July 17, 2015

Via Email: e-OED@dol.gov  
Office of Exemption Determinations  
Employee Benefits Security Administration  
U.S. Department of Labor  

Re:   Low Fee Streamlined Exemption  
ZRIN: 1210-ZA25  

Dear Sir or Madam:

On April 20, 2015, the U.S. Department of Labor (the “Department”) published in the Federal Register the re-proposal of amended regulations that would govern the definition of “investment advice” under the definition of “fiduciary” contained in Section 3(21) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) (and in the corresponding provisions of the federal tax code). In connection with this re-proposal, the Department also proposed a series of new administrative prohibited-transaction exemptions, as well as changes to various existing administrative exemptions.

We are writing in response to the Department’s request for comment on the possibility that the Department might propose a low fee, streamlined exemption, which was made in the preamble to the proposed “best interest contract” exemption (the “BIC Preamble”). Dodge & Cox is one of the longest standing independent professional investment management firms in the United States. We manage over $280 billion in assets and are known for our thorough independent research and focus on the long-term. We serve as investment adviser to six actively managed mutual funds (the “Funds”),¹ which are recognized for their low fees and solid long-term performance record. More than 4 million shareholders invest in the Funds, including many retirement plan participants and IRA owners.

We welcome the opportunity to comment on this aspect of the BIC Preamble, which describes the Department’s desire to craft an exemption for investment products that ideally would: (i) offer high quality low-fee investment products with minimal potential for material conflicts of interest; (ii) reward and encourage best practices with respect to optimizing the quality and cost of recommended financial products, financial advice and

other related services; (iii) enhance access to quality, affordable financial products and advice by savers with smaller account balances; (iv) provide easy access to investments with simple and transparent fee structures; and (v) establish objective conditions for eligibility.

An exemption that is thoughtfully crafted to provide retirement investors with access to high quality, low cost investment options is likely to be more complex, time consuming and expensive than the Department may have anticipated. Designing, implementing and administering such an exemption calls for a substantial upfront and ongoing commitment of resources and requires a sophisticated understanding of investing, investment products and investor psychology. Historically, Congress, the courts and the Department itself have not endeavored to evaluate investments and provide approved lists or prescribe specific substantive modes of conduct for fiduciaries, or otherwise to favor one set of investment opportunities over others. We suggest this approach is appropriately grounded in a realization that fiduciaries with investment expertise are in the best position to make appropriate investment choices for particular plans and participants.

In light of the above, we do not support the creation of a low fee streamlined exemption. In the event that the Department nevertheless decides to pursue the concept of a streamlined exemption in spite of the challenges surrounding this effort, we provide our views regarding the inclusion of actively managed funds in such an exemption and address whether to accord special treatment to qualified default investment alternatives (“QDIAs”). We also identify a number of key issues that should be considered in creating such an exemption.

**Actively Managed Funds**

The release implies that low-cost, passively managed funds would be an ideal type of product for a low cost exemption. While passive funds offer many benefits to investors, we believe it would be a disservice to retirement investors to establish criteria that exclude actively managed funds from eligibility. The chart below from Morningstar compares mutual fund companies that offer passively and/or actively managed funds, and shows that active managers with low fees, such as Dodge & Cox, can deliver superior performance to investors.
In addition, academic research shows that certain active managers show a persistent ability to outperform their benchmarks (and passive managers) even after expenses are deducted. It is also the case that some high quality actively managed funds charge fees that are comparable to those charged by some passive funds.

Actively managed funds can provide better risk-adjusted returns and allow investors greater flexibility to design a portfolio of funds suited to their unique risk profile and investment objectives. Beyond the direct benefits to investors, active managers promote healthy and efficient markets by providing liquidity, adding stability and facilitating efficient pricing in the securities markets. Active managers that base investment decisions on careful research and analysis help allocate resources to the best companies. Active managers are also more likely to engage in dialogue with company management over corporate governance issues and other matters affecting shareholder value and have the option to divest if company management is not responsive to their concerns. By contrast, passive funds are captive to their benchmark and have no discretion to “vote with their feet” by selling a particular investment.

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Limiting a streamlined exemption to passively managed funds would make it difficult for plan participants and IRA holders to access the most skilled managers and could ultimately hurt their long-term investment returns. Such an exemption could also have a significant adverse impact on the market as a whole.

The Department correctly observes that mutual funds with the lowest fees do not necessarily represent the highest quality investments for retirement investors. In this regard, we note that not all low fee passive funds have demonstrated an ability to beat their benchmark. Passive funds can underperform for a number of reasons, including high transaction costs, poor statistical correlation to the index, and ineffective cash management techniques. Accordingly, a blanket exemption for low fee passive funds is not in the best interest of retirement investors.

QDIAs

The Department specifically asks whether the low fee exemption should be limited to funds that meet the requirements of a QDIA. QDIA funds, which generally include target date, life-cycle and balanced funds, represent a limited range of investment options that may not meet the needs of retirement savers. We are not aware of any study showing that such funds provide better outcomes to investors over the long term. Also, not all QDIA funds are high quality funds. Target date and life-cycle funds are particularly vulnerable to conflicts of interest as the sponsors of such funds typically use proprietary funds as underlying investments rather than selecting the “best in class.” In addition, it is not clear that retirement investors understand the risks associated with target date funds, specifically with regard to a fund’s asset mix and glide path. Investors with a life expectancy extending many years past a target date may end up with an overly conservative investment, which can lead to an erosion of wealth due to inflation. Limiting the exemption to QDIA funds could cause investors to choose investments that are ill suited to their specific investment needs. For these reasons, we do not believe QDIA funds should be given preferential treatment under a streamlined exemption. Instead, QDIA funds should have to satisfy the same eligibility criteria as other funds.

Other Key Issues

As noted above, designing and implementing a low fee, streamlined exemption is a complex endeavor requiring a sophisticated understanding of investing, investment products and investor psychology. The fundamental question of how to define low fee and high quality investment products is complicated by the fact that these concepts must be examined in contextual and relative terms. For example, whether a fee is appropriately low depends on the services one receives for the fee charged and how that fee compares to fees charged by others who provide similar services. Developing quality metrics is just as

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3 In 2010, the SEC proposed rule amendments to address potential confusion and misleading information regarding target date funds. See Investment Company Advertising: Target Date Retirement Fund Names and Marketing, Securities Act Release No. 9126 (June 16, 2010), 75 FR 35920. The SEC reopened the comment period on this proposal in 2014.
challenging. Certainly, performance is an important measure of quality, but it is not the only one. Return volatility, client service, and manager stability are examples of other factors that may be meaningful to many investors. Developing appropriate eligibility standards for a low fee streamlined exemption will require input from and dialogue between experienced professionals from various disciplines. Included among the important questions to be considered in this endeavor are the following:

- Whether there are factors in addition to past performance that should be used to determine the quality of a fund, such as portfolio turnover, “active share,” tracking error, manager tenure, and a manager’s investments in its own funds.
- How to determine the appropriate performance benchmark and/or peer group.
- How to determine the appropriate performance cut off.
- How to determine the appropriate performance periods and the weighting for each performance period.
- Whether a fund should have a minimum track record, e.g., five years, to be considered.
- Whether eligible funds should be subject to a minimum asset size to ensure that the fund is financially viable for the fund sponsor.
- Whether funds that are “closet index funds” should be eligible.
- Whether money market funds are too conservative to be included.
- Whether sector/specialty funds exhibit too much return volatility to be included.
- Whether and how to help retirement investors determine their investment goals and risk profiles.
- How to keep investors focused on their long-term investment goals and prevent them from reacting to short-term volatility.
- How to determine the appropriate fee cut off for active vs. passive managers.
- How to determine the appropriate fee cut off for different asset classes.
- What tools and resources the Department will need to monitor fund eligibility.
- Whether the Department should license popular benchmark indices.
- How the Department will obtain and analyze the data required to determine eligibility and ensure the integrity of such data.
- How often should performance, fees and other factors be assessed to determine fund eligibility.
- What happens to investments in a fund that loses eligibility.

**Conclusion**

As can be seen, the substantive considerations underlying a possible low fee streamlined exemption are varied and complex, and, we believe, not susceptible to the establishment of rules in a regulatory exemption. We do not believe that the Department’s goals can be achieved with a simple, one-size-fits-all test for high quality, low fee funds. Thus, we do not support the creation of a low fee, streamlined exemption.

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Thank you for the opportunity to share our views. Please feel free to contact Roberta R.W. Kameda at (415) 274-9434 with any questions about this letter.

Sincerely,

**Dodge & Cox**