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Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210
Attn: Investment Advice Regulations

RE: Comments on 2010 Proposed Regulation on Investment Advice – Participants and Beneficiaries, 29 CFR Part 2550

Ladies and Gentlemen:

Financial Engines respectfully submits the following comments in response to the Department of Labor's proposed regulation entitled *Investment Advice – Participants and Beneficiaries,* published in the March 2, 2010 Federal Register. Financial Engines Advisors L.L.C., a wholly owned subsidiary of Financial Engines, Inc., is a registered investment adviser that provides personalized investment advice and management services directly to plan participants in 401(k) and similar plans. Financial Engines is the leading provider of independent advisory services to large plan sponsors, working with many of the nation's largest employers and retirement service providers.[1]

We appreciate the opportunity to comment on the regulation and on the additional questions posed in the regulation. The following comments are intended to assist the Department in clarifying several key elements of the proposed regulation to further advance the goal of providing plan participants with greater access to investment advice.

Financial Engines believes that the proposed regulation provides an opportunity to increase participant access to investment advice, including by setting appropriate standards for advice provided by affiliated advisors and by confirming the availability of existing investment advice arrangements.

Participants who receive investment advice can reduce costly investment errors

Financial Engines strongly supports the Department's conclusion that plan participants who receive and follow quality investment advice can reduce costly investment errors. In fact, a recent report confirms that offering investment help improves investment outcomes for

[1] Financial Engines offers retirement help, including investment advice and management services, to over 7 million plan participants through leading employers and financial institutions, including 116 *Fortune* 500 companies, as of December 31, 2009.

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participants.[2] The main finding of this report is that 401(k) participants of all ages using employer-provided, professional investment help – defined as target-date funds, managed accounts, or online advice – are better off across a variety of market cycles than those who do not use professional help. On average, the median annual return for participants receiving investment help was almost 2% (186 basis points) higher than for participants not using professional investment help, net of fees. In addition, participants receiving professional investment advice had portfolios with risk levels that were both more appropriate for their retirement horizons and more efficiently allocated among their plan's investment options. Of particular concern, given their limited time to recover from costly investment mistakes, was that the greatest variability in observed portfolio risk levels was found among retirees and near-retirees not using professional investment help. The report covers the period between January 1, 2006 and December 31, 2008, and is based on a dataset of seven large plans representing more than 400,000 individual participants and over $20 billion in assets.

Existing arrangements provide access to investment advice for millions of participants
Investment advice is available today to a significant number of plan participants through investment advice arrangements that do not need to rely upon the statutory exemption in the proposed regulation. For example, investment advice is provided by independent fiduciaries who do not engage in acts described in ERISA section 406(b)(1), including arrangements that the Department has permitted because the advisor does not cause the plan to pay additional fees for the service furnished nor to pay a fee to any affiliate of the advisor. Investment advice is also provided in accordance with the model described in the SunAmerica advisory opinion.[3]

It is therefore imperative that the existing permissible investment advice arrangements, under which millions of plan participants receive unbiased investment advice, remain available. For this reason, we commend and support the Department for maintaining in the regulation a provision stating that none of the regulation, ERISA section 408(g)(1) or Code section 4975(f)(8) invalidate or otherwise affect prior regulations, exemptions, interpretive or other guidance issued pertaining to the provision of investment advice and circumstances under which such advice may or may not constitute a prohibited transaction under section 406 of ERISA or section 4975 of the Code.

Additional clarity as to impact on existing investment advice arrangements will increase availability of advice
Participant access to quality investment advice (whether discretionary or non-discretionary) will increase once plan sponsors and industry participants feel that there is clarity around the requirements to provide investment advice. As a result, to support increased access to unbiased investment advice, and to provide additional encouragement for plan sponsors to provide investment advice to their plan participants, we respectfully suggest that the Department provide additional clarification to further support §2550.408g-1(a)(3) of the proposed regulation, by re-iterating that the requirements of the regulation are not the only acceptable means for providing

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[2] *Help in Defined Contribution Plans; Is It Working and for Whom?* Financial Engines and Hewitt Associates joint research, January 2010, available at:
http://www.hewittassociates.com/_MetaBasicCMAssetCache_/Assets/Articles/2010/DCHelpReport_Jan2010.pdf.
[3] Advisory Opinion 2001-09A (Dec. 14, 2001)

investment advice, and that the regulation is not applicable to discretionary investment management. Industry participants and plan sponsors should understand that the requirements of the regulation apply only to advice provided in reliance on the statutory exemption and that no inference should be made regarding the provision of investment advice not addressed by the regulation, or to discretionary investment management. Otherwise, we believe that the goal of supporting increased access to unbiased investment advice (whether discretionary or non-discretionary) could be significantly diminished.

In order to promote greater access to investment advice, the Department must clarify that the defined term "eligible investment advice arrangement" is not meant to confer on advice arrangements made possible by the proposed regulation any greater status or suitability than other investment advice arrangements not needing the exemptions provided within the proposed regulation[4].

Independent advisors not impacted by regulation

It should be made clear that independent investment advisors are not required to comply with the provisions of the proposed regulation, and that the requirements of the proposed regulation should not create <u>any</u> inferences regarding the selection or monitoring of independent advisors.[5] Further, we request that the Department expand upon the reference to Field Assistance Bulletin 2007-1 to additionally reference Regulation 29 C.F.R. §2550.408b-2(e)(2), which explains that a fiduciary does not engage in an act described in section 406(b)(1) if the fiduciary does not use any of the authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary. The Department should designate a fiduciary described under §2550.408b-2(e)(2) as an "independent advisor."

Questions raised by the Department

1. *For purposes of the requirement that the proprietary computer models of affiliated advisors be designed and operated to apply generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time, what investment theories are generally accepted?*

   Financial Engines believes that generally accepted investment theories are those methodologies that enjoy broad support in institutional practice and among academic experts. Having a precise and narrow definition of "generally accepted" will likely not result in regulation which accommodates and supports innovation, as such theories tend to evolve (albeit slowly) over time. The Department, plan participants and plan fiduciaries would not be well-served to establish "approved" theories that would force plan fiduciaries and investment advisers to rely on approaches that may become outdated. We believe that simply

[4] Many plan fiduciaries, ERISA counsel, and industry consultants believe incorrectly that advice provided under the statutory exemption confers fiduciary protection not available with other investment advice arrangements.

[5] Many plan fiduciaries, ERISA counsel, and industry consultants believe incorrectly that investment advice for participants is not permissible in the absence of a certification.

requiring that the computer model be based on "generally accepted" theories is sufficient to eliminate concerns of specious or highly unorthodox methods being applied. For instance, mean-variance portfolio optimization theory would meet this standard, while astrology and Elliot Wave theory would not. Generally, most academics and many institutional managers are skeptical of technical trading rules,, charting techniques, and methods that lack a solid foundation in the academic literature. By specifying that theories must be "generally accepted," it is not necessary to expressly prohibit any particular theory.

2. *Is a fund's past performance relative to the average for its asset class an appropriate criterion for allocating assets to the fund?*

A fund's past performance can be an appropriate criterion as long as the weighting on this information is appropriate given the other facts and circumstances for the investment. Other factors (such as fees) can counter the impact of positive past performance. The question is not "is past performance relevant?", but "how relevant is it in this situation?" The appropriate weight on past performance can be as low as zero in some circumstances, but generally most investment models would attach some modest explanatory power to manager performance in predicting future expected returns. However, in all cases the weight should be less than one hundred percent as there is no evidence supporting the claim that past performance will be repeated in the future with certainty. As long as there is uncertainty, the appropriate response is to down-weight the impact of past performance in making predictions about the future. However, assuming that the appropriate weight on past manager performance should be zero in <u>all</u> cases represents a fairly aggressive position relative to the opinions of most institutional money managers and financial economists.

When giving advice, it is important to recognize that you are <u>always</u> making assessments about future quantities that are uncertain. Whether it is asset class expected returns, asset class risks and correlations, fund-specific risk factors, or manager performance, all of these quantities are uncertain and may not play out in the future the way they have played out in the past. While fees are certainly easier to predict than manager performance, an advisor is always faced with making informed judgments about uncertain variables when building advice models. It is drawing an artificial distinction to say that asset class returns and risks are easily estimated, while manager performance is highly uncertain. Both are challenging to predict in the future with high accuracy. In fact the value-add of advice is to help participants deal with estimating the impact of factors that cannot be confidently expected to persist in the future.

Of course, the Department is prudent to focus on manager performance as a key consideration in protecting participants from conflicts of interest. In deciding what weight to place on historical performance, a conflicted advisor may have incentives to overstate this factor to increase their investment income. However, it is widely accepted in money management practice that historical performance (properly measured) may be useful in selecting good investments provided its explanatory power is not exaggerated. The key question in a given situation is how much weight should be placed on history to derive the

best prediction of the future. A weight of zero (in all cases) would be a strong and controversial assumption.

3. *Should specific practices be required?*

The proposed regulation already includes requirements, as to the proprietary models of affiliated advisors, for: (1) taking into account investment management and other fees and expenses attendant to the recommended investments, (2) requesting from a participant, and, if furnished, utilizing, information relating to age, time horizon, risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences, (3) using appropriate objective criteria to provide asset allocation portfolios comprised of investment options available under the plan, and (4) taking into consideration all investment options without giving inappropriate weight to any (provided that employer securities, target date funds, and annuities need not be considered), and, furthermore, requires that the following be avoided (setting aside for the moment the requirement that recommendations cannot distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future): (1) investment recommendations that inappropriately favor investment options offered by the advisor or affiliate or person with a material contractual relationship, and (2) investment recommendations that inappropriately favor investment options that may generate greater income for the advisor or affiliate or person with a material contractual relationship.

The Department could provide some additional high level guidance relative to taking into consideration risks (for example, risks associated with active management). In addition, the Department could clarify that a proprietary model of an affiliated advisor not be allowed to arbitrarily exclude employer securities from consideration, if such securities are available as a plan investment option.

Financial Engines believes that the requirement in the proposed regulation to request, and if provided, take into consideration additional information such as outside holdings and risk preferences, is appropriate and useful.

4. *What historical data should be taken into account in determining the expectation of future performance of asset classes and specific investment alternatives used by the proprietary model of an affiliated advisor?*

Historical data can be useful in determining estimates for a variety of inputs into a predictive advisory model. For instance, most models use historical data for volatility and correlations, as well as to estimate the investment style of a fund. However, it is important to recognize that estimates of expected returns derived from historical returns are noisy. That is, the potential error from any estimate derived from historical returns is large – you need a very large number of years of data to accurately estimate the mean rate of return for equities. Given, this fact, few institutional investors rely strictly on historical rates of return to drive their asset allocation models. Usually, judgment or additional information is required to properly calibrate expected return estimates drawn from historical data.

5. *What types of criteria are appropriate and objective bases for asset allocation pursuant to subsection (b)(4)(i)(D), which requires that the proprietary computer model of an affiliated advisor to objective criteria to provide asset allocation portfolios comprised of investment options available under the plan?*

   There are no purely objective criteria that are the basis of asset allocation or investment selection models. In general, well designed models will rely on historical data, accepted economic theory, and properly conditioned estimates of expected returns, volatilities, and correlations. Two areas that should be explicitly considered would be investment expenses and active management risk (additional volatility due to active management decisions). Designating certain criteria as not appropriate is risky, as there may be situations where such information would be relevant.

6. *Under what if any conditions would it be consistent with generally accepted investment theories and with consideration of fees to recommend a fund with superior past performance over an alternative fund in the same asset class with average performance but lower fees?*

   The degree to which past performance may offset the impact of fees in making predictions depends on the statistical reliability of the manager performance estimate. In other words, it depends on the weight attached to the past performance which is a function of how likely the performance is to persist in the future. In general, past performance that has persisted for a long period of time and shows low volatility is more likely to persist than more volatile and shorter-term performance track records. If the difference in fees is modest, then past performance might become a relevant variable on which to make a choice. However, if the gap in expenses is large (e.g. greater than 100 basis points), then it is less likely that the predictable component of past performance would be sufficient to warrant a bet on active management. It is also important to recognize that not all generally accepted models rely on the hierarchical asset allocation framework assumed in the question. Note that many funds have multiple asset class exposures. For example, the Financial Engines model does not categorize funds into a single asset class, but allows for a multitude of possible asset class exposures.

7. *How if at all should the proprietary model of an affiliated advisor take into account investment management style?*

   Models should consider investment style and the differences between active and passive products. Active management by its nature increases the uncertainty of future performance by making active bets that introduce uncertainty in the future investment style of the fund. Active funds have more risk than an equivalent index fund with the same style. Of course the point of taking this active risk is to outperform a comparable index in the future.

Conclusion

Financial Engines appreciates the opportunity to comment on the proposed regulation and may provide additional comments as we continue to evaluate the proposal and discuss its impact with plan fiduciaries. We welcome the opportunity to work with the Department and to provide any further assistance that may be required. Please contact us should you have any questions.

Very truly yours,

Anne S. Tuttle
Executive Vice President and General Counsel

cc: Phyllis Borzi, Assistant Secretary, Employee Benefits Security Administration
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