AVATAR
ASSOCIATES

February 1, 2011

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Office of Regulations and Interpretations,
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

ATTN: Definition of Fiduciary Proposed Rule

Dear Sir or Madam,

We appreciate the hard work of the professionals at the Department of Labor (the "Department") in proposing a revision of the regulation that defines investment advice fiduciaries, and we welcome the opportunity to submit our comments on this important matter. We hope that our observations will assist the Department in improving the regulation in a way that protects plan participants and beneficiaries from conflicts of interest on the part of certain investment providers and reduces the burden imposed on plan sponsors.

Who We Are

Avatar Associates has provided investment management services since 1970 and specializes in offering broadly diversified asset allocation strategies that are ideal for use by qualified retirement plans to meet the requirements of Qualified Default Investment Alternatives ("QDIA"s). In this regard, Avatar manages five risk-based collective funds and nine target date collective funds that use non-proprietary ETFs as their underlying investments. Our asset-based fees are among the lowest in the industry, reflecting our commitment to the interests of plan sponsors and participants.

Avatar's mission is to provide fully diversified portfolios to retirement plan participants and sponsors in a non-conflicted manner that focuses on participant and sponsor needs first and foremost. We believe that by using the low-cost structure of bank collective funds and ETFs, we provide an investment alternative that efficiently realizes the goals of Congress in enacting the QDIA legislation. Principals of Avatar have been instrumental in laying the foundation for rules relating to the investment allocation of plan assets culminating in the Pension Protection Act and the QDIA provisions. Avatar continues to be a voice in the national discourse on this topic, particularly as it pertains to the inadequacies of target date funds offered by the mutual fund industry and the deficiencies of the fund of funds structure.

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Summary of Proposal

The proposal issued on October 21, 2010 expands the categories of persons who would be deemed to be fiduciaries subject to the Employee Retirement Income Security Act of 1974 ("ERISA") by delineating when a person becomes a fiduciary by reason of providing investment advice relating to plan assets for a fee or other compensation. The Department reasoned that such a revision is needed because the retirement industry has changed significantly in the 35 year period since the current rule was adopted. The most significant trends in this regard have been the growth of participant-directed individual account plans and the increase in the types and complexity of investment products and services available to such plans. Such products include so-called target date funds that are designed for and marketed primarily to 401(k) and other individual account plans and generally consist of a "fund of funds" that invests in shares of other mutual funds of the same mutual fund family.

The proposal replaces the current five-part test for defining a fiduciary with a two pronged test that focuses on: (1) the type of service provided and (2) the function or status of the person providing the services. Where both prongs of the test are satisfied and a person would otherwise be classified as a fiduciary, the proposal also provides for certain limited exceptions. One such exception is the rule that a person will not be a fiduciary if the person can demonstrate that the recipient of advice or a recommendation knew, or under the circumstances reasonably should have known, that the person providing the advice or recommendation was acting in its capacity as the seller or purchaser of securities or property.[1]

Services considered under the test's first prong include recommendations as to the advisability of investing in, purchasing, holding or selling securities or property, as well as advice or recommendations as to the management of securities or property. In addition, a person will satisfy the second prong of the test if the person (i) represents or acknowledges that the person is acting as a fiduciary, (ii) exercises discretionary authority or control with respect to the management or disposition of plan assets or possesses authority or discretionary responsibility for plan administration, (iii) is an investment adviser within the meaning of section 202(a)(11) of the Investment Advisers Act of 1940 or (iv) provides individualized investment advice pursuant to an arrangement or understanding that it *may* be considered in connection with plan management or investment decisions.

Certain Investment Fund Providers Deemed to Be Fiduciaries

Under the Investment Advisers Act and as acknowledged in the preamble to the proposal, a bank would generally not be considered as an investment adviser and, therefore, could avoid classification as an investment advice fiduciary under ERISA, except where the bank serves or acts as an investment adviser to a registered investment company. Where investment advisory services are provided through a separately identifiable department or division, the department or division, and not the bank itself, is

[1] The proposal indicates that an acknowledged fiduciary cannot use this exception.

treated as the investment adviser under the Investment Advisers Act and presumably would take on the duties of an ERISA fiduciary under the first and second prongs of the proposed rule if it makes investment recommendations or manages the assets of a bank-advised investment fund. Thus, the proposal deliberately focuses on bank-advised funds, including, but not limited to collective trust funds and funds using a fund of funds model. If a bank were to advise a registered investment company, i.e., a mutual fund, the proposal would deem the bank to be an ERISA fiduciary even if the information provided to the plan were generic and not individualized as to the plan's needs.

Treatment of Target Date Funds

The treatment of banks and other investment advisers, such as the provider of a list of recommended funds, contrasts sharply with the proposal's effect on target date funds managed by mutual fund complexes. Department representatives have indicated that the proposal was not intended to result in fiduciary status for a mutual fund (or its investment adviser) even though the fund's assets may consist entirely of affiliated mutual funds, thereby creating inherent conflicts of interest. This position is disappointing and somewhat baffling in light of the fact that the emergence of target date funds using a fund of funds model is, in the view of many, one of the most significant developments in the qualified plan marketplace and merits a response from the Department in the proposed rule.

Technically, a target date fund is a separate corporation or business trust with its own board of directors or trustees that is charged with protecting the interests of the fund's shareholders made up primarily of retirement plans. Nevertheless, it is a truism that, in practice, business considerations of the mutual fund family, not the interests of plan participants, drive the design of these products. Excessive fees, underperforming lower tier funds and inappropriate mixes of funds are some of the problems that have resulted from the embedded conflicts of interest.

The Department's position on target date funds conflicts with the general trend of the proposal under which advice and recommendations would no longer need to be "a primary basis" for an investment decision or even be provided on a regular basis. Under the proposal, it is only necessary that the advice be potentially considered in connection with such a decision. Further, the proposal suggests that the advice or recommendation need only be used by a plan for its own purposes, regardless of the expectations of an adviser or investment provider. The broadening of the types of communications which can result in classification as a fiduciary would seem to cover much of the marketing of target date funds, except for the Department's denial that this is the case.

Burden Imposed on Plan Sponsors

ERISA holds plan fiduciaries to specific standards in selecting plan investments, including investments that may qualify as a default investment under section 404(c)(5) of ERISA. Thus, the Department has stated that "A fiduciary must engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate."[2] The Department's rejection of a rule that would treat the manager of a target date fund as a fiduciary has the effect of imposing the obligation to prudently select and monitor a target date fund on a party ill-equipped to handle it, namely the plan sponsor.

Some of the difficulties of fulfilling this responsibility are discussed below. In this regard, we note that the problem created for small employers is particularly acute because they do not possess the resources or leverage necessary to properly understand the investment. Arguably, the only way a plan sponsor can fulfill its fiduciary obligation with respect to selecting and monitoring a fund of funds with a conflicted investment adviser is to have an independent expert review and approve the mutual fund's fees as well as its investment allocation strategy, including the processes and algorithms that result in the choice of underlying funds and the weight to be accorded to each fund. This is not feasible for the vast majority of small plans but the risk assumed by not doing so will ultimately lead to small business aversion to the establishment and continued maintenance of qualified plans. In contrast, the proposed regulation should strive for a result more in line with the collective fund example where the burden on plan sponsors is ameliorated by the sharing of fiduciary responsibility with the fund's investment manager.

Performance Evaluation. Evaluating the performance of target date funds is particularly difficult for plan sponsors in light of the fact that benchmarks for evaluating such funds are new, untested and unreliable. An obstacle that arises in comparing one target date fund to another stems from their different glidepaths even as between funds with the same target date. A 2030 fund aggressively invested in equities will have a better performance in a bull market than its more conservative counterpart that is more heavily weighted toward fixed income investments, but the opposite will hold true in a market decline. Thus returns from one fund to another will vary not only on the basis of a fund's relative allocations to stocks and fixed income at any particular time but also on conditions in the market. In addition, it will be important to assess not only the allocation of fund assets between broad categories, such as equities and fixed income, but also the nature of the assets held. For example, plan sponsors must identify inappropriate levels of junk bonds as was infamously revealed to exist in certain funds with a 2010 target date.

A plan sponsor's task in evaluating the performance of target date funds is made yet more difficult by the multiplicity of underlying funds, each of which must be assessed in order to properly meet the sponsor's fiduciary obligation. Typically there are from six to forty lower tier funds, many of which do not have a three-year track record. The selection of underlying funds may change at any time without notice as may their managers and investment philosophies. These factors limit the reliance that can be placed on historical performance, thus leaving the plan sponsor without the tools to properly analyze a target date fund. In addition, many of the funds that do have performance records are ranked in the lower half of their peer group, but the plan sponsor does not have the power to require that they be upgraded.

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[2] See the preamble to the final regulations on default investment alternatives at 72 Fed. Reg. 60453 (2007). As with any investment alternative made available under a plan, a fiduciary considering such an investment must, among other things, carefully examine investment fees and expenses.

Risk Evaluation. As a fiduciary, a plan sponsor would also be required to consider the risks being taken by target date funds which vary dramatically. Some funds may be aggressively invested (i.e., have a greater concentration in equities compared to fixed income) for a relatively short period while others may have a much longer horizon for such investments. Further, some funds will reach their ultimate asset allocation at the fund's target date while in other funds the mix of assets will continue to be managed after the target date up to the anticipated mortality date of the target group. In this regard, plan sponsors must account for the needs of both older and younger plan participants. It is asking a great deal of an employer or plan sponsor to propose that they determine an appropriate level of risk for the plan and then use Sharpe Ratios or other metrics to measure and rank the risk-adjusted returns of target date funds.

Evaluation of Fees. As noted above, a fiduciary charged with selecting a target date fund as a plan investment option must carefully consider investment fees and expenses. This obligation extends to both the reasonableness of the fees and potential conflicts of interest.[3] Target date funds have a broad range of expenses. Monitoring these fees is far more difficult than monitoring the fees of a non-target date fund, because the target date fees are generally a function of the changing allocations to different underlying funds, each of which has its own fee structure. In designing a target date fund, a mutual fund family has a financial incentive to include as many affiliated underlying funds as possible in order to maximize fees. A related conflict exists with respect to the mix of the underlying funds due to the higher fees charged by equity funds. Thus, fund designers and managers have an incentive to increase the target date fund's exposure to equities. This has consequences adverse to the interests of plan participants not only as to the level of fees but also the volatility of the investment.[4] In addition to the fees charged by the funds underlying a target date fund, there may also be a wrap fee for the asset allocation process. All of this increases the review burden of the plan sponsor which does not have the ability or resources to analyze the various issues and conflicts generated by a fund's fee structure.

Conclusions

The Department should understand that the complexity and the conflicts of target date funds are not illusions that can be made to go away by ever increasing levels of disclosure. Plan sponsors do not have the ability or the resources to analyze these products or explain them to participants and, even if they did, the ever changing nature of the product gives the fund companies ultimate control. Accordingly, the traditional function of market forces in judging whether good value is being delivered is not working, thereby putting the retirement security of much of the nation's workforce at risk. Target date funds have already cost plan participants a significant portion of their retirement savings that will never be recovered.

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[3] For example, the preamble to the final regulations on default investment alternatives states: "Plan fiduciaries must take into account potential conflicts of interest and the reasonableness of fees in choosing and monitoring any investment option for a plan, whether covered under the safe harbor or not." 72 Fed. Reg. 60467 (2007).

[4] In a 2009 hearing before the Senate Special Committee on Aging, it was revealed that even funds with a 2010 target date had equity concentrations of up to 68 percent of assets which contributed to unacceptable levels of investment loss in the recent economic downturn.

The proposed rule purports to be a response to the evolution of the retirement plan market. As noted, it characterizes the managers of bank collective funds that make their product available to retirement plans as plan fiduciaries. The proposal recognizes that this does not necessarily require direct contact with plan sponsors or participants. In this instance, the presence in the marketplace of a product designed for and specifically marketed to retirement plans is sufficient to impose fiduciary status on the fund manager. Target date funds offered by the mutual fund industry should be treated no differently. It can fairly be said that one of the primary purposes of target date funds is to be funding vehicles for retirement plans. Fund managers and their affiliates ubiquitously market these products on the basis that they are an appropriate solution to a plan's investment needs. In our view, this constitutes investment advice and, under the proposal, should result in classification of the fund manager as an investment advice fiduciary.

Making target date fund managers plan fiduciaries would subject the fund's asset allocations to ERISA standards and require the fund managers to be independent, thereby eliminating many of the problems discussed above. It would not mean the end of target date funds and mutual funds could still be part of the underlying mix of fund investments. It would also have the salutary effect of increasing transparency, thus making review of performance and fees easier for plan sponsors.

Avatar respectfully urges the Department to revise the proposed definitional change to address the issues discussed above. Thank you for your attention and consideration of this comment.

Sincerely,

Larry A. Medin
President
Avatar Associates