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Sent via E-Mail to e-ORI@dol.gov

May 5, 2010

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: 2010 Investment Advice Proposed Rule
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington DC 20210

Re: Investment Advice-Participants and Beneficiaries Proposed Rule
Docket ID EBSA-2008-0011 (RIN 1210-AB35)

Ladies and Gentlemen:

On behalf of the more than 11 million working men and women of the AFL-CIO and Working America, its community affiliate, we offer our comments on the proposed rule implementing the statutory exemption on investment advice under Sections 408(b)(14) and 408(g) of the Employee Retirement Income Security Act of 1974, as amended (ERISA).[1]

The importance of strong, meaningful regulatory safeguards to avoid conflicts of interest in the provision of investment advice is of the utmost importance, particularly now as participants continue to deal with significant declines in the value of their retirement savings. As a result of the collapse in our financial markets in 2008, there have been enormous losses in participant account balances in Section 401(k) and other individual account plans, as well as IRAs. Defined contribution plans of all types lost $2 trillion between October 2007 and October 2008 and the market value of assets in Section 401(k) plans and IRAs fell by 30 percent,

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[1] The statutory exemption was added by Section 601 of the Pension Protection Act of 2006, Public Law 109-280, 120 Stat. 780 (Aug. 17, 2006). The proposed rule was published in the Federal Register on March 2, 2010 (75 Fed. Reg. 9360).

according to the Center for Retirement Research at Boston College.[2] At this point, the wrong advice could permanently damage retirement savings if the decline in the value of equity investments were realized. Participants could also be harmed even more by self-interested investment advice as financial service providers face pressure to attract business and assets for investment.

In our view, the final rules published on January 20, 2009 (74 Fed. Reg. 3822), particularly the class exemption, inappropriately expanded the provision of investment advice by financial institutions with conflicts of interest and undermined the modest protections included in Sections 408(b)(14) and 408(g) of ERISA. We commend the Department for withdrawing the January 2009 final regulation and we appreciate that the proposed regulations do not include a revised version of the withdrawn class exemption. However, as discussed below, the proposed regulations still fail to address certain shortcomings we had previously raised.

Before turning to our concerns about the proposal, we offer our responses to the questions the Department poses on the conditions applicable to computer models.

The questions posed by the Department suggest the difficulties involved in trying to police the substance of conflicted investment advice once the conflict is allowed to exist. Some general principles of investment management are widely accepted both academically and in the case law of ERISA – e.g. diversification across asset classes adjusted to reflect the age and risk tolerance of the beneficiary. However, there is no consensus as to exactly what the allocation should be within an individual's portfolio even as between broad asset classes, and no real consensus as to how to treat assets, such as a home, in determining asset allocation within a retirement account—is a home best understood as highly risky leveraged real estate equity, or as something more akin to a stable fixed income asset?

So, for example, if one advisor recommends a portfolio of 60% equities and 40% fixed income to a 45 year old, and another advisor's algorithm recommends 50% of each for the same person, it is unfortunately true that it is not possible to say that one of these two options is clearly irresponsible. However, it is highly likely that the former allocation will result in more profits for an affiliated fund management complex than the latter allocation.

On the question of the relevance of past performance, there is significant academic finance literature suggesting that the past performance of active mutual fund managers is not statistically significantly correlated with future performance. However, it is commonplace in the investment management business to use past performance as a key method of selecting funds where the objective is future performance in spite of the academic evidence that this is futile.

The Department asked under what circumstances it should be permissible for an algorithm to recommend a high performance, high fee fund over a median performance low fee

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[2] Alicia Munnell, Francesca Golub-Sass, and Dan Muldoon, *An Update on 401(k) Plans: Insights from the 2007 SCF*, Center for Retirement Research at Boston College, Brief Number 9-5 (March 2009) available at http://crr.bc.edu/images/stories/Briefs/ib_9_5.pdf.

fund. We believe this should only be permissible if neither the advisor nor its affiliate is in a position to benefit from the fee. Consequently, if the Department is insistent on giving an exemption to affiliates of the advisor from the fee leveling provisions of the PPA (see below), we believe the Department must require advisors that take advantage of that provision to use algorithms that are fee driven within a given asset class unless the advisor can make a strong showing that there is a compelling case that a higher fee fund within an asset class is preferable for the beneficiary. In addition, the Department's rulemaking in this area should recognize that measures of past performance are particularly unreliable if they are based on a measurement period shorter than an economic cycle.

The challenges the Department faces in policing this area become more severe the more options there are for an algorithm to evaluate within a given asset class, as the Department's release indicates. Efficient capital market theory suggests for example that beneficiaries face a strict risk-reward tradeoff in the capital markets – so that assets with a higher beta (correlation with overall equity markets) would have a risk premium built into them. While passive investments tend to have a moderate beta (an S&P 500 index fund would have a beta of one), an actively managed fund could be higher or lower risk, and either have a higher or lower historic market volatility, which according to modern portfolio theory, would be compensated for by higher or lower rates of return. An example of an analytically low risk actively managed fund would be an actively managed utility equity fund. However, there then is the very hard to measure risk that the fund's active managers will be incompetent at what they do—a different issue then the underlying volatility of the securities chosen by the fund manager, and one not susceptible to a easy mathematical approach.

The difficulties involved in answering the Department's substantive investment management questions highlight the folly generally of allowing conflicted investment advice. The Department should seek, within the limits imposed by Congress in the PPA, to ensure that algorithms are constructed by experts without meaningful conflicts around fee issues—both gross fees and fee margins as discussed further below.

Fiduciary Adviser Compensation

The proposed regulation, like its predecessors, undermines the statutory fee-leveling exemption in ERISA Section 408(g)(2)(A)(i) by excluding affiliates of the fiduciary adviser from the fee-leveling requirement.[3]

We appreciate the clarifying language included in Paragraph (b)(3)(i)(D) of proposed Section 2550.408g-1 as it addresses one significant concern—the possibility of an affiliate of the fiduciary adviser providing incentives to reward investment recommendations. But, as the

[3] Section 2550.408g-1(b)(3)(i)(D) requires that the fees and compensation paid to employees, agents and registered representatives of the fiduciary adviser not vary based on the investment options selected. Section 2550.408g-1(b)(3)(i)(E) applies the same restriction to the fees, commissions and other compensation due the fiduciary adviser.

Department acknowledges, the "... affiliate ... may receive fees that vary depending on investment options selected ...."

The basis for excluding affiliates from the fee leveling requirement is the statutory interpretation advocated by the Department which, as we have noted before, inappropriately restricts the scope of the statutory exemption.[4] Moreover, it is apparent from the administrative record that Congress does not agree with the approach taken in the final regulation and class exemption.[5]

In their comments on the proposed investment advice regulation and class exemption, members of the Senate and the House of Representatives reviewed the development of the statutory investment advice exemption, emphasizing that it was narrowly drawn and the result of a bipartisan compromise.[6] Each set of comments expressed concern about excluding affiliates from the reach of the fee-leveling exemption. Each set of comments was clear that this provision of the proposed regulation was contrary to the statutory language and the intent of Congress.

The interpretation advanced by the Department to exclude "affiliates" appears to ignore the statutory definition of a fiduciary adviser set forth in Section 408(g)(11)(A) of ERISA. That section explicitly includes "an affiliate" of any of the persons and entities that can serve as a fiduciary adviser.[7] By continuing to restrict the scope of the statutory exemption, the proposed regulation leaves the incentive to recommend investment options that provide greater benefit to an affiliate of the fiduciary adviser—one source of the conflicts of interest the statutory exemption sought to limit—in place. Exempting affiliates from the fee-leveling provision undermines the modest statutory protections and is contrary to the goal of making good investment advice available to participants who want it.

We urge the Department to reconsider its interpretation of the statutory fee-leveling exemption, taking into account the comments previously submitted by Congress and the

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[4] We addressed the issue in comments submitted on October 6, 2008 on the proposed regulations published on August 22, 2008 (73 Fed. Reg. 49806) and in those submitted on March 6, 2009 in response to the Department's notice extended the effective date of the January 2009 final rule (74 Fed. Reg. 6007).

[5] The AFL-CIO, as well as others, raised similar objections to the treatment of the fee-leveling exemption in both the proposed regulation and proposed class exemption.

[6] *See* Comments from Senators Bingaman, Kennedy and Grassley and comments from Representatives Miller and Andrews, available at http://www.dol.gov/ebsa/regs/cmt-investment-advice.html.

[7] Section 408(g)(11)(A) (i) through (iv) describe four different individuals or entities that may qualify as fiduciary advisers, including registered investment advisers, banks and registered brokers and dealers. Section 408(g)(11)(A)(v), in turn, provides that "an affiliate of a person described in ... (i) through (iv) ..." is included as a "fiduciary adviser." The final paragraph of Section 408(g)(11)(A) covers employees, agents and registered representatives of the other five defined categories.

Department's longstanding concerns about exposing participants to investment advisers with conflicts of interest.

Disclosure to Participants

The Appendix to the proposed rule includes a model notice to use in order to comply with the disclosure requirements in Sections 2550.408g-1(b)(7). The required notice "... must be written in a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant ...." Sections 2550.408g-1(b)(7)(ii)(A).

The model notice has not changed since it was first proposed in August 2008. It simply does not meet the proposed regulatory standard and should be rewritten. Modifications to the notice should be informed by the results of any focus group review of the model notice, a suggestion made by the Pension Rights Center that we support.[8] At a minimum, as we noted in our comments on the August 2008 proposal, the notification that a participant can arrange for advice from an independent adviser must be clearly and separately stated, not buried in the middle of the notice.

We also suggest that the final regulation and accompanying model notice include information about the profitability of the various investment options under the plan. As we noted in our comments to the regulation proposed in 2008, providing this information will give participants some ability to protect themselves from the possibility of being steered into higher margin products.[9]

Audit

The audits required by the proposed regulation do not adequately protect participants from the results of conflicted investment advice, particularly because any audit is performed after action on the investment advice is taken. In addition, no minimum criteria for either the scope of the audit or the qualifications of the auditor are proposed.[10] Nor is there any requirement that participants be informed of the audit results, including the potential affect of the failure of an investment advice arrangement to meet the requirements of the exemption.

We urge the Department to address these concerns in the final regulation should to assure the audit provides the intended protection to participants.

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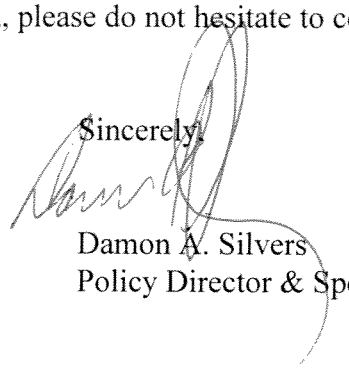
[8] *See* p. 3 of the Pension Rights Center's Comments on Proposed Regulations and Class Exemption on Investment Advice, dated October 6, 2008 available at http://www.dol.gov/ebsa/regs/cmt-investment-advice.html. A similar suggestion was made by AARP in its comments, dated March 6, 2009, available at http://www.dol.gov/ebsa/pdf/cmt-03090904.pdf

[9] The Department acknowledged our comments in the preamble to the 2009 final rule, although it did "... not believe it would be appropriate, as part of this final rule, without further notice and comment, to include such a disclosure obligation." 74 Fed. Reg. at 3832. Unfortunately, the proposed regulation does not incorporate our suggestion.

We hope our comments are helpful to the Department as it prepares the final rule on the provision of investment advice. Should there be any questions about theses comments or if we can provide any additional information, please do not hesitate to contact me at (202) 637-3953.

Sincerely,



Damon A. Silvers
Policy Director & Special Counsel