicted advice can only be accomplished, however, by repealing the statutory exemption. In order to promote independent advice, Congress should enact legislation, or the Department a class exemption, that creates an employer safe harbor that is available solely for independent investment advice.