



WRITTEN TESTIMONY OF

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FINANCIAL ENGINES

FOR THE HEARING ON

**DEFINITION OF THE TERM "FIDUCIARY";
CONFLICT OF INTEREST RULE-RETIREMENT INVESTMENT ADVICE
AND RELATED PROPOSED PROHIBITED TRANSACTION EXEMPTIONS**

BEFORE THE

**UNITED STATES DEPARTMENT OF LABOR
EMPLOYEE BENEFITS SECURITY ADMINISTRATION**

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Introduction

Thank you for the opportunity to testify regarding the Department of Labor's ("DOL") proposed regulation entitled *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice* ("proposed Conflict of Interest rule"). My name is Christopher Jones and I am proud to serve as Chief Investment Officer and Executive Vice President of Investment Management for Financial Engines. As the third employee when I joined Financial Engines nearly 19 years ago, I have had the privilege of first-row seats to bear witness to the transformational impact of technology on the financial advisory industry. Where once only the wealthy could expect access to objective investment counsel from an independent fiduciary, now millions of Americans, even those with modest balances, are able to enjoy the benefits of high quality, conflict-free investment advice.

We applaud DOL's proposal to update the definition of fiduciary under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The American retirement landscape has changed dramatically in the last few decades. We share DOL's concern that the current regulation that was crafted forty years ago may not adequately protect the interests of retirement investors and may limit unnecessarily the scope of ERISA's fiduciary protections.

Since 1996, we have provided high-quality, objective investment advice in a fiduciary capacity to millions of defined contribution plan participants. Our experience and market experience demonstrates that it is possible to put the interests of costumers first by providing personalized, unconflicted investment advice and still producing solid business results, even when investors have modest balances.

We believe that the proposed Conflict of Interest rule is not only workable for providers of advisory services, but it will create substantial benefits and protections for recipients of those services. And we further believe the Department has provided adequate time for our industry to assess the rule and its consequences.

This testimony provides further background on Financial Engines and elaborates on the need to update the regulations on investment advice to adequately protect investors against conflicts of interest.

Financial Engines

Financial Engines Advisors L.L.C., a wholly owned subsidiary of Financial Engines, Inc., is a registered investment advisor that provides personalized investment advice and management services to retirement investors. Financial Engines provides such services as a fiduciary under ERISA and under the parallel prohibited transaction restrictions of the Internal Revenue Code.¹ We are also regulated by the Securities Exchange Commission as a federally registered investment advisor.

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 to provide access to advisory services to participants in 401(k) and similar plans. Notably, while Financial Engines may be best known for providing discretionary investment management through our Professional Management

¹ Except as expressly noted, references in this letter to ERISA should be read to include the corresponding provisions of the Internal Revenue Code.

service (managed accounts program) since September 2004, the company was founded to provide non-discretionary investment advice, and continues to do so today. Since March 2010, Financial Engines has been a publically traded company registered on the Nasdaq exchange.

Established in 1996 by Nobel Laureate William Sharpe, former SEC Commissioner Joseph Grundfest, and the late Craig Johnson, then-chairman of the Venture Law Group, Financial Engines offers personalized, independent, and high-quality investment advice to individuals, regardless of their wealth or investment experience. We assist individuals with developing a personalized and comprehensive savings, investing, and retirement income plan. We use sophisticated technology to deliver services that help individuals set an appropriate risk level for their goals and situation, and create a diversified investment portfolio from among the investment choices available in their employer's 401(k) plan. We model over 39,000 securities while considering tax implications, expenses, redemption fees, loads and distributions. Importantly, we offer access to human investment advisor representatives to assist those investors who need more help. We have demonstrated that combining advice technology with human-based advisors can profitably serve investors, even those with modest balances.

We can either professionally manage an employee's 401(k) account on a discretionary basis or provide online advice through expert recommendations, interactive tools and certified advisors. For employees who decide to rollover their 401(k) when retiring or leaving their employer, we can also manage the employee's, or their spouse's, individual retirement accounts ("IRA") assets. Annually, Financial Engines provides a retirement readiness assessment, including estimated annual retirement income from Social Security, 401(k)s, IRAs, and pensions, if applicable, to all employees in the plans we serve. For employees selecting the Income+ feature of the Financial Engines Professional Management service, we will manage the portfolio to be ready to generate retirement income, and can generate steady payouts that are designed to last for life with the purchase of an optional out-of plan fixed annuity. Financial Engines is not affiliated with any other financial services entity, does not manufacture or sell investment products, and does not accept commissions or product-based revenue sharing.

Financial Engines believes that our history and growth support the conclusion that it is neither onerous nor impossible for service providers to provide high quality services in a fiduciary capacity to large numbers of plans and participants. We have a proven track record of providing high-quality independent investment advice. Financial Engines is America's largest independent registered investment advisor.² Financial Engines works with 647 employers, including 143 of the FORTUNE 500 companies, and nine of the largest retirement plan providers serving the defined contribution market. As a result, over three million people have used Financial Engines Online Advice,³ and approximately 900,000 have their retirement account professionally managed by the company. Nearly 240,000 of our discretionary managed account service clients have less than \$20,000 in their 401(k) portfolio, and the median balance is \$57,000. Over 77% of the professionally managed portfolios are uniquely tailored to the individual. The median balance for the more than 9.1 million plan participants with access to our services is \$32,000, and approximately 43% of those participants have less than \$25,000 in their 401(k) portfolio.⁴

² For independence methodology and ranking, see InvestmentNews RIA Data Center. (<http://data.investmentnews.com/ria>).

³ As of December 31, 2014, the number of people who have accepted our online services agreement.

⁴ As of March 31, 2015.

Critical Need for Retirement Investment Advice

The retirement landscape has changed significantly in the past forty years. Professionally-managed pension plans have given way to individually-managed 401(k)s and IRAs. The shift in responsibility from professional managers to individual investors has led to an increase in investment options, making investment decisions ever more difficult for individuals and increasing the risk of underperformance. A recent Financial Engines study, for example, found that nearly seven out of ten 401(k) participants had portfolios with inappropriate risk and/or diversification.

With more than 88 million individual investors now largely responsible for managing their own retirement assets, there has never been greater demand for high-quality investment advice. Investors obtain advice from a range of sources, which differ in legal and conduct standards, as well as in the way in which they are compensated. Studies have shown that, although investors are content with the advice they receive from these sources, they do not fully understand the legal differences among them or the types of payments they receive.⁵ It is imperative that the regulatory structure governing investment advice protects the integrity of this service.

Moreover, the need for new rules is clear since potential conflicts of interest do exist in the retirement business. The status quo is no longer tenable given the immense stakes of our nation's shift to the defined contribution model for retirement savings. Under current regulations, conflicted advisors can steer investors towards products that offer higher fees and commissions for the "advisor," and not what will provide the best retirement outcome for the investor. Complex fee-sharing arrangements, commission structures, and other conflicts of interest create pressures—sometimes overt, sometimes subtle—to shade recommendations towards the interests of the "advisor." The vast majority of investors are entirely unaware that these conflicts of interest even exist, and end up with investments that have lower returns and higher fees, siphoning off tens of thousands of dollars in savings from the average person's retirement account. Advisors may also have incentives to steering investors from low-cost 401(k) plans into more expensive retail IRAs. This makes investors vulnerable to firms that claim to be on their side, but eschew any fiduciary responsibility to act in the sole best interests of the client.

The potential harm to consumers from these conflicts of interest is significant. A 2013 study showed that even brokers who are unaffiliated with a mutual fund company tend to steer their clients toward mutual funds that pay the brokers more, but that underperform by over one percent annually on average.⁶ Although one percent might not appear significant, such annual underperformance can quickly translate into a retirement balance that is tens of thousands of dollars lower over a 30-year career.

This status quo is unacceptable. Every day the nation's newspapers recount stories of individual investors being taken advantage of by unscrupulous advisors and the engrained conflicts of interest that permeate the retirement industry. It is time that investment regulations are updated to reflect the new reality facing retirement investors in America.

⁵ Angela Hung et al., *Investor and Industry Perspectives on Investment Advisors and Broker-Dealers* (2008).

⁶ Susan E. K. Christoffersen, *What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives* (2013).

DOL's Proposed Conflict of Interest rule

We support DOL's proposed Conflict of Interest rule. Based on our experience, we believe the proposed Conflict of Interest rule is workable for investment advisors and beneficial for investors. The proposed Conflict of Interest rule, which includes the more flexible Best Interest Contract exemption and encourages low-cost, technology-based tools, is workable for advisors. Our business model and market experience is proof that the use of technology can help investment advisors to profitably offer high-quality, unconflicted advice to investors, even those with modest account balances. This advice can be provided both through web-based interactive experiences, and through human advisors. Moreover, we are confident the proposed Conflict of Interest rule will further accelerate the trends towards low-cost, technology-based financial services and products, which will, in turn, make unconflicted advice increasingly cost-effective for advisors and accessible for investors of all means. Technology has democratized high-quality, objective advice, once only available to high net worth investors.

At the same time, we believe it is just as important to ensure that any proposal that is put forward is simultaneously workable for investment advisors and beneficial for investors. DOL has engaged in an open discussion with stakeholders like us over the past five years to ensure that these requirements are met. We thank DOL for encouraging input on the proposed Conflict of Interest rule.

In this regard, Financial Engines' comment letter outlines certain ambiguities and areas that may result in unintended consequences.

- **The proposed Conflict of Interest rule may restrict the ability of advisors to present services to investors.** In order to increase access to personalized, unconflicted investment advice, it is essential that investment advisors are able to communicate to investors information about their services. Unless clarified, we fear the proposed Conflict of Interest rule may prevent advisors from communicating information to retirement investors about their services. Some such communications could thus be characterized as fiduciary investment advice at the time the advisor presents the services available. Unless an exemption is available, a prohibited transaction may result if the advisor then receives fees, even when those fees are reasonable, fully-disclosed, and free of potential conflicts of interest.

On a related matter, it is also important to address the situation of advisors who are already acting in a fiduciary capacity relative to a particular retirement investor, but who would like to present different types of advisory services to the investor. Changing to a different service can be appropriate for investors whose circumstances change over time. It is important that advisors are able to act as fiduciaries with respect to a service, and are able to offer to perform other services without triggering fiduciary status by doing so.

- **DOL has asked stakeholders whether it is appropriate to omit provisions of IB 96-1 relating to specific investment products and alternatives.** We believe that the investment education carve-out is appropriate without including specific investment products and alternatives under the plan or IRA. We recognize, however, that there may be circumstances in which the identification of specific products does not create a conflict of interest. In order to accommodate for these circumstances, we suggest that the language be modified to allow presentation of specific investment products if one of two additional criteria are met, , perhaps with the clarification that the examples may not be the only choice for an investor:

(1) all of the investment products or alternatives available under the plan or IRA applicable to a specific asset class are presented, or (2) only investment products or alternatives with respect to which the education provider has no conflicts from differential compensation arrangements are shown.

Further, we agree with DOL that educational materials and models should disclose material facts and assumptions under which they are based. However, it is important for DOL to clarify how advisors should assess what is material in the context of facts and assumptions.

- **Finally, DOL asked whether it should adopt some or all of the Financial Industry Regulatory Authority's ("FINRA") standards in defining communications that rise to the level of a recommendation for purposes of distinguishing between investment education and advice under ERISA.** We are afraid that if DOL were to adopt FINRA's standards or imply that they are incorporated by reference into the proposal, there would be unnecessary confusion, as many of the advisors subject to the regulation are not regulated by FINRA. Therefore, it may be difficult for them to anticipate and interpret any future changes to FINRA's standards.

Conclusion

On behalf of Financial Engines, I would like to thank you again for the opportunity to testify today. Financial Engines shares DOL's concern that the current investment regulations may not adequately protect the interests of today's retirement investors. We support DOL's proposal to update the definition of fiduciary investment advice in order to try to better protect investors against conflicts of interest. We believe our experience demonstrates that it is possible to provide unconflicted advice and produce solid business results, even when investors have modest balances. We welcome the opportunity to work with DOL and provide any further assistance that it may find useful.