UNITED STATES OF AMERICA

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DEPARTMENT OF LABOR

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EMPLOYEE BENEFIT SECURITY ADMINISTRATION
(EBSA)

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PUBLIC HEARING ON COMPUTER MODEL INVESTMENT
ADVICE FOR IRAs

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TUESDAY,
JULY 31, 2007

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The Hearing convened at 9:00 a.m. in Room N-4437 of the Department of Labor, 200 Constitution Avenue, N.W., Washington, D.C., Ivan L. Strasfeld presiding.

PRESENT:

IVAN L. STRASFELD, Director, Office of Exemption Determinations, EBSA
CHARLES JACKSON, ESQ., Planned Benefit Security Division, Office of the Solicitor
ALAN LEBOWITZ, Deputy Assistant Secretary for Program Operations
JOSEPH PIACENTINI, Director, Office of Policy and Research
FRED WONG, Office of Regulations and Interpretations

T-A-B-L-E O-F C-O-N-T-E-N-T-S

P-R-O-C-E-E-D-I-N-G-S

9:36 a.m.

MR. STRASFELD: Good morning. My name is Ivan Strasfeld. I'm the Director of the Office of Exemption Determination, EBSA, U.S. Department of Labor. Under the Pension Protection Act of 2006, the Secretary of Labor is required to determine whether there was any computer model investment advice program meeting certain criteria described in the statute which may be utilized to provide investment advice to IRA beneficiaries.

On December 4, 2006, the Department published an RFI in the *Federal Register* to obtain, among other things, information regarding the operation of computer model investment advice programs regarding IRAs. The Department also solicited comments from certain trustees and other interested person. The purpose of this hearing is to receive additional public comments regarding computer model investment advice programs and their utilization by IRA beneficiaries.

As to the procedures for this hearing, we will follow the agenda that has been prepared and previously made available as provided for in the notice scheduling this meeting. The speakers will be called in the order listed. We ask that each speaker attempt to stay within the allocated 15-minute period.

To the extent that members of the panel have questions for the speakers, the question and answer part of the testimony will not count towards your 15-minute presentation. We wish to note that nothing should be read in the way questions may be phrased and you should draw new inferences as to the Department's views from the question asked. At the conclusion of the scheduled presentation, other comments will be received if time permits.

If you have filed a written statement with the Department, it is not necessary to read the entire statement. Rather speakers are encouraged to summarize the statement in their oral testimony. Prior to beginning your testimony, we ask that you identify yourself, your affiliation and the organization that you represent for the reporter.

For those that wish to supplement the record, this record for this proceeding will be kept open until the close of business on Friday, August 31st. The official record of this proceeding will be open for public inspection and copies will be made available in our public disclosure room which is in Room North 1513 in this building.

I will now introduce other members of the panel. To my left is Joe Piacentini. He is the Director of the Office Policy and Research. I've already identified myself. To my immediate is Alan Lebowitz, Deputy Assistant Secretary for Program Operations. To his right is Fred Wong, a member of the Office of Regulations and Interpretations and to his right is Charles Jackson, an attorney with Planned Benefit Security Division of the Office of the Solicitor.

All right. With that out of the

way, let the festivities begin. Our first, Investment Company Institute, Mr. John Breyfogle.

MR. BREYFOGLE: Can you hear me?

MR. STRASFELD: Yes.

MR. BREYFOGLE: Normally, I'd like to say that we'd like you to follow the most persuasive arguments. If you can't do that because we think we're the most persuasive, go with either the tallest person or the first person. So we'll offer any of those three interpretative principles for you guys to follow.

(Laughter.)

MR. BREYFOGLE: My name is John Breyfogle. I'm a partner with Groom Law Group. I'm here representing the Investment Company Institute. We appreciate the opportunity to testify before you on the feasibility of computer programs in the IRA marketplace.

We have provided written comments. I think Michael Hadley, he's the Assistant General Counsel at the ICI, has helped prepared. So I will attempt to summarize the highlights.

The interest of the Institute in providing advice to IRAs is substantial. Mutual funds are the investment vehicle of choice for IRAs. Fund firms sponsor IRAs to IRA investors as well as provide through their affiliates a wide range of advisory, management and other services. The ICI has long supported legislation to foster investment advice in the both the ERISA and the IRA marketplace.

We think that the fundamental goal of Congress in enacting the statutory exemption was to increase the array, the type of investment advice that was available in both the ERISA marketplace and the IRA marketplace. Obviously, the exemption presents some pretty significant interpretative challenges for the Department. It's not the simplest or cleanest exemption. So we appreciate the challenge before you. But we do think that the policy objective of encouraging different types of and more flexible advice in both of the marketplace, the 401(k) marketplace, the IRA marketplace, really should guide your decision making. I do want to thank you for the field assistance bulletin that was issued at the beginning of the year. That was a very helpful and quick first step that confirmed several important issues to the Institute's members.

The other thing I would commend is sort of the Department proceed in fleshing out this exemption on sort of two track basis. One is obviously the determination that you have to make under the statute on feasibility, a prompt decision, which we think should lead to a class exemption process. We think that would the first track to go down.

The second track to go down is to clarify as much through rulemaking the general rules that are applicable under the statutory exemption. We would like to see if, at all possible, some enhancements to the fee leveling rule beyond what was able to be done in the FAB. We would also like to see some enhancements in the computer model universe, particularly to facilitate so-called off-model advice or advice after a portfolio has been presented by a model. So to really realize the Congressional policy objective, we think two tracks is necessary and we would appreciate your work in that regard.

The issue before us is a very important one, obviously. The IRA market is an incredibly important market for the retirement world. We have some data that's been presented in our testimony. A couple of things that were notable to us is that as of the end of last year IRAs actually hold more money than defined contribution plans. So more retirement savings is now in IRAs. $4.2 trillion was held in IRAs at the end of `06. Forty-two million households, more than 42 million households, have IRAs.

Much of the growth in IRAs is fueled by rollovers. Our data shows in `04 that over $200 billion in rollover money went into IRAs; whereas only about $12 billion of new contributions went into IRAs. So it's a very important area.

At the same time, the rules in

the IRA space are very different than the ERISA rules in terms of, well, not really rules, the available investment choices. As you guys know well, in the typical defined contribution plan, you have limited sets of choices. Relatively few plans have brokerage windows. Participants usually pick among a dozen or somewhat more investment choices that have been vetted by plan fiduciaries.

In the IRA world, there are virtually unlimited choices that participants can go into and many IRA sponsors including Institute members make available the full range of choices that you can get in through IRAs.

Our data shows that there is over 6,200 mutual funds available to IRAs. There are over 5,000 publicly traded companies, all of which offer a myriad of debt and equity securities that are available to IRAs. There are currency instruments, foreign securities, futures, options, insurance products, hedge funds, limited partnerships. There are essentially very few things that an IRA investor cannot invest in. Given the importance of IRAs as a source of retirement savings and wealth, given the wide range of choices, we think it's sort of especially compelling for the Department to look to ways to increase the types of investment advice, the flexibility of investment advice in that space.

In terms of the feasibility determination that you all have to make today, I'll just briefly recap what we think are some of the relevant statutory principles that should guide this decision. Basically, through the PPA, there are sort of two types of investment advisory programs that are permissible. One is the so-called Level Fees PACT that you've clarified somewhat in the FAB. The other is the computer model option. Computer models have to meet certain statutory standards, generally accepted investment theories, use relevant participant information. They have to be certified by an eligible investment expert. Also as part of the statutory exemption, the computer model has to take into account all of the investment options under the plan. That's a specific statutory requirement.

We think though that Congress recognized that computer models may not be suitable as defined in the statutory exemption or even doable with respect to the IRA market and obviously you were called on to make this feasibility determination. There's a variety of criteria that obviously you know well that has to be applied in making this determination. The one that we think from an interpretative standpoint, that's most important provision, is the provision that says you have to find whether any computer model can take into account the full range of investments including equities and bonds and if you can't make that determination, you move into a class exemption process that generally has to have terms consistent with the statutory exemption but without the computer modeling condition.

So we think the critical question is what did Congress mean when they directed you to see if a model can take into account the full range of investments including equities and bonds. We do recognize there are potentially different interpretations. There is not necessarily one clear and sole interpretation.

We do think though that the most natural reading of the statute is that a computer model has to consider, essentially be able to consider, each potential IRA investment and by that it would have to include equities and bonds of which there are literally thousands, all the mutual funds available, as well as all the other types of securities and non securities and property that IRAs can invest in. We think that's the natural reading of the statutory directive.

There is no indication that Congress contemplated that a computer model would meet the statutory criteria if it limited the universe of investments in providing model advice and we just point out that in adopting the condition to the exemption Congress used words that were more limited, that the model have to take into account what's available under the plan; whereas the more expansive language for the feasibility determination directs the Department to make the finding with respect to essentially the whole universe of investments.

Assuming that the Department were to agreed with that, and I don't assume that, but then the question "Is there a model out there that can do that?" The ICI conducted a survey at the beginning of the year of its members. Twenty members responded. These members are the biggest fund companies out there. They hold over $4.2 trillion in mutual fund assets. They hold about 50 percent of the IRA mutual fund assets and none of the members has a model that has a capability to model that universe.

Our recommended next steps would be for the Department to promptly making the finding that computer models aren't feasible in the IRA applying this interpretation of the statute and looking at the record that's being submitted to it and, at that point, we think it should promptly move to the class exemption process where we believe you should seek to promote both models that may model a limited universe as well as advisory programs that are not model driven. We don't think an exemption should be biased to one or another method of providing this important service to this space. We think the key conditions would be obviously IRA holder consent and robust disclosure.

So with that, I'm going to stop a little bit early. I'll take any questions that you have at this point. Thank you.

MR. LEBOWITZ: John, this whole debate is really about what that phrase "full range of investments" means, isn't it?

MR. BREYFOGLE: Yes, absolutely.

MR. LEBOWITZ: So if we were to conclude that it means "asset classes" and not the full range of every conceivable investment, what do you think the answer would be to the core question here as to whether such a program, computer model program exists?

MR. BREYFOGLE: The other criteria of objectivity and things like that, I think most of the commentors suggest it could be met, could be satisfied. It's really this is the key interpret question that I think has to be resolved. So I do think there are objective models. I do think there are models that can provide advice and can be generally accepted, all the other criteria. So I really do think this is the nut.

MR. LEBOWITZ: Right. So am I understanding you correctly? If our conclusion is that our interpretation of the statute is that the full range contrary to your view is referring to asset classes, then the answer to the question that Congress posed to us is whether such a program exists would be yes.

MR. BREYFOGLE: I think you'd have to -- I haven't looked at whether each of the other criteria can be met and that hasn't been the focus. Assuming you could make the determinations on all the other criteria, I think the answer would likely be yes. I don't think that's what Congress meant through the inclusion of this provision though and I think the fact that the statute uses words of limitation and the exemption condition uses deliberately expansive language here without words of limitation, having been involved in the process at the time and having some understanding of what was being thought at the time, I actually don't agree that that's the right interpretative answer. But I do think that the Department has flexibility to interpret this provision and it wouldn't be outside of that statute if you reached that conclusion. But I do think that it would drive you down a set of solutions that would be necessarily less flexible than the kinds of solutions that we would like to see in the IRA space that we think that you might be able to get there through an exemption process.

MR. LEBOWITZ: The exemption, at least the provisions in the statute that we would be directed to adopt, seeing at least that first reading now you seem to have a different --

MR. BREYFOGLE: I do. I don't think -- I mean, I think obviously this whole exemption is poorly framed. The feasibility provision which was tacked on in conference in the last few days is also poorly framed. But I think if you work through it, basically it's telling you the class exemption consistent with the statute but without the computer model condition.

So what does that tell you to do? You could read it literally and say, "We have to issue a class exemption that has a fee leveling condition in it" because that would be consistent with the statute. But that would be utterly inconsistent with the purpose of having to go to the class exemption process.

I basically think that what they're directing you to do is to get into the exemption process and the Department has fairly wide latitude in what it can do. It should obviously adopt the types of disclosure conditions, presumably some form of a workable audit rule, some provision that requires obviously IRA holder consent. The exemption wouldn't be consistent if it covered discretionary products. So there are other things that you can do.

I don't think that the Department's latitude once it gets into the exemption process though would be all that limited. I think you could both foster personalized advice that's not driven by a model or maybe it starts with a model and then gets to specific recommendations as well as model advice that has the limited universe. I think both of those should be considered and pursued in the exemption process.

MR. LEBOWITZ: We could do that anyhow if we wanted.

MR. BREYFOGLE: There's the right.

MR. LEBOWITZ: It's a policy judgment, too, to go down that road.

MR. BREYFOGLE: Right. The Department, I think, outside of this directive could just pursue its own class exemption that quite frankly is a more workable and sensible one than what was put together in the PPA conference. Absolutely, there is general authority under 408 to do that.

MR. LEBOWITZ: Is that what you meant by -- You said during your testimony you used the word "enhancements." Is that what you were getting at?

MR. BREYFOGLE: I was getting at that the Department really should attack this problem on a two track basis. One is through the rulemaking process in interpreting the actual statutory exemption to the extent possible to give us more flexibility on the level fee's approach as well as the computer model approach as well as pursue the class exemption process. So in terms of how I used "enhancement," I'm not remembering exactly how, but was it in connection with talking about the rulemaking or the exemption?

MR. LEBOWITZ: I think you were talking about the actions the Department had taken up to this point.

MR. BREYFOGLE: Yes.

MR. LEBOWITZ: And then you talked about your view that there was a need for some enhancements in some respects.

MR. BREYFOGLE: What I was saying there was obviously I thought the field assistant's bulletin was a very good quick step to just solidify everybody's understanding about the Frost Bank approach, about the SunAmerica approach, about duties and liability of fiduciaries.

The fee leveling guidance while we think was helpful, we think could be improved possibly by rulemaking so that the level fee rule only applies to the person giving the advice. That was something we had suggested to the Department prior to the FAB. Additionally, we thought that there was some clarifications on the computer model front that would be enhancements as well.

MR. STRASFELD: Let me ask you a question about to the extent we can't make the findings or the determination and we have to proceed along a class exemption track the language that the instructions we were at the Department given was that we have to ensure that the requirements of the statutory exemption were met other than the computer model and then the other provision was we have to ensure that investment advice is provided under a program that utilizes prescribed objective criteria to provide asset allocation portfolios comprised of securities or other property available as investments under the plan.

MR. BREYFOGLE: Yes.

MR. STRASFELD: I read that as being somewhat of a narrowing of the authority for us to grant an exemption pursuant to the statutory exemption. As Alan mentioned, we obviously have the authority consistent with our findings to provide relief outside of this context. But I would like any comments on what you think that statement means.

MR. BREYFOGLE: On the latter statement, I think that there is a way to reconcile that which is obviously they're telling you you can't do a computer model. So we can't just read to mean a computer model.

MR. STRASFELD: Right.

MR. BREYFOGLE: The way most advice products get delivered is in the sort of personalized, one-on-one advice setting is an individual advisor is going to sit with you. You're going to fill out a questionnaire. They're going to get a risk profile, risk tolerances. They're going to look at all your assets. Most programs, they will come up with some basic asset allocation strategy that will be quantitative and model driven and from that spot, they're going to populate it with specific securities and property recommendations.

So to get to your point, how could you satisfy the condition and still get to the flexibility that we want and, I think, need given the sort of dizzying array of choices that are available to IRA holders one is that you require that people do that kind of questionnaire, do that kind of profile, make sure there is an asset allocation strategy in place and then give recommendations that are not model driven that are consistent with that kind of objective, overarching asset allocation strategy and I think that would be a way to reconcile the statute. It would be a good, sort of protective condition and also add a lot more flexibility and also work fairly consistently with products that are actually delivered in the non-ERISA, non-IRA world.

MR. STRASFELD: So would you view this requirement as being met if there is some objectivity in the presentation by the registered rep in terms of asset classes and, as you indicated, then it's populated with particular products although there would be some limitation on the advice provider?

MR. BREYFOGLE: I don't think there would be any limitation on what you could recommend.

MR. STRASFELD: Sure.

MR. BREYFOGLE: But it would have to be consistent with an overall objective allocation strategy.

MR. STRASFELD: Right.

Following, how would that work exactly? I'm interested as to what this individual would have before them in making their advice, providing their advice, to the IRA participant. I assume from reading this language it would suggest that he just can't do whatever he wants. There is some limitation on him.

MR. BREYFOGLE: Right.

MR. STRASFELD: What is that?

MR. BREYFOGLE: And I think it's a misnomer to think that that's really what happens in a marketplace. People don't just do whatever they want or just say, "Hey, I want to put you 100 percent in this."

MR. STRASFELD: Right.

MR. BREYFOGLE: People really do start with an objective, data-driven process of questionnaires and putting together a sense of your risk tolerance, understanding what your portfolio as a whole is and then coming up with an allocation scheme and trying to populate it with specific securities recommendations.

MR. STRASFELD: Right.

MR. BREYFOGLE: And to me, that's entirely consistent with the statute to say that there are some steps you have to get to before you can give specific non-model driven advice. I don't think it's all that inconsistent with what people do and I think it would be a way to satisfy the objectivity criteria. Obviously, these are issues that we would, the Institute would, want to do some policy making and process and make recommendations of the course of the class exemption process with the Department to choose that pathways.

MR. STRASFELD: Okay. Any other questions? Thank you very much.

MR. BREYFOGLE: Okay. Remember tallest and first.

MR. STRASFELD: I remember that.

(Laughter.)

MR. LEBOWITZ: How tall are you John?

MR. BREYFOGLE: Six foot five.

MR. LEBOWITZ: Put that in the record.

MR. BREYFOGLE: I'll be taller if

anybody else is 6'5".

(Laughter.)

MR. STRASFELD: All right. Financial Engines.

MR. FINE: I'm Financial Engines. I'm not 6'5". And I'm not first, but I'm going to testify.

My name is Ken Fine. I am the Executive Vice President of Marketing for Financial Engines. My job and the job of my team at Financial Engines is to define how our products and services work and to design how we communicate the output of those products and services to individual investors.

I've been with the company for about ten years and have led the development of all of our products and services since the company was founded. I have with me two colleagues who will be available to answer questions on methodology and legal issues, our Vice President of Portfolio Management, Sylvia Kwan, and our General Counsel, Anne Tuttle.

In terms of our testimony here

today, we recognize you already have a deep understanding of the IRA market. As such, I'm going to focus my comments almost exclusively on the specific question at hand which is is it feasible to provide investment advice to IRAs using a computer model.

I'm going to go through that in four basic steps. I'll give a quick outline of financial engines in our history. Then I'll talk about our specific experience actually providing investment advice on IRAs using a computer model. Then I'll move onto our methodology, how we actually go about doing so. Then I'll end with summary and recommendations.

In terms of corporate background, we were founded in 1996 by Bill Sharpe. Bill won the Nobel Prize in 1990 for his work in contributing a modern portfolio theory. The basic idea behind the company was to take the work he had done over the previous two decades with pension funds and in academia and bring that to bear on the problems of the individual investor.

The primary business that we're in providing investment advise and investment management to 401(k) accounts of employees of Fortune 500 companies. So that's primarily what we do. To put that into perspective, as of June 30th, 106 of Fortune 500 have hired us to provide advice to their participants covering about 6.5 million participants. That gives you a sense for the scope of our business.

In terms of the services that we provide, there are two, investment advice and investment management. The difference between the two, on the advice side, we provide recommendations that people then decide to implement. On the management side, we actually execute the trades and manage the portfolio.

The technology that drives these services which would be very relevant to the discussion of the computer model are also twofold. We have a forecasting technology which uses Monte Carlo simulation which essentially provides a range of outputs which shows how much someone's account might be worth in the future, so a range of possible outcomes, good, bad and in the middle.

The second technology is our optimization technology and that technology essentially selects portfolios with the highest expected return for a given level of investment risk. So that's a quick background on who we are and what we do.

Transitioning to our experience specifically with IRAs, in 2001, we rolled enhancements to our services that enabled us to provide investment advice across all tax deferred and taxable accounts. To be specific that includes 401(k), 403(b), IRAs, Roth IRAs, SEP as well as taxable brokerage accounts. So that was in 2001. We've been doing this for approximately six years.

Those services are available in several different locations. They're available today on FinancialEngines.com. They're also distributed and accessible through Vanguard, City Street and American Century. In addition, some of our corporate customers have elected to make investment advice on IRAs available along sign investment advice on 401(k)s, so the IRAs with the 401(k) and then also have us provide investment advice on IRAs for those who want to take advantage of that service. We've been doing that for about six years.

In terms of total scope, we have provided investment advice on IRAs to approximately 30,000 individual investors covering about 50,000 IRA accounts and $4 billion in assets. That's the IRA-specific advice.

Now moving onto how we do and what we do, in terms of providing advice on an IRA with a computer model, five key points. The first is that the business itself and the models we have developed are independent, meaning we do not derive -- our revenue is not influenced by or impacted by the advice that we give. One hundred percent of our revenues come from our advice and management. We do not collect commissions, top dollar payments, 12(b)(1)fees or really any revenue related to the sale of investments. So that's an overarching umbrella across all of our methodology.

In terms of interacting with the individual investor, the process begins with gathering information and we break that information gathering process into two different levels. There is the minimum information that we consider necessary to begin the advisory experience and then there is additional and substantial optional information that someone can provide to enhance that experience and make the investment advice more personalized.

The minimum information required is at date of birth investment horizon and the specifications on the investment universe that the person can invest in, we usually get that information from the financial institution and I'll speak more on those details in a moment.

Optional additional information that the investor can provide includes information on all other accounts. So, for example, if the individual would like advice on their IRA but wants that in the context of their 401(k), another IRA and a taxable brokerage account, that information can be provided on a specific investment level. Risk preference. Other sources of income, pensions, Social Security, etc., salary, financial goals and the contribution rates into the various accounts. So that constitutes the additional information people can provide that enhances the total advisory experience.

Once that information is provided, we then provide the individual investor with two deliverables, if you will. The first is a forecast of how much that IRA account and any other accounts that they've told us about might be worth in the future. So we use Monte Carlo simulation at the specific investment level and forecast what that set of investments might be worth in the future. Then we provide specific advice which includes buy and sell recommendations on the investments and the investment choices and options available in the IRA account.

With respect to asset coverage in

the investment universe that is available when using a computer model, that universe is as follows. We can provide advice across all mutual funds. That includes equity, fixed income, actively managed and passively managed, across any size universe. It could be ten funds or 10,000 funds. The model could handle any size. Exchanged Traded Funds, ETFs. Institutional and co-mingled fund products. Individual stocks. Baskets of stocks. Separate accounts. Stable value and cash investments. So any of those products or assets classes can be in the investment universe as part of what the individual is getting forecast on and receiving advice on.

With respect to bonds, we provide simulation of individual bond positions, meaning we'll take a bond or a set of bonds and simulate how much those might be worth in the future. Today we do not provide advice across bonds. If that was something we wanted to do, it is a straightforward extension of our current methodology. It's something we have not yet taken on.

If the individual would like to include assets in his or her total picture that I haven't mentioned, then there is the option to define something or enter something called a user defined asset where the individual can or the advisor can put in assets, specify the size of that investment and the expected growth rate in the future.

Once the advice has been provided, the individual has the ability to personalize that advice. For example, let's say the advice was to invest 25 percent of the IRA account in a particular international equity fund. If the individual received that advice and decided he or she wanted to invest, let's say, 30 percent, that person could change the recommendation, lock in 30 percent. The computer model would then do the best that it could with the remaining 70 percent given the investment universe and try to diverse any additional risk which has been taken on with that additional allocation.

Wrapping up, three key points. It is possible to provide high quality investment advice on IRAs using a computer model. We've been doing that for about six years. With respect to regulatory and providing guidance on this activity, it's our opinion that if the advisor that's providing the advice does have a conflict of interest and has interest in the products that are being advised across, that it's vital the model be unbiased in its recommendations.

In terms of what does unbiased really mean or how might you check or verify that a model is unbiased, first, the recommendation should be unaffected by the identity of the investment manager or any revenue implications to the advisor and we believe the heart of where we would look if we were looking at the model to check how biased or unbiased it was, we would look at how it accounts for fees. So our fees are explicitly accounted for in the model and how. In terms of then providing guidance, we believe that the framework, the PPA for 401(k), would be suitable in the context of an IRA and would suggest that it be clear that this applies to advisors that do have a conflict, not those that do not.

Those are my prepared comments. I could take questions.

MR. LEBOWITZ: So your -- Well, in your written submission to us, your answer to what we talked about earlier is the core question whether a program exists within the framework laid out in the statute was very simple and you said yes and went on to describe your company's approach to it. Am I right that you're saying that however the full range of investments is defined, your program, your product, is capable of modeling almost without limitation?

MR. FINE: I'd say, sir, our program is capable of modeling sets of investments that I specified and included in the written testimony which is a large portion of the investment universe. Our experience is, obviously as a company, we provide advice through a computer model, that's what we do, whether it's 401(k), IRAs, whether we're using those models for management in addition to advice, is that there are certain levels of investment, certain levels of breadth of investment universe that's appropriate for certain investors.

So, for example, we do not provide investment advice on calls and puts. That's not something we do in our model and we believe that there's a market for people who do that and it can be done in other ways. Our experience is that the investment universe that we do offer advice over is appropriate for an IRA for the vast majority of people who invest in IRAs/

MR. LEBOWITZ: Do you think that Congress intended that the advice that the computer model in the IRA context takes into account options?

MR. FINE: Well, I don't know what Congress intended, but I would not expect that that would be considered a typical investment with an IRA for most people.

MR. LEBOWITZ: And do you have a view on the interpretative issue that we're grappling with here on what Congress intended in the context of this phrase "full range of investments"?

MR. FINE: Yes. Our interpretation is that it would be a range of investments that's consistent with what the typical investor invests which could include mutual funds, stocks and bonds. So it would not be an exhaustive list of every possible single instrument that anyone could ever invest in. Rather it's the majority of investments that people do invest in.

MR. LEBOWITZ: Thank you.

MR. STRASFELD: I have a quick question. All right. One of the major distinctions between IRAs and 401(k) plans is in 401(k) plans you, the participant, are limited to the options available under the plan and when you get to the computer model for 401(k) plans, it specifically describes it as such that you have to be able to model everything offered.

I just want some practical guidance in the IRA context. In a lot of these you can sort of invest in whatever you want even down to an open brokerage window. So how does your process begin. Let's assume in some of these cases the IRA participant or beneficiary may come to you with an idea in mind. He wants to invest in a family of mutual funds. But what about the situation where the participant is not particularly knowledgeable and just comes to you and says, "I basically want to go with the full range in order to increase my diversification and limit my risk"? How do you go about the process of actually selecting what's in there? Who actually in the context of IRAs picks the investment universe?

MR. FINE: There are really two different ways that that process can work, at least, the way that we deliver our services. The first is what -- The distinction is whether it's delivered through an advisor, so an advisor using our computer model or an individual investor using our computer model on their own.

So let's say in the case of an advisor. We would generally work with the advisor to determine what universes do you want to make available in your business. One universe could be all retail funds. It could be a particular family. It could be groups of families. It could be basically any universe they would define and they would include that in their up-front discussion with the individual investor saying "Here are the different options" or even in some cases, create sets of advice based on different universes and compare them, saying "Here's what we can do with Universe A. Here's what I can do for you with Universe B and then here's how that affects your retirement picture." So that would be an advisor-driven experience.

In the case of where an individual is working, interacting, with the service, it's similar that the individual makes that selection. So what we've done, for example, in our service is we've created a menu of common universes and fund families that people can invest in and we've done research to identify that those universes cover well north of 90, 95, percent of what people do invest in. So we've done some market research and people essentially select the universe they think is appropriate for them or they could select all. We basically look at all the different universes and we optimize across those universes.

MR. STRASFELD: What have you seen the vast majority of people selecting? I mean, do they go for a huge universe or families of mutual funds? Is there something that's typical?

MR. FINE: It's a good question. I don't have data, but my experience has been that people left to their own devices choose the universes associated with the provider of their IRA. So if their provider is financial institution A, they will look on the list for that institution and we have done research to make sure that we've included the investments for that institution. They'll pick that one. If they're shopping around and thinking about switching from financial institution A to B, then they might put both or they might put the other one. That's usually the basis they use to make their decision or they might default to everything. That's usually the case.

MR. STRASFELD: Thank you. Any other questions?

MR. PIACENTINI: I do.

MR. STRASFELD: Good.

MR. PIACENTINI: Early in your testimony, you said that there's a minimum list of factors that ought to be considered in a model, date of birth, investment horizon, investment universe, and then there are other factors that might also be considered. If advice is provided on just the minimum versus advice provided on all of the factors, how different does the advice turn out to be?

MR. FINE: Good question. So the way our classes work since we use simulation as a basis for the advisory experience as opposed to a questionnaire that provides generally a more hypothetical set of questions around what your preferences are, what we would do, and I'll walk through briefly a typical experience and make it very tangible, let's say you were interacting with a service either directly or you were talking to an advisor and you had an IRA account with a certain financial institution, we would start by gathering that information often electronically if it's there in a recordkeeper and provide a forecast of that and say, "Here's your starting point. You have an account and here's how it might turn out in the future."

The next step would be "Would you like to get advice across this same universe or would you like to look at another universe?" And when we move to that step, then we would show someone two things. We would say "If you would like to maintain the same level of investment risk that you have today, here's what we could do that's a little bit better." So it reflects the types of decision making you've already done, but it's a bit more of efficient portfolio.

Then we would provide an ex-portfolio which is if you would like to compare that to what people typically do with your investment horizon. Here's how that looks. That's the experience we can provide with the minimum information. So here's your current situation and here's how you could do it with a couple different levels of risk.

At that point, the individual has the opportunity to interact and add more and say, "Well, I appreciate those starting points, but I'd actually like to explore yet another risk level. I would like to see what things look like if I've very conservative or very risky or now I'd like to add in my 401(k) account and see how that affects the advice." So we start with what we have, basically two different risk levels, and then we start to expand the picture based on whatever other information the investor wants to provide.

MR. PIACENTINI: I guess where I was trying to focus was if you additionally take into account the 401(k) account or some other source of income, for example, from a spouse. Is there the potential that the advice would change a lot?

MR. FINE: Absolute. Yes. Certainly. So we do look at the interaction of covariances between the specific investment products in the different accounts. So if someone, for example, were to tell us about a brokerage account that had very high risk stocks, that would affect the recommended allocations within the IRA. Yes, it would.

MR. PIACENTINI: And you said that your model employs optimization to maximize return for level of risk.

MR. FINE: Yes.

MR. PIACENTINI: Does it do that with respect to the investment horizon or with respect to the nearest period?

MR. FINE: That would be a good question for Sylvia.

MS. KWAN: Yes. What Ken was talking about as sort of the initial is driven by investment horizon. So depending upon the investment horizon, we get someone at a particular level of risk and once they've seen the forecast and all the outcomes, they can then change that level of risk to what they desire. So the starting point is based on investment risk.

MR. PIACENTINI: Okay. Last question. You said in terms of evaluating unbiasedness the first place you would focus this on is the treatment of fees.

MR. FINE: Yes.

MR. PIACENTINI: So I guess my question is can that be summed up as returns ought to be treated as net of all fees and expenses or is there something more to it than that?

MR. FINE: I think that's my interpretation. Sylvia, could you address that?

MS. KWAN: Sorry.

MR. FINE: What's the most appropriate way to include fees in the model? Is it simply saying returns or net of fees?

MS. KWAN: Yes.

MR. PIACENTINI: Thank you.

MR. STRASFELD: Thank you very much.

MR. LACKRITZ: Good morning. May it please the court. Good morning. It's a pleasure to be here and an honor to be able to testify to you about this issue.

My name is Mark Lackritz. I'm the President and Chief Executive Officer of the Securities Industry and Financial Markets Association. We're a trade association of over 650 securities firms, banks and asset managers both locally, in the United States and globally. We operate through offices in New York, Washington, London and Hong Kong and our members represent about 95 percent of the overall securities industry and financial markets' activity going on in this country.

Our diverse members provide a vast array of financial products and services to investors from all different walks of life including custodial, brokerage and advice services, in this case, to more than 13 million IRA accounts. I'm here in that capacity as the president and CEO of a trade group but also in the capacity of somebody that just announced yesterday that he has plans to retire in the near future. So I am here as a user of these services as well and I'm also a father of three adult daughters, each of whom have their own IRA accounts and none of whom have found any computer models to be anywhere close to being satisfactory for providing investment advice. Enough about my personal experience, but I think that's relevant in terms of what we're talking about here.

We don't believe that a computer model that would meet the statutory requirements of the Pension Protection Act is either effective or feasible and we urge the Department to make that finding and to issue a disclosure-based exemption for the provision of investment advice for IRAs.

I would just like to give you a broad overview of why this is the case. First of all, investors and beneficiaries deserve clear, understandable, relevant and customized investment advice so they can make decisions that are tailored to their own personal circumstances. They should have robust choices when making financial decisions and shouldn't be forced into a one-size-fits-all approach of a computer model that simply cannot offer the level of service an investment advisor can. Maybe someday we'll get to that point where technology and computer are going to be able to do that but we're clearly not at that point now.

Investment advice encompasses much more than existing computer models provide. In a key survey of mutual fund investors, nearly two-thirds of shareholders identified asset allocation as only one of five distinct difference services that they received from their advisors. They also identified financial planning assistance, retirement assessment management and specific investment recommendations as services that were regularly provided in these advisory relationships. Investors that have used a professional financial advisor say that they have done everything they can to financial prepare and they feel more comfortable with their knowledge and involvement of saving for retirement than those who don't or have not.

A recent Forrester survey concluded that for every single generation independent financial advisors and financial advisors at brokerages "are at the top of the list of most helpful resources for retirement research." Consumers that have used the internet to research retirement put the channel right behind human advisors in terms of helpfulness. That's understandable.

We don't ask you to get medical advice from a model. We don't mandate that you get medical advice from a model. Is it feasible? I suspect it might be feasible. Does it make any sense? Absolutely not. Do we do the same thing with legal advice or regulatory advice? Of course, we could get models here, but do we want to mandate that? I don't think so.

Consumers who have used the internet to research retirement put the channel behind advisors in terms of helpfulness and online solutions or other web-based guidance programs really aren't good enough yet to attract more than a fraction of the population. You just heard the previous speaker talk about serving 30,000 accounts. I think that's terrific. We're talking about millions and millions and millions of accounts here. We're talking about IRA assets that in the next ten years are going to grow to about $10 trillion.

Just to harken back to earlier era, a trillion here, a trillion there, it's real money. This is significant and this is an important economic asset in the long run. In addition, those who are most likely to use the internet to plan for retirement are the least confident in their ability to estimate when they'll retire, how much it will cost and where the money will come from.

I guess I'd like to focus on a couple different points. One is the statute itself. I mean, let's just talk specifically about the question that you raised before, Mr. Lebowitz, because I think it's exactly the relevant question here.

IRAs may invest in stocks, bonds, CDs, mutual funds, annuities, real estate, limited partnerships and private stock, both foreign and domestic and futures and options. There are no limitations here and the statute specifically talks about, takes into account, the full range of investments including equities and bonds. That's not classes of assets. That's specifically referred to in the previous section. If we're talking about classes of assets, this section wouldn't be necessary. You could just refer back to that other section.

It also determines the options for the investor portfolio of the account beneficiary. It also allows the account beneficiary to direct the investment of assets and have sufficient flexibility in obtaining advice to evaluate and select investment options. That's not just mutual funds. That's just not an allocation of mutual funds and within equities and bonds, as you all well know, there are all kinds of different categories. Is it value? Is it growth? Is it large cap? Is it small cap?

Is it high risk? Which sector is it in, etc.?

Now obviously technology is doing things we couldn't have imagined 20 years ago and I suspect 20 years from today it will be doing things we can't even imagine today. One of them may well be to level of sophistication to actually interact on a one-to-one basis and, in fact, provide specific kinds of advice with respect to specific kinds of investments that are permitted to an IRA account holder. But I would suggest to you that right now technically that's not feasible as even was admitted before by the Financial Engines' witness who said yes, they had provided investment advice for a broad, for a majority, or I forget the word he used, but it wasn't a full range of investment options. It wasn't there. It's not here.

And therefore, what do you do? We'd like you to issue an exemption, a broad-based exemption, that provides for audit compliance at high level so that you, in fact, provide for audit at the level of policies and procedures utilized by these providers and that would make it simple, that would make it effective, and that would provide the investment advice that millions, literally millions, of IRA account holders really want.

I mentioned my daughters earlier because I think that's exactly the group we're talking about, people in their 20s just starting out, beginning to save money for long term, looking around for serious investment advice. There's a whole profession that provides this and we think of investment advice and financial advice, obviously, in very serious terms, just as seriously as we think of medical advice or legal advice or other kinds of professional advice out there.

So I would strongly suggest that what we need here is a broad-based exemption and from the standpoint of compliance, it should be at a very high level so that we're not getting into the weeds and making it so costly and burdensome and creating additional liabilities so that in fact we end up clogging the system and we don't get the deliverables that actually the IRA beneficiaries clearly want and clearly need. I wanted to state that as clearly as I could.

I guess the other point I wanted to make was I thought that Congress -- It seems to me looking, reviewing, the statute Congress was extremely clear here. Unless computer models can take into account all potential investments of an IRA including what I've talked about before, the statutory exemption for computer models cannot be used and the Department of Labor must issue a non computer, model-based exemption. Nobody has testified that a computer model has been developed and the development will clearly be hampered by extraordinary cost and the need for computer capacity which will make the use of these models for IRAs prohibitively expensive.

Just taking a count of what's already held by an IRA in computer model is not providing investment advice. That's not -- You know, yes. I can say "What does this look like in a Monte Carlo simulation?" "Well, it looks good." "It looks bad." "Well, I don't know what that means. Does that mean I should change? If I should change, does that mean I should sell Microsoft and I should invest in Google? Does it mean I should short Google options and invest in a swap or a caption or something like that?"

I appreciate that technology has an enormous capacity here. I'm not -- We're not being Luddites. Our members all use and have taken advantage of a great deal of technology. It's opened up avenues and options and opportunities that nobody deemed feasible recently.

But we're not to the point of providing this kind of advice for IRA holders on a wide basis. So it seems to me from the statutory history, from the technology that's currently available, from the evidence you have on the record that you really should come to the conclusion that these are not feasible from the standpoint of providing investment advice to IRA account holders and you should proceed to issue a broad-based exemption with an audit requirement at a high level.

I will close with that and open it up for any questions that you might have.

MR. STRASFELD: Mine's more in the nature of an observation. Since I was involved in this process since the beginning, it seemed to me that Congress must have had some awareness that they wanted us to take the really broad reading of this language that the model would have to take into account every investment conceivable in the world. It must have known there is no model that could possibly do that, I mean, in terms of it just wouldn't be possible and the oral comments have demonstrated that no matter whether they were saying that yes, we can or no, we can't. But the reality was they said there is no model that can model the universe. So that's what they intended. They must have already known the answer to that. So why would they have had us go through this exercise?

MR. LACKRITZ: First of all, I think it's a really good question and I think I don't know from a legislative history that I've looked at there's a clear answer. I suspect what they're trying to do is I don't think anybody can anticipate what technology can do in the future. So I think what they were looking to you to do is to see "Look. Is this feasible now? Is it feasible 10 or 15 years from now?" Maybe it will be at some point, but it's not feasible now. So I think they've provided you some flexibility, giving you direction, as to here and now and in the future there may be. You have some flexibility. That's the best I can come up with. There's probably legislative history we haven't found.

MR. STRASFELD: I'm still looking if you find it email it to me.

MR. LACKRITZ: We'll absolutely get it to you.

MR. STRASFELD: Thank you. Any other questions? Yes.

MR. PIACENTINI: So I think I understand the distinction you were talking about between advice delivered by a person, by a professional, versus a computer and some of the differences between the two. But I guess my question is is there somewhere a tradeoff to be made between the cost and perhaps therefore the availability of advice to a broader population versus the comprehensiveness and maybe in some sense the quality of the advice. Is there a tradeoff to be made there?

MR. LACKRITZ: Sure. There's always a tradeoff. I think there's, of course, going to be tradeoff here. I think what we've seen from surveys, what we've seen from beneficiaries and investors that we've surveyed, and we do this on an annual basis and actually fairly periodically, just like the ICI does with respect to their surveys, these individuals wants clear, understandable, relevant and timing personalized information and yet there are lots of ways you can imagine getting information to investors. That's just the first issue.

The second question is what are

we going to do about it and that's really where investors need help. That's really where we want investors to get the help that they need which is your money -- relationship shows you're going to fall short of what you need to retire at 60. Okay. You're 45 years old right now. Your assets are allocated a certain way in your IRA and you're going to get a lump sum of cash. I mean, the biggest challenge here is that a lot of the IRA asset accumulation are going to be lump sums of cash from defined contribution plans that people are going to take out at the same time.

So they're going to say to somebody, "I have $500,000 for my retirement account. What the hell should I do?" That's really where an advisor is really important. That's when the computer model will then spit back the question and say, "What kind of equities are you interested in" and you say, "Well, I'm interested in a relatively low risk because my age is 45 and I have 15 years until I want to retire" and they're going to say, "Well, then you should be in high cap, large cap stocks, growth stocks. You should be in large cap value stocks. You should have a beta of no more than X or Y." That doesn't -- I can tell you that our daughters are far more computer literate than I will ever be and they have called me three times saying, "Look. I need somebody to help me on this" and I think that's something to take into account.

You are absolutely right. There is a tradeoff here. But I think I would err on the side of making sure that investors got it right, not got it fast and cheap at the lowest common denominator. You want to make sure people get good, solid advice for their own future.

MR. PIACENTINI: Okay. One other question. You touched on a couple of examples of specific types of investments that maybe a computer model couldn't do a good job of taking account of and I found myself wondering how often will it be appropriate for an IRA investor to get advice down at that granular level, for example, choosing stocks not only based on whether they are large or small cap or growth or value but based on sector who are deciding what they should do about an individual security, perhaps whether to shorten an individual company as in your example. Is that something you think should be part of the advice picture under consideration for the majority of IRA beneficiaries?

MR. LACKRITZ: Sure. I think, first of all, this is not a one hit wonder to use the vernacular from pop culture. I mean, this is a continuing process. Investing is not for amateurs. It really requires constant- and nurturing. I mean, what happens when the market drops five percent all of a sudden because of something in Asia? Lots of people with lots of money tied up in the markets all of a sudden can get really panicked and a computer doesn't exactly say "Don't panic. It's going to be fine" or "Double down" or "Double up" or "Sell" or "Buy."

It's an ongoing process and I think part of what I would urge you to remember in taking account of this kind of deliberation is that this is an ongoing process. You get a snapshot at one particular point in time and it's like a medical checkup. Every couple of years, you want to make sure you keep it current. You go back to the doctor every year for a physical. You should be doing the same thing with your retirement account.

MR. STRASFELD: Thank you very much.

MR. LACKRITZ: Thank you.

MR. KANT: Good morning. My name is Douglas Kant. I'm a Senior Vice President and Deputy General Counsel in the Legal Department of Fidelity Investments, a financial services firm based in Boston. I'm an ERISA lawyer and I work with our retirement business. I'm accompanied today by Robert McDonald who is a member of our investment staff who is a Senior Vice President with Strategic Advisors of Fidelity Company.

As a first remark, I was kind of hoping Bob would give me the height advantage but he tells me that Breyfogle has about an inch and a half. So we're just going to start by conceding the height.

I'm going to talk about a few legal issues, a couple of which have been beaten up pretty good already and then Bob will really want to talk about the investment challenges faced by he and his staff in trying to construct or develop computer models, computer-based methodology to deal with the computer model rules under the Act.

Fidelity Affiliates services millions of IRA accounts. I will comment that we are interested in the computer model really both in the retail IRA space and in the 401(k) world. So we care about both a lot. Strategically, it's The Fidelity Company that's been charged with developing computer-based methodology. This will be the engine that will drive the investment services we want to provide to our retirement clients that may be provided by in maybe interactive websites, get a website, maybe an phone interaction with our phone reps, maybe a face-to-face meeting with a brokerage rep.

I also have to say that we're working on this computer-based methodology realizing that at the current time the only rule we can rely on the level comp rule. So right now, that's been our purpose. This is a computer model. We'd like it to conform to a computer model rule, but right now, we don't know what that rule reads like. We need a lot more filled in.

A couple of the earlier speakers got into discussion with you about the basic problems since the language in both the computer model rule that requires the computer model to take into account all available investment options and then somewhat different language in the PPA provision that requires to go through this feasibility/termination process that talks about a computer model takes into account the full range of investments including equities and bonds and although in some ways that has a more general feel to it, nevertheless, it leaves us perplexed. It sounds like a very formidable obstacle to try to produce a computer model that will do all this.

I have to say from my perspective the biggest concern we have right now is we don't know what the rule means. And it's a year after the Act. We really need the Department to try to make some decisions. I understand there's no legislative history, but right now, we simply can't finish up the computer model in terms of any comfort that it will satisfy the rule because we don't really know the methodology parameters, we don't know the certification process and certainly can't start the process of hiring a computer model certifier. We just can' do it yet. So for us, time is really running by. Again, this is true in the IRA space and 401(k) space equally.

A couple of other issues I will mention on the legal front. The computer model rule says the model should respond to preferences, investor preferences, as the certain types of investments. We would assume that means that we can solicit the preferences in terms of, for example, what types of investments they would like an advice model based on. The statute seems to support that, but we would really appreciate confirmation on that point.

The other thing and this we really struggle with this is the statute requires, and this is part of the general rule, part of the general conditions for both rules, the statute says that we have to give, our advisors have to give, investors past performance and historical rates of return of investment options available under the plan. We can talk about this in the 401(k) world. If they really mean that we're supposed to put investment information in the hands of investors for everything they can buy in their brokerage account, it's impossible. It's not doable.

From our end, we assume that providing access, making sure we make this information available to the investor, is the way to go and that may mean telling them how, where to get the information if they want it. Without that, I think we have problems under both rules. Without that kind of practical approach to the statute, I think we have problems under both rules.

And finally, we've heard several pleas for you start work on a class exemption. I think we would echo that from our side and we've made comments on interpretation of the statute in an earlier submission we made in response to your RFI. Another basic concern now is we may get to the class exemption one way or the other. I think we're going to need a class exemption. I think we're going to need another rule, an administrative rule, that can be crafted in a flexible fashion. Class exemptions take a long time. You know that better than I do. So I think really this is sort of I'll end with a plea to begin that work.

Now if you think that the statute sort of warrants you to wait until the end of the termination process, I guess then I would ask you to be open to industry request to start an class exemption projects anyway because you don't need that authority. The PPA authority is narrow. You can go much broader and we would certainly encourage you to do that. If it requires an industry submission to trigger that, so be it. I'm pretty sure some people in this room would be happy to accomplish that fairly quickly.

With that, I'm actually going to turn it to Bob and let him give the investment side and then either one of us are available for questions. If that's all right, I'm going to just have him start right away. Thank you.

MR. McDONALD: We're employing the unique tag team approach to the presentation today. My name is Bob McDonald. I'm the Senior Vice President with Strategic Advisors, an indirect subsidiary of FMR Corp.

As Doug mentioned, my brief comments today will focus primarily on the practical considerations associated with constructing a computer model advice solution that would conform to the requirements of the PPA. Fidelity does not currently offer an computer model investment advice program to IRA participants, investors; however, we do use a computer-based investment framework to facilitate the delivery of investment education which may provide some insight to think about how a computer model investment advice program might be offered within the IRA context.

The computer model based framework that's currently in place in our educational tool also limits the investments in the portfolio that is modeled for the participants to the broad universe consisting of mutual funds, both Fidelity and non Fidelity. Within those limits, an IRA beneficiary can choose whether to view model portfolios constructed either from an Fidelity only universe or from the open architecture unfettered universe of all funds.

In addition, the tool allows investors to express certain preferences in defining the universe of these mutual funds for purposes of constructing a model portfolio. In the current tool, investors can choose to focus on funds with either below average expense ratios, funds with above average stock consistency, funds with above average performance relative to an appropriate benchmark or any combination of those attributes.

The limitation of the investment universe to mutual funds is really a function of Fidelity's belief that asset allocation across a set of diversified investment options is most suitable for the majority of its customers. The literal requirement to take any consideration in the full range of investments including equities and bonds in determining the options for the investment portfolio of the beneficiary does present a significant challenge to the development of the computer model advice solution.

In order to build a computer model that could credibly consider or recommend the purchase and sale of the full range of investments particularly individual securities and nonstandard asset classes as opposed to diversified investment options such as mutual funds, a security would need to be identifiable, its value would need to be reasonably quantifiable in some objective, systematic fashion and some measure of its historical behavior must be observable or available.

Most IRAs are essentially open architecture, brokerage accounts and, as such, get invested in a wide, in fact, nearly limitless range of investment vehicles. Both the sheer number of these potential holdings and the uniqueness and complexity of many of the securities that are eligible for purchase through such an account may present insuperable challenges to the development of the computer model that would satisfy all of the literal requirements of the PPA with respect to the computer model IRA advice.

Even limiting the universe to those assets for which pricing and return data and certain fundamental characteristics are readily available, it's not without significant remaining challenges as you move beyond the universe of diversified options into a universe that includes, but is not limited to, individual securities, both equities and bonds, options, futures, commodities, currencies. A computer advice model, as I said, must be able to evaluate the expected return and risk including an estimate of the unique idiosyncratic risk of each security. It's also necessary to specify the relationship of each security with all other securities under consideration.

This is a manageable challenge whether working with a bounded universe of diversified investment options. As a practical matter, it represents a significant challenge to characterize the necessary attributes and relationships of all possible securities.

As I said, both the sheer number of these instruments and a uniqueness in complexity make this whole effort rather problematic. The expense of gathering, consolidating, monitoring, validating and continually updating the necessary data would place an onerous burden on the computer model provider.

The problem becomes intractable

when nonstandard assets are required to be modeled. A computer model has no systematic ability to recognize or value assets such as private placements, limited partnership holdings, certain option strategies, negotiated instruments such as swaps or private company stock. As a general matter, the computer model can only consider any security that it can recognize value and analyze.

This doesn't necessarily mean that a computer model would or should recommend the purchase of all securities. For example, Fidelity's current educational tool recognized individual securities in an investor's existing portfolio for purposes of assessing asset allocation, style balance, security concentration. The tool provides the investor with the flexibility in analyzing their portfolio to either hold these positions or to purchase and sell individual securities in order to see the impact of those actions on their overall portfolio.

The model portfolio, however,

that's delivered to an investor consists exclusively of mutual funds. In short, Fidelity attempts to characterize the risk of all positions owned by a customer but limits the buy universe to mutual funds selected according to objective criteria.

The same framework could be applied albeit with a broader universe to a computer model advice solution. Customer holdings that could be identified and characterized either individually or through the use of asset proxies such as indexes would be considered for purposes of providing a holistic assessment of the customer's overall portfolio.

The buy universe, the set of securities and assets that would be considered for purchase, could be limited with appropriate disclosure to the subset of all allowable IRA holdings that are both allowed by the IRA trustee and have sufficient data to recognize value and analyze the assets. If the universe can't be limited in this way, if all instruments that could be owned in an IRA, must be considered, must be individually and uniquely characterized and must be eligible to be recommended for purchase, then the literal requirement to take into account all investment options would practically speaking make the computer-based advice model infeasible.

I'll stop there and we'll jointly take questions.

MR. STRASFELD: Let me ask the bottom line question which is reading the language taking into account the full range of investments, what in Fidelity's view does that mean? Does it mean as you said every conceivable investment in the world or some subset?

MR. KANT: Can I give the lawyer's answer?

MR. STRASFELD: Those are usually less valuable, but sure.

(Laughter.)

MR. KANT: We'll give you two answers so we can determine.

MR. STRASFELD: All right.

MR. KANT: I won't be surprised

if you get the same response. I guess from my side I think what Bob is trying to describe is the challenge in really trying to kind of grab the information for every conceivable asset. From my side, and I've tried to read the statute more liberally, it says what it says and that's been a real challenge for us because frankly if all I have is the statute and I don't have any sort of regulatory comfort, it seems to me we just can't do it. It's just too much, I think.

MR. McDONALD: And it think the point that I was trying to make in my remarks really was to focus on the middle part of that phrase which is "take into consideration" as well as the end part of the phrase which is the "full range of investments." If there is the opportunity to characterize taking into consideration the recognition of pre-existing holdings for purposes of this holistic assessment, then I think there are ways that you can characterize broadly the full range of asset class exposure associated with a customer's current IRA positions. It doesn't necessarily extend then to that full range of investment options necessarily being appropriate for consideration within the buy universe.

So I guess I was trying as I'm thinking about how I would build such a model if we could extend the current educational framework to say "Let's do our best to try and understand and characterize what's currently being held regardless of whether it's a mutual fund, a collective trust, a separately managed account or any of these other asset classes" but to focus the buy universe in a way where we know objectively we can characterize all these assets and recommend a complimentary sort of holistic investment solutions.

MR. STRASFELD: All right. Let me try a follow-up. Let's assume that your model can take into account the individual holdings of an IRA beneficiary, but you only make buy recommendations with respect to either your family of funds or all the funds that Fidelity offers. Would that in your view satisfy this requirement?

MR. KANT: I don't know what you're -- What do you think?

MR. STRASFELD: Well, the purpose of this hearing actually is to see what you think.

MR. KANT: I really don't know. I mean, you're taking them into account. You're can only do it on one side of the equation and I guess that's the big dilemma for us in terms of is that enough.

MR. LEBOWITZ: Am I correct that your reluctance to answer that directly sort of suggests that we have a fair amount of discretion in determining how to define these terms?

MR. KANT: I think your views seem to be a lot more important than mine. So the answer is yes.

MR. PIACENTINI: Let me ask a slightly different question. If the answer was it is enough to limit the consideration to recommending buy and so on, some narrower field, is that enough in achieving the result desired or would the advice sometimes be inadequate such that advice that was more expansive, had more expansive consideration, would have been better advice?

MR. McDONALD: Would the ability to move beyond a bounded set of asset classes lead to a deficient advice solution in essence? Yes.

MR. PIACENTINI: Would the inability to move past that be deficient advice? That's my question. And if so, why?

MR. KANT: If you're asking, for example, whether a methodology that only produces, say, a mutual fund solution was a brokerage counselor, you have a much broader universe of individual securities to pick from. Putting aside what the statute requires, I hope that's not an inadequate answer because that same person may have a 401(k) account and I'd like to think that the investment advice that they get which is maybe just mutual funds is not adequate. That's sort of a more general sort of investment view of this. On the other hand, the investment guy may have a different view.

MR. McDONALD: I think sort of the organizing framework that we've used to put our educational tools out there and I think that we would use in an advice model is that we're going to better serve the customer, the vast majority of customers, by putting together a broadly diversified portfolio that delivers an appropriate asset allocation that takes into consideration preferences and personal attributes. I think we can derive that diversification benefit most efficiently for the vast majority of customers through the use of diversified building blocks or at least a subset of all assets that may include individual equities in some limited way.

I think the marginal benefit associated with extending the opportunity set beyond that into undiversified vehicles has limited benefit for the vast majority of IRA beneficiaries.

MR. KANT: I would mention just we're really talking about what we're doing now coming out of the gate.

MR. McDONALD: Yes.

MR. KANT: I certainly think that our business people at Fidelity are contemplating this, eventually the investment advice, sort of would encompass the range of individual securities to buying a brokerage account. Just we're trying to walk first.

MR. McDONALD: Yes.

MR. KANT: But I do think it is incumbent on us to be able to at least characterize what somebody walks in the door with to the extent that we can so that we can understand how we can improve their situation or at least compare and contrast where they are with where they might be with a diversified investment advice solution.

MR. STRASFELD: Thank you very much. Why don't we take a ten minute break and come back at 11:10 a.m. Off the record.

(Whereupon, the foregoing matter went off the record at 10:58 a.m. and went back on the record at 11:10 a.m.)

MR. STRASFELD: On the record.

MR. SMITH: My name is Michael K.

Smith. I'm with Zacks Independent Research. I'm 6'4" and 220 pounds if you're keeping score.

Zacks IFE is a business unit of Zacks which has been around since 1978. It's a source of independent research and market data. Zacks IFE was founded in an anticipation of the complication of audits in qualified plans. We are a 330 investment manager of fiduciary allocator for the QDIA defaults, customized life cycle funds, demographically adjusted balanced accounts and managed accounts as described in the Advisory Opinion 2001-0-9A. The Fund also provides audit services for computer-generated proprietary advice models for parties in interest seeking to comply with Section 601 of the Pension Protection Act.

A way of background, I was a consultant along with the late Brian Tarbox to SunAmerica on their success bid to take discretion over participant assets invested in their variable fee funds. Previously, I was TCW when they received the prohibitive transaction exemption that really created the computer modeling industry in qualified plans. I'm an investor in three independent modeling companies, party to a patent on their implementation of qualified plans and evaluated most of them for some of the largest financial firms in the country.

As much as it pains me to say this, I can confirm that conclusion of the firms that are seeking class exemptions that current computer models are ineffective in considering all available securities in their formation of advice.

One of the financial services firms described 13 computer modeling tools available to their facilitators in their RFI response. At the end of the day, these all do the same thing, forecast asset class returns to create portfolios on the efficient frontier. Some tools create 99 buckets of asset class allocations. Some 27. Some create nine. Mutual funds, ETFs and similar pooled investments are the nat to these buckets and managed on an ongoing basis to arrive at a terminal wealth result.

This morning the panel would like

to know, I'm going to add some emphasis and clarity from the question from the *Federal Register* from last Wednesday, "What particular types of investments or asset classes should a computer model," a computer model should not could, "take into account in order to provide appropriate," not perfect, "advice to IRA beneficiaries?" Again, those emphases were mine.

The direct answer to the question is pooled investments, preferably low fee pooled investments such as funds, ETS or collective trusts that capture the asset class category returns in areas such as domestic and international equities, mid, large, small growth and value categories, international, high yield and high grade bonds. These are the asset classes and vehicles that computer models should consider to form prudent portfolios.

Again, I can see that a tool someday may be developed that can create a seemingly infinite number of portfolios on the efficient frontier using a seemingly infinite number of securities. But so what?

Effective and appropriate portfolios can be attained using the inputs I've described for results that are very similar, defined as terminal wealth and standard deviation from of terminal wealth.

The next question on the agenda in the *Federal Register* in the agenda last Wednesday was related to safety and prudence. The panel has asked the industry to clarify how inherent biases can be ameliorated from these model specifically "the Department seeks additional information on the manner in which such programs could operate without bias as to the investments offered by the fiduciary advisor or affiliate if the particular advice program allocates IRA assets only among such investments." Here we would recommend that the construction and assignment of allocations be controlled by an independent fiduciary and minimum proprietary models should be audited by an independent expert to assure investors that the advice is with a range of advice that a similar expert would formulate for their given set of facts and circumstances, the fees are reasonable and that the self viewing has been removed. To further ensure an unbiased result, we would hope that the independent fiduciary allocators compensation from the party interest is not an unreasonable percentage of their revenue.

As someone who has been involved in the development of computer model products and qualified plans from the beginning, I can tell you that the goal is to control participant emotions. As fee hearings on Congress are announced and class action lawsuits are filed and as 150 million working Americans listen to media stories on fund scandals, the best way to restore trust in the system is to remove the ability for a party and interest to self-deal. That was the goal of our work at TCW and SunAmerica. About $40 billion has been invested in this matter and we hope the Department will consider adding such protections in the formations of IRA advice.

Those are my comments.

MR. STRASFELD: In your view,

what is the answer to the question we raised over and over again as to the meaning of "takes into account the full range of investments"? Is it as you suggested that a pooled diverse universe is sufficient?

MR. SMITH: The answer to your question is yes. I don't interpret the work on Congress as in qualifying plans clearing up, moving uninvolved participants to manage portfolios, professionally manage portfolios, life cycle funds, manage accounts, balance funds. I don't see how they went from cleaning up that, do it yourself, choose from the investment roster in appropriate investments to default into professionally managed investments on the efficient frontier. I don't see how they then extended that in reverse to in the IRA arena go out with any investment, security, limited partnership, options, futures, Mexican time share, Salvador Dali lithographs, anything out there, It seems to be consistent with the statute on the qualified accumulation side of pooled investments as I've described as the intent of the statute.

MR. STRASFELD: Any other questions?

MR. LEBOWITZ: You started your testimony by saying that you thought the answer to the question was no.

MR. SMITH: Correct.

MR. LEBOWITZ: So what was the question you were raising at that point.

MR. SMITH: Peer model tools that consider every security available to an investor. The answer is no.

MR. LEBOWITZ: Right. That's consistent with all the comments.

MR. SMITH: Yes.

MR. LEBOWITZ: But in some sort of surrogate fashion, there are such things.

MR. SMITH: Yes.

MR. LEBOWITZ: In terms of these pooled investment options that cover various asset classes.

MR. SMITH: If the universe were constrained to pooled asset class, sector-based investments, yes, there are computer model rules that can do a perfectly fine job. Again, at the end of the day, we're trying to get to a terminal wealth goal. Whether you use that using low fee index type funds, mutual funds or 6,000 individual securities. They're all getting to the same place.

So the spirit again, the spirit of the legislation I felt was, we feel is, for safer and more prudent and more effective retirement outcomes, more effective to define as people will use it. The fees aren't too high. The inputs and the outputs aren't too complicated and the model I've described I think using a constrained universe is consistent with the accumulation portion of the statute.

MR. STRASFELD: Joe.

MR. PIACENTINI: When you talked about independence related to evaluate the impression of whether there's bias, you said something about to see whether the advice was within the range that somebody else would be giving and I guess an ongoing question in my mind is how much divergence and advice might be attributable to bias versus how much might just be expected in some kind of noise that different models will have somewhat different investment theories or different ways of characterizing other assets that the individual might hold. So how does one distinguish bias from that kind of noise?

MR. SMITH: Two issues. One is the actual output as I described along the efficient frontier and I think everybody does that pretty much the same. We all look at the same data as far as asset cost returns, inflation aggregates, things like that.

What I'm suggesting or what I'm discussing is more the construction of that advice, what vehicles are used, how can it be ensured that a party and interest doesn't self-deal, tilt allocations toward variable fee funds which is in our economic interest to do so or in a flat level environment we talk about flat level fees. Flat levels doesn't equate to flat profits necessarily. It could go the other way and that's where I think it's beneficial to have an independent third party come in and evaluate those systems.

The other recommendation I made very clearly is that entity shouldn't be taken too much money from their client. I've seen some suggestions of a college professor signing off on these things. I think $100,000 to $200,000 to a college professor is a meaningful amount of money. So we, our business, as we look at the 601 audit won't take any more than five percent of our overall revenue from any one of the parties and interests whom we evaluate.

MR. STRASFELD: Thank you.

Morgan Stanley. Matthew Thomas.

MR. THOMAS: Good morning. My name is Matthew Thomas. I'm the Executive Director with the Morgan Stanley Global Wealth Management Group and the Director of their Financial Planning area. Also with me today is Bill Ryan from our ERISA Counsel Office and Wes Coollum from our Government Relations Office.

I appreciate the opportunity to speak today. Morgan Stanley believes that the retirement security of millions of American workers depends on their ready access to investment advice with respect to their private retirement savings. As more assets are contributed to and transferred to IRAs, many roadblocks to infect the investment advice will have a long term adverse impact on these IRA beneficiaries and ultimately on the retirement security. My remarks today will focus on the feasibility of computer-based investment advice for IRA accounts covering the universe of investments that these accounts may invest in.

Morgan Stanley is a global financial services firm. Various affiliates of Morgan Stanley provide brokerage, custodial investment related services to IRAs including acting as a nonbank IRA custodian for more than 1.45 million accounts. These IRAs are invested in a wide range of products, corporate stocks, bonds, more than 2,200 open ended mutual funds and over 100 fund families. These are advised by Morgan Stanley affiliates, Van Kampen and

Morgan Stanley Investment Management as well as other nonaffiliated advisors. Also included are ETS, corporate, governmental bonds, debt instruments, structured notes, alternative investments as well as hedge funds, private equity funds, fixed and variable nonqualified annuities and foreign investments.

These IRAs total approximately $123 billion. In addition, custodial IRAs offered through Morgan Stanley Investment Management and Van Kampen with State Street Bank and Trust Company as IRA custodian comprise an additional 400,065 IRA accounts with an aggregate value of approximately $4.3 billion.

Morgan Stanley in the aggregate has assets under management of more $690 billion for these and other clients. Given this scope we believe that are well positioned to provide the Department the benefit of our experience and understanding in the investment advice area as it examines computer model investment advice programs for IRAs as described in Section 601 of the

PPA.

Morgan Stanley believes that with the maturing of the baby boomer generation, the need for retirement planning will become more complex as investors begin the transition from investor accumulators to spender D accumulators. Getting investors from early retirement to the last stages of life will require customized analysis management not only to households' financial assets but a detailed strategy to meet both the planned and unplanned liabilities of retirement in late life.

Investment advice is only one component of a truly client-centric retirement solution. The other components are a sound financial plan, a disciplined approach to creating retirement income and a rigorous ongoing monitoring process for client retirement accounts, all of which can be supported and delivered by investors by today's technology. We believe that this advice process will prove to be the hallmark of a successful retirement planning in the near future.

Focusing on investment advice component for the moment, Morgan Stanley believes none of the computer modeling tools which we use or which are commercially available can take into account the full range of investments including individual securities, equities, bonds and to determining investment performance options for IRA account holders. While such a computer model may appear ready for development in the future, right now, it simply does not exist. Therefore, based on the matter in which IRAs that we see at Morgan Stanley are currently invested, the mandated use of computer models to give advice can only limited the client's ability to fully evaluate and select all potential investments options.

The intellectual underpinnings of most allocation modeling tools do not lend themselves to specific product level recommendations outside of the mutual fund context. Account availing issue, the concern about the embedded fees and cost structures in mutual funds and mutual fund related products that they are subject of Congressional, SEC and DOL focus may work against the Department primarily relying on a tool which is best suited to mutual funds.

To the extent that computer models in 2007 can best allocate across asset classes using the type of vehicle with any real degree of accuracy, mandating computer models for IRAs limit IRA beneficiaries from the investments they have shown interest in and the asset type specifically points to by Congress in the PPA that should be considered.

Virtually, all computer-based models are based on the intellectual premise that a diversified and efficient asset allocation of an investment portfolio offers clients the ability to analyze and make rational risk return investment decisions. The basic goal of asset allocation is to diversify away some of the inherent risk of investing in just one or two asset classes.

Through asset allocation it is possible to reduce the overall volatility of an investment portfolio by introducing different asset classes that have different performance and volatility characteristics. Asset allocation offers investors two primary alternatives, the ability to achieve the greatest investment return possible for a given risk or required rate of return with the least amount of risk possible. These alternatives are produced by creating estimates for how individual asset classes are expected to perform over time in the near future, that is their future investment return; how volatile these asset classes will behave over time into the future or their standard deviation; and the relationship between an individual asset class's return in volatility as compared to other asset classes over time referred to as correlation.

And important application in incorporating these three assets is mean variance optimization. Mean variance optimization takes into consideration all the individual asset classes identified. Variations between asset allocation approaches are largely influenced by how a particular asset class is defined, whether it's small, medium or large cap, foreign or domestic, and whether an particular asset class such as an esoteric class as high yield or alternatives are considered for possible inclusion in an overall investment portfolio. Thereafter, mean variance optimization combines all the possible mixes of asset classes into the portfolios with their own expected returns and standard deviations.

I highlight these concepts for the following reason. The computer model portfolios themselves are comprised of asset classes, not specific investments. And the economic theory is underpinning. The models require in effect aggregate historical rates of return and volatility for such classes.

When the range on investment options offered to a particular client is both constrained and constructed to mirror the broad investment classes, but limited to vehicles for which data inputs are readily available and reasonably limited such as mutual funds with each fund in turn representing a pool of individual investments that generally fits within certain broad asset categories, again, large cap, small cap, domestic and foreign, the portfolio models generated by various asset allocations programs are useful tools that plan participants can use to apply to the efficient frontier analysis to the retirement plans but artificially their selection of actual investments.

If, however, you permit investments like IRA beneficiary and individual instruments, individual against stocks, bonds, annuities, alternative investments, such investments either do not clearly correlate to a particular asset class or may be inherently more volatile if issued by a single legal entity than a pooled vehicle. This is due to the individual instrument's specific, unsystematic or what we might refer to as idiosyncratic risk.

Existing computer models are not designed to choose particular investment products or solutions that fall outside the pooled vehicle context and even if they produce particular recommendations, that is a list of available products, it cannot adequately ensure that these solutions are optimal within the efficient frontier framework.

Morgan Stanley's Global Wealth Management Group and its 7,500 financial advisors currently employ a variety of proprietary and nonproprietary computer-based asset allocation programs and tools that are used to analyze client assets including IRA assets and form the basis of an asset allocation recommendation. This asset allocation is just the first step in investment advice and a high level step as well. The actual selection of investment products is not generated by a computer model because in today's technology there is no model able to translate asset class decision into particular stocks, bonds, structured products, etc.

In our written response to the Department's request, we outline the asset allocation investment products that Morgan

Stanley Financial Advisors currently use. I was planning to discuss these features but in the interest of time we're happy to provide further descriptions of these products in writing to the Department if you think that's appropriate. The products I'm speaking of are things like Asset Scan, our portfolio architect advisory mutual fund program, our Fund Solution mutual fund advisory program, Custom Portfolio which advises on a basket of stocks, not individual stocks.

To briefly summarize, all these products to a greater or lesser degree attempt to model asset allocation strategies using variants of mean variance optimization and provide clients and their financial advisors with various detailed projections of potential investment outcomes determined in part through the use of Monte Carlo modeling techniques.

However, these asset allocation tools as generally described above suffer the following limitations. The models tend to evaluate portfolios by asset classes and readily available indices in the attempt to fit the instruments held in a client's portfolio within these categories. Not all asset allocation tools, however, uniformly characterize the investments as falling within a particular asset class.

Each model may have a particular variations that while within generally accepted investment guidelines treat particular instruments differently. Further, these models perhaps may tell you what an asset class your investment is in but they can't tell you what investment to put your asset class in afterwards. So they have very little front-end use in selecting portfolios of assets.

To the extent particular models offer fulfillment options of clients, the recommendations made almost exclusively focus on mutual funds options or a fixed universe of investment options offered with a particular advisory program. We know of no programs that can either properly evaluate or make specific recommendations for the following instruments, especially in a brokerage context with a wide variety of potential investments described below. That universe would include individual stocks such as described in the Wilshire 5000 Index, corporate bonds, foreign debt or equity securities, currency instruments or currencies themselves, futures, annuities whether they be fixed or variable, options, alternative investments as organized through limited partnerships, group or collective trusts.

Separate and apart from the fact that these models are incapable of offering specific fulfillment options other than the limited world of mutual funds, we would also note that the mathematical premises of the modeling techniques used generally relate to portfolios rather than specific investments. Even if a model could generate particular bond or individual stocks to comprise an asset class or to wholly fulfill an asset allocation recommendation, that result would introduce an unacceptable level of unsystematic or idiosyncratic risk that would substantially understate the potential for volatility in the model and would, we believe, mislead the client to believing that a portfolio is optimized for risk return purposes. These are, at least, in the foreseeable future fundamental and in our view insurmountable challenges to a computer-based advice model for IRAs.

But there are also significant practical challenges. The potential transactional cost to the client of continuous reinvestment or realignment of their current IRA assets to follow the advice of a new model are not insignificant. To that point, the Department should take notice that the recent abolition of fee-based brokerage options, the revocation of the so-called Merrill Rule, which compels brokerage accounts to charge clients on a transaction-by-transaction basis rather than a fixed fee for all brokerage transactions in a year. This may have unintended consequences of actually increasing the cost of such computer-generated reallocations. Further, in the aggregate, any mandatory reallocation of IRA assets based on changes to the computer models host the potential to cause a significant level of dislocation within the capital markets as the sheer size of IRA assets begin to move.

The cost of creating a model with a data span necessary to cover all potential individual investments is, we believe, extremely high and would require computer functionality in excess of what we believe most laptop solutions would currently support which would be a cost that neither Morgan Stanley nor other providers of which we are aware is currently interested in pursuing.

So, first, the model isn't available and, second, if it were, we wouldn't afford to provide it through our 7,500 advisors because of laptop limitations. As a practical matter, if it can't be delivered through the most efficient delivery system at the individual level that the financial industry has to offer, I have to wonder can it be seriously considered.

A model-driven advice model will

place undue constraints on future product development in the retirement arena and reduce the financial services' ability to quickly meet emerging needs to pre and post retirees. While Morgan Stanley is a leading provider of indices used as the basis for most of the current computer models used in the market, even Morgan Stanley believes that certain public data does not currently exist which enable a model to provide the kind of information which a beneficiary would need to appropriately consider each investment. That is we are not currently aware of indices that are readily available to consistently classify and analyze all potential investments that may be offered to an IRA holder.

As described above, we are concerned that the fundamental parameters of mean variance optimization and the efficient frontier theory which are designed for entire portfolios do not readily translate themselves to non mutual fund, non pooled investment vehicles that mimic entire asset classes and that IRA clients relying on such models receive a false sense of security as a tradeoff of risk and reward.

In our experience, the primary flexibility an IRA client has had in modifying the model's output is through the questionnaire which allows the client to exclude certain types of investments from considerations, investments that may only have a short history or the ability of the client to choose not to include proprietary or mutual fund managers affiliated with the current financial institutions. But it has been Morgan Stanley's experience that many IRA clients simply disregard model outputs if they do not, for example, include particular types of investment classes or if they are not capable of evaluating particular bond fund or pooled investment on their own.

Morgan Stanley does not believe that any models available today given that they are constructed on a portfolio theory basis will satisfy the criteria if nonpooled investment or assets that do not easily fall in particular asset categories are included given that Congress clearly intended IRAs to receive investment advice on individual securities as well as other potential investments.

We are not clear how the Department can approve a computer model that simply cannot prudently take these investments into account. Such models may mistake both the asset class performance and volatility with such investments. Thus, we believe that any such model will take into account the universe of investment options available to IRA holders or therefore allow the IRA owner sufficient information to evaluate these investments appropriately.

Assuming this is the case, the next logical step is for the Department to determine consistent with the requirements of the PPA what kind of relief can be offered in lieu of a strict reliance on computer-based models for IRAs.

We think a more nuanced approach is possible. We think an alternative based in part on an audible computer-based asset allocation system could be retained since the asset allocation methodology clearly has value especially by contrast to a fee-neutral approach that does not specify any qualitative portfolio analysis, a condition for exemptive relief.

However, since we believe that Congressional intent was to exempt investment transactions made in connection with such models and that such models need to be modified to take into account individual securities, annuities or other investments, some link between the model asset class and the investment could be demonstrated along with the requirement of the advisor in recommending these purchases would clearly need to disclose the compensation and potential conflicts inherent in tallying the advice to deal with all the potential investment options. It is in this area that we believe the Department should focus its attention as a starting point in the creation of specific relief and continue to allow the collaboration between traditional asset allocation approaches augmented by individualized security selection.

Thank you.

MR. STRASFELD: Thank you. Allen Vaughan, 401(k) Advisory Group.

MR. VAUGHAN: I'm going blind. So I have to use this. I'm not the most eloquent public speaker either. I'm more of a teacher but just bare with me.

I'm Allen Vaughan, President and Founder of the 401(k) Advisory Group located in Atlanta, Georgia and as my bio reflects that I gave to Chris, I've been in the retirement plan industry since 1984 working inside retirement plan operations and administration and now on my own for the last three years where I created the 401(k) Advisory Group really as a response to a huge gaping hole that I saw in the retirement plan industry. We utilize what I call prudent, due diligence and standards of care outlined by the Senate for Fiduciary Studies and I founded this company primarily to provide advice to the participants as well as to the plan sponsors in a participant driven environment, more so, than just providing a spreadsheet of the funds in the current menu and trying to sell a plan. We're out there trying to make a real difference with our clients.

So I'm in the trenches working with those plan sponsors and their employees directly and I think that gives me a unique perspective today. I'm not an attorney and although I've worked for many of the largest banks, insurance companies and brokerages here in the U.S. inside the retirement plan operations departments, I'm not some multi-national investment firm. As Dr. McCoy used to say, "I'm just a country doctor." This is what I've been doing in working in the trenches with employees. So I hope my feedback to you today and my input, it will be unfiltered and directed and nothing really subject to interpretation.

But what I see inside the 401(k) world, I also see within the IRAs. For example, my first 401(k) plan in 1990, the plan sponsor had a 1980 Jaguar as a company asset held within the fund or within the plan and it was his daily driver. I know a more recent plan was a medical practice in Florida where the doctors were going out and buying low rent housing, throwing in a toilet, putting in some carpet and flipping the house, no audit procedures, nothing like that at all and as you can imagine with the market as it is down there now, those guys are really having a hard time getting rid of plan assets and liquidating them. As far as I know, they're still doing that kind of activity.

One of the points in common with IRAs and 401(k) plans is the vacuum of an established process of prudent selection of investments at the individual account level and even more poignant has been the outcomes within both. As you heard in prior testimony this morning on behalf of the ICI, there's over $4 trillion in assets in IRAs and as you probably already know, there is $2.7 trillion assets in defined contributions in 401(k) plans. That's $7 trillion. I don't know how much is in the markets these days, the securities, but the total market capitalization in the United

States is $75 trillion. So these assets are nearly 10 percent of the American economy, ten percent.

But as an example of just how poor the average investor has performed inside these accounts, there are some good statistics that show that. For example, the S&P 500 over the last two years has average about 12 percent annual returns, but the average stock investor has only earned and bond investor has only earned between three and four percent and there's no telling what these individuals who have had nonregulated securities have done.

Since 2004, I have performed several participant-focused consultations for plan sponsors and in that research I have found some interesting common traits I'd like to share with you that I think are very important in this decision regarding computer-generated programs for IRAs.

On a consistent basis, plan-by-plan, I saw roughly 20 percent of participants picking either every fund of the plan's menu or every fund less the money market or the stable value account. In plans that offered lifestyle fund options, some of the latest, greatest out there, nearly one-third of the participants choose the lifestyle funds, but in those plans I could not find a single employee who had correctly utilized their selection. What I found were people selecting one, two or all the lifestyle funds in conjunction with using other funds on the menu.

The percentage of participants that choose to place all of their moneys into a money market or stable value account varied between 25 to 30 percent of the employee universe. Roughly, another 20 percent picked only equity fund options and the percentage of people that displayed a semblance of utilizing what looked like an intelligent allocation model based on their age and nearness to retirement was less than two percent. Less than two percent. Now you couple that with the fact that the average participation rate in this country is around 72 percent right now of eligibles and we're only covering maybe 50 percent of all the working population with these plans, you have a real problem.

I knew that if these people even got advice from a broker more often than not the advisor is nothing more than gut-hunches and guesstimates and not based on sound principles of investment management. Maybe they were just looking pie chart and saying, "Here. This is what you need to do because you're 55 years old and you're close to retirement. So let's just build this portfolio around this." Inside of 401(k), they're not even supposed to do that.

So I started working on the retirement coach software back in late 2004 to keep my firm from falling into the same trap with regard to providing consistent advice no matter the employee's age, near to retirement or risk sensitivities. This computer modeling program is used in a level fee environment. It is a mandatory system that I've used of one-on-one enrollment coupled with investment advise. The participant has to strenuously avoid seeing me.

Now it's only used with mutual funds. That's the only investment vehicle I'll use. I don't work with nonregulated securities. And although I've built it to where you possibly could, the issue is my choice as an investment fiduciary to the plan, as a fiduciary advisor and investment manager to the plan, I don't use those fund options.

The first plan to go to that process was in March of 2005. Now some of the results I've had, I've had nothing less than 95 percent participation of the eligibles. I have plans that have 100 percent participation and their human resources managers, whenever an employee becomes eligible, they give me a call and I run down there and I enroll their employees and they put in the right percentage of the deferral rate and we use the established allocation models that are inside the program. In short, participants in the plans in which we provide fiduciary management and advisory support have their moneys prudently invested. They also know that they are putting the right amount of moneys into their plans. They know exactly what the net impact is on their paycheck.

But there are some weaknesses to this program that I want you to know about and this would be universal with any kind of program. It can be subverted to aid the using advisor of broker and providing more compensation based on the allocation model's design. That is you can tweak those slices of the pie chart. Now whether he gets paid X here and X times 2 here according to Bruce Ashton, and I shouldn't really stand in his stead here, but the opinion is that's not necessarily against the law but it is certainly unethical and I find that really troubling with these allocations programs. That's why I think there needs to be a prudent process involved in working with these plans.

Next, the user could utilize virtually any asset allocation modeling system he or she desires, be it Monte Carlo or New Variance or simply eyeballing it.

Finally, the program does nothing

in the realm of creating a process of prudent standard of care for the plan or its participants.

I think these three issues are what I see also provides a challenge for IRAs and what I'd like to see are these three points to become reality and it's maybe somewhat pie in the sky but I think that it deserves some discussion at some future point.

First, that the Department of Labor begins the process of creating a set of guidelines for the prudent process so that a reasonable standard of care can be quantified irregardless of who builds the program. Other people in private industry have already done this. So I think 90 percent of the framework has already been done.

Number two, on the form 5500, I think there needs to be additional reporting as to who the fiduciary manager and who the fiduciary advisors are for the plan and I think that information will be very helpful to the DOL as far as enforcement and auditing processes are concerned.

And, finally, I think, this is really the pie in the sky, my desire is that DOL begins the process of limiting the menu of future investment purchases inside 401(k)s and IRAs only to pool the investments that are regulated by the SEC for disclosure and auditing purposes as well as the standardization of data for a uniform methodology of research within the complete set of investment alternatives. That is no real estate, no other tangible or physical assets. Frankly, those who represent these types of investments and want them to remain as investment alternatives simply want to avoid due diligence reporting and oversight of being held within a pooled, regulated security.

How do you quantify risk with art? How do you quantify risk with a shelf full of Corvette parts? You can't. How do you quantify the risk of holding a piece of South Alabama non timber real estate? You can't. And therefore you can't quantify risk. So you simply cannot utilize an asset allocation modeling technique which is predicated on quantifying risk for that participant or IRA beneficiary. And if you can't quantify risk and volatility then you cannot provide prudent investment advice.

As a general rule in my classes, I've provided advisory services only to plan sponsors which do not have what I call "nonpooled, nonregulated securities." If they want it, then I just walk away from the business.

Granted, mutual funds are not perfect. For example, in this morning's *USA Today*'s Section B1, it says "U.S. Funds Add Foreign Stockholdings." In fac, I have one of those mutual funds in one of 401(k) plans and when I get home, I'm going to start proceedings to eliminate that fund because that's the kind of stuff that messes up asset allocation modeling. But with mutual funds and regulated pooled accounts, you can see that. That's reported. It's disclosed. You can't see what generally a company holds inside its holdings. So using a company stock, I find, is rather difficult to work with in an asset allocation model or any security that they may offer.

So that's all I have to add. Any questions for me?

MR. STRASFELD: Exactly what is the product that you offer to your clients at your 401(k) plans? Is it some sort of computer model?

MR. VAUGHAN: Absolutely.

MR. STRASFELD: And it's based on generally accepted economic theories using Monte Carlo simulations or something along those lines?

MR. VAUGHAN: Absolutely.

MR. STRASFELD: And limited to pools of some sort?

MR. VAUGHAN: Absolutely. That's it.

MR. STRASFELD: All right. So in your view, would the arrangement satisfy this requirement under the statute with respect to the determination we make that it takes into account the full range of investments?

MR. VAUGHAN: I think there needs

to be a reporting back to Congress about the inability to provide that kind of computer-based generated reporting for or asset allocation modeling, for a participant beyond a nonregulated security or even with a stock or a bond.

MR. STRASFELD: Anything else?

MR. VAUGHAN: Now I'm not saying that as a modeling and investment management, our advice is an art. It's meat and potatoes as far as math is concerned. It's very scientific. But using real estate or artwork or car parts, like I said earlier, I think are inappropriate investments inside qualified and nonqualified IRAs.

MR. STRASFELD: So what would you think should be in or what would be the investment output of a model that you think would be appropriate for 401(k) or IRA?

MR. VAUGHAN: In my program, I've utilized Monte Carlo simulation. I switched over from mean variance to Monte Carlo simulation last year. I used 12 investment classes that are firmly established by several financial planning folks in this country. So in that respect, yes, I have real estate but I use real estate mutual funds. I have precious metals, but I use a precious metals fund. There is international bonds, but I use an international bond fund. And so the underlying risks characteristics of that pooled investment are published everywhere with Lieber and Morningstar or whoever so I can make a determination of whether that's a suitable investment for that menu. So prior to any selection for that plan participant, I've already selected that fund menu for its appropriateness within that plan.

MR. STRASFELD: So your universe is pooled funds.

MR. VAUGHAN: Exactly.

MR. STRASFELD: Okay. All right. Thank you very much.

MR. VAUGHAN: Yes sir.

MR. STRASFELD: Lewis Harvey, Dalbar.

MR. HARVEY: Good morning and I appreciate the opportunity to speak here and very briefly, Dalbar has been around since 1976. Our focus and mission has been research in the financial services community. Our particular relevance perhaps in this discussion is the studies and the work that we have done relative to investor behavior and how that translates to investment results for the individual investor.

I'd like to do really three things very briefly in the time I have here and that is to recap the goal and the problem that we're trying to solve here. Secondly, I would like to give you three reasons why the solutions as amended won't work and also raise a couple of alternatives for success.

Looking first at the goal, the problem, clearly I think we'll agree that the objective is to secure retirement income for individuals and secondly, that there is a problem with the current structure that's in place. Given that that's the case, we obviously need to change something. The problem as we would define it would be poorly investment beneficiaries basically in two areas. One is diversification and the other is the access use of short-term assets to produce long-term results.

The second part of the problem, however, I think has been alluded to by several speakers before and that is the beneficiaries do act imprudently. They sell and buy and trade at the wrong times. They obviously need some help.

The general question is can the proposed computer model correct the situation without creating other problems. I would like to suggest that the answer to the key question that has been raised today as to what did Congress expect could be viewed from a different perspective if we were to rephrase that question to ask whether the Department of Labor can create rules that would adequately select a universe of investments to be used in the IRA world. By changing that around, then it seems to me that you have rational question coming from Congress rather than what clearly would be irrational based on the testimony that you've heard to date.

The other part of the question that we see that Department of Labor needs to focus on is what population is going to be served by this computer model. Is it going to be 0.2 percent of the IRA population or is this solution intended to address the 90 percent of the employee population?

One other issue I would like to raise in the context of this discussion and that point of view is that my entry into the financial world occurred back in 1965. If we were having this discussion in 1965, I don't think anybody would be talking about including mutual funds. The reason I raise that issue is that we need to think forward and not just momentarily. So we need to contemplate the rise in use and application of investment vehicles that could occur in the future that we perhaps see today as mere little drops on the horizon.

I'm going to try to fulfill now my second promise and that is to give you three compelling reasons as to why this solution won't work and I'm going to stay away from the notion that we have this infinite list of securities that could be done, but assuming that there is some defined universe and the Department of Labor is capable of defining it. My three reasons come in three categories. First is cost, second motivation and third usage.

In terms of costs, I think we've heard today the problem is not writing the logic necessary to come up with investment allocations. The problem is the data. The enormous amount of data that one would have to consider is extremely difficult. We've heard the types of possibilities listed, but I'd like to add to that dialogue the consequence of not including various investments. It really means that beneficiaries are denied possibly what could the best alternative for them. And again, I'm not talking about today. I'm talking about looking forward in the future where these rules are going to apply.

It's also, I think, imprudent for the government to favor one sector over the other and I won't try to explain that anymore. I think that's patently obvious. So the issue of cost I think is a very difficult one.

The second which I have not heard discussed this morning is motivation. Let's sit back and think beyond the issue that we're looking at now at the overall picture. What's the goal of financial firms? Clearly, it's to gather assets. The goal of the financial firms are to gather assets.

Now what effect does a computer model as described in the statute represent? I maintain that it disburses assets. It says that if I don't in my universe have the best product, then I'm going to send those clients that come to me to someone else. Clearly, it's not in the best interest of the firm. In fact, I would say it's irresponsible for a financial firm to literally run a model that would send clients to some other firm that would benefit from their assets.

Basically, unless the tool is in fact biased in favor of some firm, it doesn't seem to have economic viability. Imagine, for example, if General Motors produced a computer model that selected the best car. It would be very, very difficult for General Motors to say Toyota or Honda or Chrysler makes the best car. That's what we're asking people to do within this construct.

It seems to me that no rational firm would voluntarily offer a service or a product that would in fact send customers elsewhere. That's two arguments I've given you.

The third argument may well be the most compelling and that has to do with usage. Use of computer models historically has been low. We've discussed and there's lots of discussion that that's going to change over time as we as a society become more computer literate. However, there are some other considerations, I think, relative to computer model usage to date.

The first one is the interest on the part of the beneficiary to begin with whether or not this 25 year old beneficiary, this 30, 40, year old beneficiary is interested enough in their retirement which are several decades in the future to bother with this. This clearly would reduce the number of people who are likely to use the computer model. It's not going to be a majority.

The second issue having to do with usage has to do with the fact that the burden on the beneficiary is great. The burden is enormous on the beneficiary when you consider that that beneficiary has to learn a new language. It's a language that's unfamiliar to them. They secondly have to overcome their own instincts which we know to be ineffective in investment terms. And thirdly, they have to go obtain data. They have to understand what their current investments are and this is a task that you're asking somebody who may be marginally interested in their long-term investments.

I also want to emphasize that the learning of which I speak is more than academic. We're not talking about learning facts. We're talking about overcoming emotions. We're talking about feelings. We're talking about learning how to act and behave differently with respect to investments in order to accept the empirical data that one would receive from a computer model. You put those factors together and you say no wonder the usage is low.

The question on the table is how much of our IRA population would a computer model as described in the statute actually serve. I maintain that there are other less burdensome solutions that are more desirable than the computer model.

I conclude -- My conclusion, I should say, it's not that I'm concluding because I still have another brief section to talk about, but the conclusion we come to is that the only feasible model is from independent advisors that are not funded by either product or transaction forms of compensation.

That leaves us with independence and the problem with that is now we're asking the IRA beneficiary to pay yet another party for another service. So we're looking at the expense side as well.

Will the computer model solve the problem as stated initially? I think the answer is resoundingly is no. Alternatives, however, are not far away. Our suggestion as presented in our earlier letter is to take advantage of the strengths and the capabilities and the benefits contained within the participant directed plan sponsored plans where there's already a preselected universe that has been prescreened, that has the monitoring and selection process imposed on it. The due diligence is already imposed on it.

And we think of two ways of taking advantage of the concepts that are there. One is encouraging and facilitating the use of the employer sponsored plans for IRA assets, in other words, create a structure that would encourage participants or beneficiaries depending on which side of the fence you're starting from to consolidate their investments within the structure of a defined contribution plan.

This would give them advantages and access to fiduciary advisors. It would give them access to qualified default investments. But most importantly, it would give them access to a responsible party acting independently to select and monitor the available investments.

The second suggestion that we have that would compliment this would be for those beneficiaries that did not have access to an employer sponsored plan and in that case, we would adopt the QDIA regulation that's forthcoming for IRAs.

The QDIA regulations would then have essentially the same rules that you would have within 401(k)s as you'd have in the IRA world which means that the public would only have to learn one set of rules. You wouldn't have duel sets of rules. From an IRA, I have to speak English and if I'm in a 401(k), I speak French.

The other requirement I think if we were to do the QDIA route would simply be that we'd have to periodically certify this QDIA structure that would be available again to a large proportion of participants simply because they're not burdensome. It's a fairly straightforward sort of thing that would be adaptable to participants who are in the low interest categories.

With that, I see I have almost run out of time and would end my comments there and invite any questions that you might have.

MR. LEBOWITZ: Your last recommendation with regard to QDIA utilization in the IRA context.

MR. HARVEY: Yes.

MR. LEBOWITZ: I'm not sure I followed you. Are you talking about something where either by statute or some administrative action that participants in IRAs would be limited to a defined set of investment options defined by the government?

MR. HARVEY: No, the very opposite and that is to by exemption allow providers to offer a qualified default to their customers that's a prepackaged advice solution that can be reviewed, audited and certified so that the same qualified default investment option process that one uses within the defined contribution plan replicates that set of rules for IRAs.

MR. LEBOWITZ: So the exemption then presumably for the advice that the advisor provides to the participant would only be available to the advisor if the participant invested in one of the qualified default investments.

MR. HARVEY: Not quite. I'm suggesting that there are at least two worlds here, one in which there is an independent advisor in which case there's really not much need for an exemption. The other case is where you've got this provider who offers IRA plans. Should that provider not be able to offer to their clients, to their investors, the opportunity to get into qualified default investment and therefore, relieve them of this immense burden that I described before. So you defaulted into a particular investment based on, and I'll just go down the QDIA route, age. It can be a balanced fund. It can be targeted, the whole nine yards.

MR. STRASFELD: Thank you.

MR. HARVEY: You're very welcome.

MR. STRASFELD: All right. I think we're going to take a break for lunch. Why don't we reconvene at 1:30 p.m.? The cafeteria is closed. That's good and bad. One, there won't be food poisoning, but, two, you can't eat in the building. There are restaurants. Where is that little side street? I think on C Street there's a number of restaurants. Off the record.

(Whereupon, at 12:10 p.m., the above-entitled matter recessed to reconvene at 1:33 p.m. the same day.)

MR. STRASFELD: Let's get started to we can avoid rush hour. Is UBS present? Is Edward O'`Connor, Joanne Carter or Tammy Boynick. I'm going to go with Edward.

MR. O'CONNOR: Good afternoon.

MR. STRASFELD: Good afternoon.

MR. O'CONNOR: I'm Ed O'Connor, Managing Director of UBS Retirement Services. Joanne Carter is with me in the back and also Peter Rowan, my colleagues.

First, to thank you all for the opportunity to testify today. I have two main points. One is about the role of the financial advisor and secondly, about product innovation, which was touched on I heard a little bit earlier on.

But I will be brief, because I've heard many of my points. When you're the ninth to speak, many of the points that I did bring up, were brought up, so in deference to your time, I will be a little fast in some of my testimony.

First a little bit about UBS, 8,000 financial advisors servicing individuals and entrusted with about 130 billion in assets, in IRAs for those individuals, that's about 1.2 million IRAs. Within those IRAs, you've heard already, there's many different types of investments. There's securities, there's properties, we talked about here, financial instruments ranging from CDS to structured products, annuity contracts and so forth.

An initial count we did last week for this testimony is in total in all IRAs at UBS 350,000 different types of investments, distinctly different types of investments. And you've heard all that before. Most of the argument I heard today which was arguing for a either perhaps for a computer model or for a more restricted process for IRAs, when I listened to the arguments, they were very much giving examples of a 401(k) participant and there is a difference between a 401(k) participant and a 401(k) account if you will and what that worker has and an IRA and I will get into that a little bit.

The typical example you have today of a 401(k) participant, the one we always thing about when we're thinking about what's best for a 401(k) program is the young worker who's starting and beginning to first time save for retirement. And most of the time, this young worker doesn't have other assets. This is their nest egg that they're beginning to accumulate over their working life.

And of course, the good thing about 401(k)s are if you do move around the ability to roll over to different 401(k) plans or an IRA is something you can do because of the affordability of working Americans today. But what is interesting later on in life is as that worker ages, more likely he or she has accumulated other assets and when they get close to retirement, and they're thinking of perhaps of rolling into an IRA, if it makes sense to them, you need to begin to consider those other assets. The average American household, one-third of their financial assets and let's be honest, all financial assets for most Americans is about retirement, and one-third of those assets have -- one-third of those assets are in retirement, another two-thirds in stocks and bonds, CDS, annuities.

So when you're now in an IRA, and I'm thinking more in the later stages of life, and you're looking at what's best for them, you really should consider their other accounts, if you will. At UBS for every one dollar that we've been entrusted with an IRA, there's another four dollars, a little different than the average but another four dollars that our clients have with us on average in other accounts. So when our financial advisors are providing advice, they are certainly considering the entire financial picture and as you know, those accounts have obviously a different tax structure to them. Maybe a different time horizon. And some of the dangers, when we talk about how to restrict an IRA, we may be too focused is a nice term, perhaps, maybe too myopic in looking at what's appropriate for an IRA.

I heard earlier arguments for let's not include real estate. I actually can talk about situations where a real estate investment does make sense for an individual in an IRA when you look at their full financial picture. And we can talk about that later if you'd like to. Another example, just to give you and I find many of our clients doing this, when they're getting close to retirement, and you are talking about their IRA, but again, they have other assets, is well, let's put more of the income generating type of investments in my tax deferred IRA and them more investments that are of a capital gains nature and obviously, there's a tax motivation there for the individual, that they're really trying to manages their taxes as best. So another example of how when it's time for the IRA, you really are much more imbedded in the full financial picture of the client.

Actually, the final point I have is really what I want to spend the most time on is product innovation. I think actually we are right in the beginning of the unprecedented, if you will, explosion in product innovation that you are beginning to see from the financial services industry and it has to do with the baby boomers. This is the first generation that it's thrust upon them to secure their retirement and baby boomers are expected to live decades past the traditional age of 65.

A unique challenge for them is to secure their retirement, generate income for themselves, while at the same time still investing in the markets so inflation doesn't eat away at their nest egg. And it's a unique challenge. Because of that challenge and from a private sector perspective, you can look at it as an opportunity, you will see more and more types of products that are packaging features together. About a month ago I spoke with former Congressman Bill Thomas and he was interesting because he was, as you may recall, the former Chairman of House, Ways and Means, and he was challenging me, he was challenging UBS and he was challenging the industry.

He was saying, "I want to see more", as he called it, "twofers and threefers", and I wasn't sure what he meant by that. But what he was talking about are products that combine the features of investing, the features of some type of protection, principal protection, perhaps, and/or some type of an income guarantee and/or health care features in one product.

Some of those are already available today but I think you're going to see more and more of that being created as time goes on. And, of course, what features the weighing of those features should be different for individuals depending on their wealth, their health and their stage of life. How could a computer model, how could a restrictive process measure those choices in an IRA?

And I think my concern is if we do put too many restrictions on an IRA, my biggest concern today is that that product innovation will be hindered and I go believe that's a bad thing if we do that. So that's my main points. I wanted to be a little more brief because most of my other points have been taken. I'm here for any questions.

MR. STRASFELD: I thought maybe in some respects, you know, everyone was looking at this too narrowly because this particular statutory exemption is just one way that investment advice could be provided. I mean, we've already stated over the years -- well, obviously, we've come out with our IB on investment education which actually goes a fair amount of way. There's obviously the SunAmerica approach that we've come out with that's going to a completely disinterested advisor. So, you know, when I'm looking at this, I'm only looking at one particular type of investment advice, you know, depending on how we come out. It will either be through the statutory exemption or through the class exemption that's dictated by the statutory exemption, but it's still only -- it's not really foreclosing investment advice. It's -- you know, I think the investment advice market could undoubtedly grow and there's probably a number of ways you could do it without having to come to us to seek our blessing by exemption.

So I assume -- so just -- you know, just to make that point, I assume you seem to be able to view -- you know, I guess just focusing on the narrow question, you are -- I assume are of the view that the full range means everything.

MR. O'CONNOR: A full range, the word "everything" is a pretty broad term.

MR. STRASFELD: Well, it means

more than, I guess, asset classes which is --

MR. O'CONNOR: Yes, I would say that.

MR. STRASFELD: Right.

MR. O'CONNOR: Where they're concerned about innovation.

MR. STRASFELD: Right, I guess may initial rambling is really to -- you know, this -- we're trying to, you know, come to some conclusion but it's in a fairly narrow context and there are obviously, other means of providing investment advice. You know, we've through individual class exemption, methods that are not -- you know, don't per se, run afoul of the risk of further transactions, but I just wanted to clarify that. But you're of the grouping that or the group that concludes that this should be read in a more -- a broader fashion.

MR. O'CONNOR: Yes.

MR. STRASFELD: All right, let me then -- all right, so if we take that to its -- you know, to its logical conclusion, then we will conclude that, you know, that we can conclude that there is an IRA computer model available. So I'll ask you, too, as I've asked, you know, some of the other commentators, what would you envision this class exemption that we're supposed to do if we can't make the determination? You know, what would that address or what would it look like?

I mean most of the other commentators have said that it should focus primarily on disclosure, but the direction that we seem to be getting from Congress is that it utilized prescribed objective criteria to provide asset allocation portfolios composed of securities. So it doesn't even really necessarily talk about individual holdings. It seems to talk about some sort of collective vehicle which, you know, I'll have to admit I'm not sure exactly what they were getting at.

MR. O'CONNOR: Right.

MR. STRASFELD: Did you have any views as to -- I mean, obviously, this requirement that's imposed on us or will be imposed on us, must have some meaning.

MR. O'CONNOR: Okay.

MR. STRASFELD: I'm just trying to figure out what that meaning is.

MR. O'CONNOR: Well, let me answer it maybe a different way because when I think about it.

MR. STRASFELD: Yes.

MR. O'CONNOR: What really is our intention, I believe, now I'm speaking as an individual here --

MR. STRASFELD: Right.

MR. O'CONNOR: -- not to Congress. It's about insuring, helping to insure appropriate advice with regard to those IRAs and within that to address potential conflicts and those conflicts could be either outright restricted or you need to disclose loud and clear.

MR. STRASFELD: Right.

MR. O'CONNOR: I think where maybe the biggest opportunity is, is in a very clear picture of the fees you're paying and what you're paying for. And if I connected that to my point about product innovation maybe I'll be more clear. It's going to be harder and harder to understand what you're paying for. And if you do break down a product and if it's called an investment product into its basic categories, this could become simple, if we worked on this the right way and it is disclosure, but I think it's a very different way of looking at disclosure.

You custody assets, you're paying a firm to hold the money for you and to entrust it for you, so there's a fee for that. It's sometimes very hard to understand what you're paying for that, right? There's a servicing and administration of your investment. There's a statement that comes out once a month, once a quarter. There's a place to make a phone call, ask a question, move the money for you. So there's custody in administration, right.

MR. STRASFELD: Oh, yes, we have -- at least we're familiar with that.

MR. O'CONNOR: Right. Then there's investments.

MR. STRASFELD: Right.

MR. O'CONNOR: What are you really paying for that, and then what are you paying -- again, thinking about the future here, what are you really paying for the guarantee, whatever that guarantee may be? And I think we have to start looking at the structure of our disclosure. This can be an opportunity for us. My suggestion is to look at that structure about disclosure for the challenges that are going to be coming forward with regards to new products and new packaging of products. That's my view.

MR. STRASFELD: Okay. If people think they're getting something for nothing, they're not.

MR. O'CONNOR: Right, absolutely.

MR. STRASFELD: All right. Do you have anything, Joe?

MR. PIACENTINI: Just one narrow question. You were talking about the importance of looking at the assets outside the IRA, looking more across all the assets. You mentioned consideration of tax implications, tax deferred, taxable accounts. I don't think that's come up earlier today and it's not something that's mentioned in the conditions and statutory exemption.

MR. O'CONNOR: Right, yes.

MR. PIACENTINI: How important do you think it is to consider tax implications in investment advice? How commonly is it done by advisors or by advice programs?

MR. O'CONNOR: Mentioning in the context if we just create a restriction or a process or a model just for the IRA and to look at the IRA and say, does the answer to this IRA make sense, when you step back and look at their whole financial picture and I think I gave an example where why are you only investing in income or into vehicles in this IRA? It doesn't seem appropriate, suitable, but when you step back and realize the individual is choosing from their own tax management standpoint, the individual's choice, right? "Well, I would rather have capital gain types of investments in my taxable accounts".

So when you step back and look at the whole picture, it's appropriate and suitable, but if you begin to just focus, which we did a lot today, on just the IRA, an IRA is much closer to -- by the time they're in an IRA, it's more about all of their assets. I'll give you one more example, maybe this a little more clear.

When do you need this money is really one of the most important questions that we ask our clients. When do you need this money, and many times when we talk about this, it's very much in a wealth accumulation mode, "So it's when I retire, age 65, I need X amount of money." Well, what is the type of distribution flows, it would probably be a little more practical if I talked to a client, "But when do you need this money? Is it the same amount of money each and every year?"

And then you get into conversations about their house. "Oh, you plan on selling the home. Okay, well, maybe then your time horizon for needing this IRA is a little bit further down the road if you're selling your home. What kind of health care coverage do you have? All right, is your health care coverage sufficient for you for the rest of your life or do we have to think about those costs perhaps later in your retirement years because perhaps medical costs very likely will grow in the second half".

So example of a taxed account or not taxed account or the house is all about -- when you're talking about an IRA, now you're really talking about a person that's getting, generally speaking, closer to retirement and it's about everything they have and how to best manage their money for their retirement.

MR. STRASFELD: Thank you very much.

MR. O'CONNOR: Thank you, Mr. Strasfeld.

MR. STRASFELD: PENSCO?

MR. ANDERSON: Good afternoon. Thank you for the opportunity to speak today on behalf of the American public, the self-directed IRA industry and PENSCO Trust.

PENSCO Trust is a $2.2 billion dollar self-directed IRA custodian operating as a bank and trust. And I'd like to agree with a lot of the comments I heard today and disagree with some others. The first thing I would say --

MR. STRASFELD: Could you identify yourself?

MR. ANDERSON: My name is Tom Anderson.

MR. STRASFELD: Thank you.

MR. ANDERSON: The first thing I'd like to say is, I think that the Department of Labor has a very untenable position in this regard. I think it's clear from most of the speakers and I would concur, that a model is impractical. That being the case, your left with the choice of coming up with an exemption for a class of individuals that will potentially created an institutionalized self-dealing situation because these are not independent financial advisors but advisors that are associated with firms that sell proprietary products.

So that's a very difficult

situation. I don't believe that such a class exemption has been granted since the IRC-4974 code was devised and I would suggest possibly another alternative which would be to suggest to those firms that have proprietary products that they find a way to develop more independent advisors within their own groups. Because if you look at an independent advisor today, since they're not compensated based on the investments that they choose for their clients, looking at the client from a holistic standpoint, they're going to more theoretically follow the modern portfolio theory which is to include in the portfolios of their clients assets that are not highly correlated.

And I can say for being in the business that I'm in that thousands of our clients over the last five years during the market down-turn, the scandals in the securities industry and the mutual fund industry, people were dying to get out of their 401(k) defined benefit -- defined contribution plans and out of their traditional IRAs to into alternative assets and those that did, did quite well, not to say that, you know, in two years the stock market will decline by 20 percent and the -- I'm sorry, the real estate market will decline by 20 percent and the stock market go up 20 percent, but those two asset classes alone and there are hundreds of asset classes, are not correlated and therefore, a given portfolio over the last five years equally balanced between real estate and the stock market no matter virtually what you chose within those two markets, would have probably been ahead overall in terms of value.

$1.7 trillion was lost in retirement accounts from 2000 to 2005 mainly because of systematic risk and that's because IRAs were stuck in traditional assets or retirement assets were stuck in 401(k)s with a limited set of choices. So I would suggest that high risk, which that being the backdrop and with the Enron situation and with other things that are included in the Pension Protection Act of 2006 would suggest that they want more self-directing. They want more choices for retirees and pre-retirees and their investment choices, including the fact that they have a provision now that says that you can't just offer a single company stock as a part of the plan. You have to offer at least three other mutual funds and also you're permitted to include alternative assets.

It does put in place to get out of the situation when people are locked into a down market. So you can't, I think, doing duty to the American public, suggest that there can be a class exemption that's for advisors that limit the assets their clients can choose for IRA investments to a limited set of investors. It's in conflict with the IRC-408 Code which suggests there's only two asset classes you can invest in, collectables and life insurance. It's also in conflict with all the other provisions that are promoting more self-directing and more liberalization of IRA rules inherent in the Prevention and Protection Act.

If you look at the largest

pension fund in the United States, $249 billion, 37 percent of that fund currently is allocated in alternative investments. So there's a reason for that, because those investments do not correlate with the stock market and so there's a hedge against other asset classes. So to suggest to IRA holders they can no longer, you know, buy real estate or by private equity, that's going in the wrong direction. I think it's also going in the wrong direction that the Congress is trying to signal.

They were trying to say all are permitted investments within the IRA rules. Now, that may be impractical but to suggest to restrict that is going the other way or to suggest let's eliminate IRAs, I think that's political suicide if you're in Congress to go back to your constituents and say, "You no longer have control over your IRA and you're going to have to roll it back into a 401(k) and we're going to limit it to a small set of assets".

A couple other things that people should be aware of, I think is the overall trend with people now living longer and realizing that they have to manage their retirement portfolio over a longer period of time, as the gentleman from UBS just stated, they're going to have to manage this from an investment standpoint. This is no longer a fixed instrument kind of deal where you just lock it up. They're going to live longer and need 20 years of financial resource after age 65. So they have to actively manage this account and grow it, because the bottom line, IRAs would not exist at all if it wasn't for the fact that they give tax deferred or tax-free compound growth.

So the last thing you want to tap is your IRA and you want to be actively involved in managing it and more and more boomers who are relatively more sophisticated, now want to be out of the limits that are experienced in 401(k)s and traditional IRAs. If you look at the average balance sheet according to the Census Bureau and the Department of Labor statistics of 2001, the per capita balance sheet shows that approximately 39 percent of the average American's balance sheet is invested in real estate or composed of real estate. Seven percent is composed of private equity and only 18 percent in the stock market, mutual funds, bonds, and that includes IRA monies invested in those categories.

So it's inconsistent that IRAs up to this point have been restricted into the traditional arena. They should be allowed to do everything that's allowed under code in 408 and we see more and more of those trends. PENSCO, as a company, is growing in our industry. We're a member of the Retirement Industry Trust Association and we're growing at approximately 20 percent within the $4.2 trillion IRA market whereas the overall IRA market is only growing at eight percent.

Merrill Lynch did a recent study that indicated that 75 percent of the people that are retiring are rolling out of their defined contribution plans into IRAs presumably because they want to take more control over their investment. So any suggestion to limit the set that an advisor can choose from, I think, is ill-founded. Not to say that many people don't need advisors, and I would suggest that unless a model can be devised or a set of controls and audit procedures to insure that any financial advisor that's associated with a proprietary product company has to incorporate other asset classes would be inappropriate. It would be basically institutionalizing a violation of IRC-4975 because they'd be pushing people into assets that they've compensated for selling.

So to conclude, I would suggest that, number one, I agree with the majority of people who have spoken earlier that suggest that a model is just impractical. I think that if you could come up with a model as everybody would envision, you wouldn't have a need for financial advisors, so that would eliminate the exemption requirement. But it's just not going to happen. I mean, you have people here representing companies that have models saying that's not going to happen. So the question is, how can you do service to the American public to insure that self-dealing will not exist when you grant this exemption and that's through proper controls procedures guidelines as to asset allocation.

Following more of the minor portfolio theory incorporating alternative asset classes. I'm done.

MR. STRASFELD: All right. Well, I'm somewhat confused by your testimony.

MR. ANDERSON: Sure.

MR. STRASFELD: If you conclude on the one hand that there is no model, which other people have stated, that's fine, but then you've gone a step further and said that there's no exemption we should do because it would encourage self-dealing because the advisors who are the subject of the exemption would put IRAs into products for which they receive compensation. So if we're not doing the exemption and we're not doing the model, then what are we doing?

MR. ANDERSON: As I suggested, I think you're in an untenable position. I think that the --

MR. STRASFELD: That's right, that was the start.

MR. ANDERSON: I think Congress intended you to liberalize what restrictions there have been on retirement accounts coming off of all of the problems over the 2000, you know, period through 2005 when there was a systematic drop in the market that period had their retirement accounts in. They've heard from their constituents saying, "We want more liberalized choices". So that's the signal. However, I don't think they maybe thought through the practicality of coming up with a model like that to prevent, almost like a protective advice, prevent self-dealing.

MR. STRASFELD: What limitations are you talking about, because it seems to me under the Code IRAs can't invest in collectables, but under out provisions and under the Code, they can pretty much invest in anything they want.

MR. ANDERSON: No, I'm just suggesting that if you get a class exemption, about 97 percent of all IRAs are offered by companies that have proprietary interest in the products they sell.

MR. STRASFELD: Oh, sure, sure.

MR. ANDERSON: And if you give an exemption to advisors that are going to suggest to people what they invest in and they're compensated for suggesting that they go into their products, then it's going to be very difficult to make sure that there is some objectivity in that advice.

MR. STRASFELD: Now, is there -- right, which I don't necessarily disagree, but is there -- besides disclosure, is there something else that we could put in an exemption that would assure more objectivity to know they may be paid for the products they're advising?

MR. ANDERSON: Well, I don't have the magic wand on this one. I think everybody probably would have a different opinion on what you could do, but I would just suggest that maybe there's some balance between having a totally fee-based financial advisor that's totally objective and not compensated by a proprietary firm and a proprietary financial advisor. Maybe they have some guidelines to go beyond the proprietary products. Maybe there's a limit as to what percentage -- even if it's 75 percent, some limit to say there is a stopgap, you can't sell more than 50 percent of our products or advise. I don't have the solution.

MR. STRASFELD: In the absence of an exemption or a model, is there anything else that would be available to IRAs other than, I guess, a fee based advisor?

MR. ANDERSON: No, but a lot of the firms that are represented here, I know have independent advisors associated with them and many of those are doing the full diversification and others that are more narrow firms in terms of products they offer don't. I don't know how to bridge that gap.

MR. STRASFELD: Anyone else.

MR. ANDERSON: Thank you.

MR. STRASFELD: Thank you. Ameriprise Financial, Inc. Scott Plummer?

MR. PLUMMER: Right.

MR. STRASFELD: All right, good.

MR. PLUMMER: Good afternoon. My name is Scott Plummer and I am Chief Legal Officer for RiverSource Investments, the US based asset management subsidiary of Ameriprise Financial. With me today is Kurt Lofgren, counsel to our Retail Retirement Unit. I won't begin my remarks with a comment about height other than to say, like the speakers you've heard today, Americans come in all shapes and sizes. I know I'm stating the obvious here and I believe that all participants in this process want to achieve the outcome that gives the largest number of Americans the opportunity to satisfy their retirement needs and so hopefully you will hear that theme within our remarks today.

To begin, I'd like to mention that I've worked in the asset management industry for 14 years and have witnessed the technology enhancements that have occurred for many companies including RiverSource Investments, which have been implemented to drive consistent, competitive performance and improve overall risk management.

Computer models have played and continue to play an important role in the development of retail financial services products and have significantly improved asset allocation strategies available to individual investors. In addition, Ameriprise Financial, the parent company of RiverSource Investments, is a leading financial planning and advice company with more than 10,000 financial advisors throughout the United States, offering asset accumulation, income, banking and protection solutions to help clients achieve their dreams.

With that as a background, I'd like to turn to the topic of today's meetings, computer models' ability to meet the advice needs of Americans investing in Individual Retirement Accounts. The Pentions Protections Act's advice provisions are intended to expand access to advice for Americans planning for a retirement. We strongly supported the legislation signed into law last year. In terms of investment advice the PPA struck an unusual compromise that we've discussed quite a bit today. The Department must determine the feasibility of a computer model to provide investment advice that meets explicit statutory standards including whether it is able to take into account the full range of permissible investments including equities and bonds in determining the investment options for an IRA account.

I'd answer one of the questions from our perspective, that's been asked quite a bit today. I'm from the Midwest and when I read "take into account the full range of permissible investments", at one level that's what I read and that's what I think that the legislation was intended to drive. A couple of other levels of response to that question is the -- as you move up to more general -- a grasp of more general categories, so asset classes, obviously, the credibility of the computer model is diminished by the fact that you don't have the specific data underneath that's been tested and validated and again to state the obvious, the more general the output, the more general the advice that's provided. So to be clear, we do not believe such a model is feasible.

In our view, computer models cannot take into account the full range of investments available to IRA beneficiaries and do not allow IRA beneficiaries sufficient flexibility to consider personal relevant financial information in obtaining advice. Importantly, we believe the best public policy would be to provide a disclosure based class exemption as the best means to help insure greater access to meaningful professional advice.

At RiverSource Investments we have developed a number of highly sophisticated and effective quantitative investment models that generally fall into one of three categories; asset allocation, security selection and investment optimization. These are used by our institutional investors as we seek consistent competitive performance over time but are not designed for direct use by IRA beneficiaries or their clients.

Our proprietary asset allocation models have the ability to allocate assets across more than 20 asset categories including many but not equities and bonds. While very highly sophisticated, these models do not cover the full range of permissible investments for an IRA since the universe of permissible IRA investments is virtually limitless due to the dynamic nature of today's financial markets as we've heard quite a bit today. On this basis, the practicalities of obtaining the necessary amount of data for this universe of investments in order to develop and maintain an all-encompassing model makes it unfeasible, if not impossible, to implement.

In addition to take into account all of the investments available with an IRA, the PPA also requires the computer model to allow the IRA beneficiary with sufficient flexibility in obtaining advice to evaluate and select investment options. In our view, today's computer models do not provide IRA beneficiaries with sufficient flexibility to alter the advice provided by the computer model to suit their individual financial information. Due to the intellectual rigor and scientific validation dedicated to developing the logic and assumptions that drive the most effective computer models, we do not foresee a meaningful ability for an IRA beneficiary or even a well-trained financial advisor to materially modify a model. In fact, we believe that such manipulation would likely corrupt the very integrity of the model itself. At most, variations to any model are limited to a handful of inputs reflecting external variables such as the age of the IRA beneficiary.

Although computer models cannot meet the statutory requirements set forth within the PPA, computer models can be very useful tools for IRA beneficiaries and financial advisors. However, in order to be most used effectively, we believe they should be implemented in conjunction with the comprehensive and personalized advice capabilities of a knowledgeable financial advisor, with the results evaluated in the context of the IRA's beneficiary's entire financial situation.

At Ameriprise Financial we have more than 2.7 million individual, institutional and business clients. Our core focus is on the mass affluent and above in the US market which represents more than 41 million US households. Many of these individuals are members of the baby boom generation that have an unprecedented opportunity to shape their retirement years around their dreams and goals. Our clients represent a cross section of America, the traditional employed worker, the self-employed, the small business person, and they each have unique financial needs.

Our clients select and maintain IRA accounts with us principally because they want the help of a personal financial advisor. Our clients can invest in several different IRA products. The majority of our clients' IRA assets are held in brokerage accounts with Ameriprise Financial Services, Inc., our broker/dealer affiliate. IRA beneficiaries can select from thousands of different mutual funds. In addition, clients can hold publicly traded stocks and bonds, certain options, real estate investment trusts, and union investment trusts within their IRA. We also offer individual retirement annuities and IRAs that hold face amount securities which is a product somewhat unique to Ameriprise although it is similar in many respects to a Certificate of Deposit.

Over half of our IRA assets are held in fee-based RAP accounts. While we have a broad product sweep, we do not offer certain other investments that could otherwise be held within an IRA, such as certain precious metals, direct real estate holdings, or privately held stocks. Our clients seek investment advice as to which types of IRAs to select, the investment structures within the IRA, the allocation of their assets and the most effective withdrawal strategy, all within the context of a comprehensive financial plan. Given the breadth of investment choices available to IRA clients, a limited scope computer model would be of little value to them.

Instead we believe that the financial planning process is the most effective way of our IRA clients to manage their finances and prepare for the future. Our financial advisors are subject to oversight by several government agencies and self-regulatory organizations including the DOL, the SEC, the NASD and various state agencies. Our advisors offer financial planning consistent with the Certified Financial Planner Board of Standards. After the advisor has been engaged by the client and gathered the relevant personal financial data, our advisors have access to numerous tools that help them analyze the client's financial situation and make asset allocation recommendations unique to that client.

These tools help the advisor evaluate the client's finances holistically, favoring the impact of taxation protection and other goals at an asset class level. Advisors then have access to several investment selection resources, including research tools from Morningstar to compare and contrast potential holdings within each asset class as well as continuously updated fact sheets with respect to certain investment options.

Our clients, however, are not unique in terms of their interest in obtaining professional assistance in the management of their retirement assets. For example, a 2007 Spectrum Group study found that among both baby boomers and World War II generation, 67 percent used a professional financial advisor in deciding whether to roll retirement plan balances into a personal IRA. A 2007 Forrester Report found that for every generation financial advisors are considered the most helpful resource in retirement research. And in 2004 the Roper study we commissioned found that clients with an advisor save almost twice as much for retirement.

Your decision to issue a broad disclosure based exemption would enable our clients and many other IRA investors to receive the advice they need to help them effectively manage their IRA savings over a lifetime. There are a number of exemptions and advisory opinions that provide some avenues for the provision of investment advice. However, much of this guidance was issued in the 1970s and 1980s before the development of today's robust IRA market. We feel strongly about the need for a broad IRA advice exemption rather than a patchwork of nuance positions. The latter framework is extremely difficult to communicate to a financial service provider's field force much less to clients when they request assistance in managing their IRA accounts. As the Department moves forward to consider a class exemption, there should be no doubt that if the conditions are met, the fiduciary advisor will not be engaging in a prohibitive transaction by providing investment advice to the IRA beneficiary.

The statute already provides for significant conditions relating to providing investment advice. Most importantly, this exemption does not alter the standard of care required on the part of the advice giver. In fact, as the term implies, the fiduciary advisor is considered to be a fiduciary and must acknowledge this fact. As a fiduciary, the advisor must act in the best interests of her or his client. Additional considerations include the disclosure of fees and conflicts, obtaining prior written consent of the IRA beneficiary, receipt of more than -- of no more than reasonable compensation.

The transaction must be arm's length. The advice must be non-discretionary and the records must be retained for six years. The statute also includes an audit requirement but leaves the details of such an audit to the discretion of the Department. It is our opinion that these requirements, which would be in addition to requirements already in place by other securities regulators, will protect the interests of IRA beneficiaries. In that regard, we would request that the Department coordinate its guidance regarding the disclosure and audit requirements to take into account requirements already in place for certain fiduciary advisors. We believe a coordinated approach provides better synergistic benefits for regulators, while allowing the fiduciary advisor to focus on one set of integrated compliance requirements.

A registered investment advisor is required to disclose the nature of its business, compensation arrangements, affiliation of other entities, disciplinary history, and any other conflicts of interest it may have. Such disclosure is found in the advisor's form ADV or brochure. Similar to the Investment Advice Exemption under the PPA, the purpose of the disclosure requirements under the Advisor's Act is to protect investors. Therefore, we believe that the same level of disclosure is appropriate here. The PPA requires disclosure, past performance and historical rates of return for investments available to the plan. This requirement may work for IRAs where investments have been limited by the company sponsoring the IRA. However, as just been mentioned previously, where the

IRA sponsor utilizes open architecture through a brokerage account, this requirement would be difficult or impossible to meet. A practical approach would be to require the past performance and historical rates of return be made available upon request.

In closing, we believe it's not feasible for a computer model to meet the statutory requirements of the Act and request that you move quickly to issue a disclosure based exemption. Thank you for this opportunity to testify today. The IRA Investment Advice Exemption is very important not only to our clients and our company but to all the Americans as they pursue financial independence during retirement.

MR. STRASFELD: Okay, thank you very much.

MR. JOHANSEN: I was misintroduced at the beginning.

MR. STRASFELD: What is the correct name?

MR. JOHANSEN: Kurt Johansen.

Lofgren is our chief counsel.

MR. STRASFELD: All right.

MR. TRONE: Are we taking an official transcript today?

MR. STRASFELD: Yes.

MR. TRONE: Then I'd like to suggest that maybe we move to a bigger room to accommodate the standing room audience that we have.

My name is Don Trone and I am the President of the Foundation for Fiduciary Studies and the founder of Fiduciary 360. I have more than 20 years of experience in publishing and developing fiduciary training programs and software which support the decision making process of investment fiduciaries. The mission of the Foundation for Fiduciary Studies is to define and promulgate prudent practices for investment fiduciaries and a series of fiduciary handbooks have been written for the investment industry on these practices and I have two of those handbooks with me today. One is "The Prudent Practices for Investment Stewards". The second is "The Prudent

Practices for Investment Advisors", and I'll leave these with the staff.

All of the fiduciary practices in these handbooks have been substantiation by regulations, case law and regulatory opinion letters. The legal memorandum that accompanied these fiduciary practices were prepared by the ERISA law firm of Reich, Luftman, Reicher and Cohen. A copy of the legal memorandum is provided as well. In turn, the Foundation's fiduciary practices are used extensively by Fiduciary 360 which coordinates the resources for the Center for Fiduciary Studies and Fiduciary Analytics. The Center for Fiduciary Studies provides fiduciary training programs and awards the professional designations accredited investment fiduciary and accredited investment fiduciary analyst. More than 5,000 professionals have undergone one or more of these fiduciary training programs.

Fiduciary Analytics is an applications development firm building sophisticated online tools for trustees and investment professionals based on the fiduciary practices defined by the Foundation. In fact, today we have more than 1200 financial services firms using these fiduciary based tools including many of the people that provided testimony today. The Foundation's practices have also been adopted by CEFEX, which is a global independent assessment and certification organization. CEFEX works with the investment and fiduciary communities to provide comprehensive assessments that measure risk and trustworthiness of investment fiduciaries.

The assessment procedures that have been developed by CEFEX are based on ISO 19011 which is a global auditing standard, and are similar to other industry assessment procedures such as SAS 70 and Six Sigma. We've identified two pre-suppositions to the discussion of computer-driven advice models. First, and I think it's already been addressed by most of the other previous speakers, it's not just about developing an asset allocation solution. It's about a comprehensive investment management process. And whether we're talking about a process that's associated with the computer model or an investment advisory service that's been suggested by several of the other speakers, it's still about an investment management process.

In our opinion, the availability of appropriate technology is not a challenge. The challenge for the Department is to define the fiduciary practices and rules that will drive the technology. With fiduciary rules based technology and those are the operative words, fiduciary rules based technology, the investment industry will be fenced within a defined level playing field and a Department regulator and auditors will be able to quickly identify the players who are out of bounds, which leads to our second pre-supposition.

It's still about procedural prudence. ERISA was designed to be a flexible doctrine that gives consideration to incorporating changes in the types of financial products made available to investors as well as evolving investment strategies and theory, Lew Harvey's comment earlier today about mutual funds in 1965. At the root of the doctrine is the concept of a process standard and the requirement that investment decision makers demonstrate the procedural prudence. Now, I'm not an ERISA attorney but I would suggest maybe the Department to back and look at ERISA Section 404(a)(1)(b) as the answer to your question, Mr. Stratsfeld, beating you to the punch, what is the appropriate universe of investment options.

The appropriate universe are those investment options where the investment decision maker can demonstrate the procedural prudence in the selection of each and every investment option. Your answer might be as simple as Department re-emphasizing the need to demonstrate the procedural prudence and the selection of each investment option. Going to the comment that was made this morning by the Securities Industry and Financial Markets Association, talking about the policies and procedures at the institutional level. We concur with that provided that those policies and procedures define a fiduciary standard of care for the conduct of their investment advisors.

To assist the Department in developing the fiduciary rules to be used in the computer advice model, and again, whether we're talking a model or individual investment advice as has been suggested by several of the speakers, and to define the procedural prudence associated with the investment decision making process, we would recommend that the Department form a separate advisory council, similar to the Department's ERISA advisory council, to periodically meet to suggest inputs for the technology.

And I'd like to use the remainder of my time to demonstrate one example of fiduciary rules based technology that we have developed. This particular tool is called the Fund Analyzer. By way of some background, investment fiduciaries have a responsibility to establish a due diligence process for selected investment options and on ongoing duty to monitor the implemented strategy. This is of particular importance to affiliated investment advisors of service vendors who may be recommending a proprietary fund of the service provider.

More than eight years ago, we published for the industry what we believed to be the minimum due diligence process that a fiduciary should demonstrate when selecting and monitoring an investment option. The minimum due diligence process consists of nine fields and with each field we have also identified a threshold that must be met to demonstrate conformance and this information is summarized in illustration number one.

In fact, if you look at illustration number one, you'll see that the first field of due diligence is that we suggest that the investment option come under regulatory oversight. In other words, the investment option is part of a regulated entity such as an investment option that is managed by a bank, an insurance company, a registered investment company or a registered investment advisor.

In January 2001, we launched the online version of our technology that applies the due diligence process to a universe of mutual funds and separately managed accounts. The Fund Analyzer maps the minimum fiduciary due diligence process to readily available databases, the Morningstar universe of 16,000 open end mutual funds being our primary source. In other words, we take the due diligence process that we talk about in Illustration Number One, and we map it to all 16,000 funds in the Morningstar universe.

In turn, we weigh each field of the fiduciary due diligence process and its relative importance to a fiduciary's decision making process. Using the weighted factors and ranking the results relative to peers, we determine an overall fiduciary score. There are five classifications of fiduciary scores which are also color coded to facilitate reviews by investment decisions. The color coding makes it so simple even a -- and you can fill in the blank. This information is displayed in Illustration Number Two.

Our technology then provides the investment decision maker a number of different formats to present the information to a client and to review the details behind the fiduciary score. In other words, we believe in full transparency. It's not enough to simply say what the fiduciary score is, but also give the details of what made up that particular score. Some of the sample reports, the first is the fiduciary score sheet. This provides the decision maker a flash report of what's working and what's not. I call it the bench strength. It's as simple as putting the ticker in of an investment option or tickers in a portfolio and you come back with this fiduciary score sheet.

In the first column, you see the fiduciary score for the current quarter of each investment option, in the second column, the three-year average. The next level of detail is called the plan summary. We provide the decision maker more detailed information about each investment option. It continues with the color coding but also compares the rolling performance of each investment option to its peer group and relative index, which is consistent with current ERISA case law.

Illustration Number Five is the fiduciary score due diligence breakdown which provides the decision maker a pass/fail analysis of each of the due diligence criteria. Illustration Number Six is the fund profile which provides the decision maker a very detailed analysis of each field of the due diligence process and a comparison to a defined threshold. So when you look at this Illustration Number Six, all nine fields of that due diligence process now with their threshold are displayed in the one profile.

And any time a field of information has a shortfall to the threshold, that field of data is shaded in gray so that visually, you're alerted to what the fiduciary shortfall is with each investment option. Illustration Number

Seven provides the decision maker a detailed analysis of the consistency of a particular investment option, so you can go quarter by quarter back over the last five years to see what the fiduciary score has been. And then finally the last illustration which is my favorite, provides the decision maker a narrative, plain English narrative, of the fiduciary shortfalls of a particular investment option and provides the investment advisor the opportunity to add their own observations to the report. And then along side the investment advisor's recommendation there is the capacity to record the client's direction to either place the fund on a watch list or replace it.

Thank you.

MR. STRASFELD: What would be an example of the so called shortfalls in terms of analyzing an investment? I mean --

MR. TRONE: Sure. Some of the more prominent ones, the expense ratio of the investment option. We have a fiduciary duty to control and account for investment expenses, but as an industry, we've never drawn the line in the sand to say expense ratios on this side of the line are reasonable, the other side of the line are not. And so what the technology will do, it will take a peer group and rank all the expense ratios of that peer group, cheapest to most expensive. We believe the threshold is at the 75th percentile. That if the expense ratio of an investment option is in that bottom quartile, that most expensive quartile, a fiduciary is going to have a very difficult time defending themselves against a charge that they're prudently managing fees and expenses. That would be one illustration.

Another would be manage your tenure. You know, at what point do we say the same portfolio management team should be in place to be worthy of a fiduciary consideration? And then in turn from a monitoring standpoint, what does that say when we're worrying about the departure of a key portfolio manager? This type of reporting will pull out all those key factors.

MR. STRASFELD: And I assume performance factors enter into that somehow?

MR. TRONE: Yes, performance is one, three, five year performance ranked against the peer group, also risk adjusted performance, we look at the chart and also compare it against the peer group.

MR. STRASFELD: All right, so a lot of these are peer group comparisons; is that right?

MR. TRONE: Yes, yes. Yes, the history behind this actually was a project, Don Phillips, the managing director of Morningstar asked me to do about eight and a half, almost nine years ago. He said, "More and more 401(k) trustees are relying entirely upon Morningstar data to select their investment options. What if one of these trustees ran into difficulty with an auditor or a litigator? Would they be able to substantiate or demonstrate their due diligence, their prudence by relying solely upon Morningstar data?" So if you're familiar with the Morningstar software, Principia Pro, you open it up and you see 158 fields of information. All right, you're the Department of Labor and I'm a 401(k) trustee or I'm an investment advisor with an IRA rollover and I call you and I say, "I've opened up Principia Pro. I'm looking at 158 fields of information. What's the first field of information the Department of Labor wants me to look at, what's the second and the third"?

MR. STRASFELD: Based on the request, I'd have to see fees, but I'm speaking for myself.

(Laughter)

MR. STRASFELD: All right, so what's the answer?

MR. TRONE: Well, that's the nine fields that we came up with. So what I did was I spent four months inside the offices stress testing all these various fields and thresholds, put the screwdriver down a little bit tighter on the threshold, how many survivors do you have, loosen it up. And in a turn now, we have eight years of actual experience of running this due diligence process that we can show the consistency of the results, the transparency, the objectivity of the whole process.

MR. STRASFELD: Now, how would this overlay on the investment advice associated with an adviser using affiliated funds? They would apply that process to their own funds and see how it compared to the various -- their peer group?

MR. TRONE: Exactly. There's some in the industry that say the mere use of a proprietary product is a fiduciary breech. We would disagree. We still point to the procedural prudence. Identify a rules based process that you're going to follow, apply to your proprietary product and if your proprietary product screens as well as a non-proprietary product, why not? But the imprudence is to be able to demonstrate that process and demonstrate that it's consistently used. And the fact that the process has been developed by an independent objective third party, in this case, the Foundation for Fiduciary Studies, it reassures the investors and the public that the process is not being gamed to accommodate the particular financial services firm.

MR. STRASFELD: Thank you.

MR. TRONE: Thank you. Have a good summer.

MR. STRASFELD: Thank you very much. All right, last but not least, Universal Retirement Consultant Group, Inc., batting cleanup.

MR. UNGER: Thank you. The good news and the bad news. You're actual final presentation. Of course, the bad news, it's me. I will -- so much has been said so far that I've basically thrown out my presentation and I'm going to try and focus on some of the inconsistencies that you may believe exist based on the presentations you've seen. I believe that much of those differences that you've seen in the speakers so far depend upon context, where they're coming from. It's not my intention to cast aspersions here but in large respect this is about --

MR. STRASFELD: You're the last speaker, so --

MR. UNGER: Yes, well, it very much is about commerce. They're all representing their own best interests as they should, not because it's just their interest but because it's their interest, that's what they believe in. But I'm reminded, I guess back in March of the hearing that was held on 401(k) fees. You almost didn't need an announcement of who the people -- who the speakers were. You could kind of figure it out based on their positions. I think the same was true today in a large -- to a large degree.

And I say that only for you all to take a real close look at all the presentations that you've seen and put them in that context, recognize where the motivation people were coming from. I come down firmly beside -- by the way, don't have a computer model, don't represent a computer model. I absolutely believe that it is feasible that a computer model can be built. I believe there are feasible computer models that are already built that indeed, service IRA participants.

It's somewhat interesting that some of the folks who believe that they -- that it cannot be done, actually encourage their representatives, some strongly, in a few cases actually require their representatives to use their own computer model to actually provide investment advice to those IRA account holders and they do so out of the notion or the believe that it will provide them a degree of legal liability relief should they end up in an unfortunate arbitrary -- or arbitration case.

So that's part and parcel to why I believe it. Now, how do I get there? We've said this over and over. Taking into consideration the full range of investments, how do we define that? It is interesting that it doesn't say every investment option but neither did it say a reasonable number of investments. So I kind of fall in the category that says that leaves a certain degree of wiggle room for the Department to consider but I also recognize that it's not without risks, perhaps political is the right word, because with a required degree of leadership and courage, not personal leadership or courage but Departmental, institutional leadership and courage to kind of take the step that this is feasible and here's how we're going to do it.

I actually believe the devil will be in the details, and by that I mean, how are we going to certify or qualify an investment expert? And I've spent the better part of my 28-year career, 26 years of it, dedicated to the retirement industry but also always involved on the investment side and struggling to manage these two very different disciplines in the context of retirement planning. It's -- it is, I recognize very, very challenging. Nevertheless, I think it's done. It's done regularly and it all boils down to ultimately how you're going to define the regulation. Your biggest concern, I think will be how do you certify these things and who's an expert.

I've said this over and over again, there's no such thing as an investment expert. There's no such thing as a retirement expert, only diminishing levels of ignorance. And I guess if you're less ignorant than the person you're talking to, then you can argue that you're adding value. I do want to mention how I eventually came to be here. I know I was in discussions with several people at the Department of Labor and actually began in conversations that I had with some of the staff with Representative Miller and it's my theorization or hypothesis that the retirement market, most notably 401(k)s but I believe it still applies to other individual account plans, specifically IRAs, are in a least a certain degree of true blown market failure and I mean market failure in the true industrial organizational macro-economic theory of market failure.

Not to remind you of your freshman Economics 101 course, but there are serious structural problems to the marketplace and it is occurring specifically at the participant level and I actually don't care whether you're talking about an IRA or a 401(k). You can have literally identical investors, literally identical retirement savers, who save the exact amount, even invest using the exact same percentages over the exact same investment managers and end up with stunningly different numbers come retirement; one ultimately retires in safety security and the other one can't retire at all.

How can that be? And I believe there are a host of reasons, over-regulation, under-regulation, poorly written regulation. Yes, our industry does have its share of less than scrupulous providers, but I think in the end it all boils down to asymmetry of information. It's a very complex marketplace, very complex topic. When we try to simplify it in a way to explain it to those providers or participants or plan sponsors, if it's an employer based plan, it becomes very, very difficult and the degree of ignorance, pardon my expression there, but the degree of ignorance is all over the lot.

I could go on and on with regard to that notion of what I sometimes refer to as the black market of IRA accounts, the black market of 401(k) accounts, but I do believe to a degree it does exist. And it is -- while it seems far afield from this issue of, well, can I have a computer model or not, will a computer model work or not, I believe that in the end these computers models and part of the challenge that you're receiving so much differing feedback is that virtually all the models are founded on modern portfolio theory as originally theorized by Dr. Markowitz and then others later on with what's often referred to as post-MPT, which defines risk slightly differently and differentiates between good risk and bad risk, and the finally, I believe you saw financial engines in Bill Sharp's group focused on adding to MPT optimization, portfolio optimization, the notion of Monte Carlo analysis, which is really just probabilistic planning in my opinion, applied.

Of all of the models that I've seen, the probabilistic planners are probably the most useful but not for the reasons you may think. They're useful because they're educative to the participant. Wait, if I put 100 percent of my money in the most risk -- or the risk-free investment, I actually take more risk? And that's what those models can show, and for that reason they can become I believe somewhat valuable, but it's not for what many IRA participants really think it is and that is, "Well, if I do this, I'll make more money", and I believe absolutely, that's false. At least I'll make more money over and above or after I pay the fees associated with utilizing that particular service. And I believe that that's probably false.

As a consequence, and this comes back to my notion on market failure, I really believe there are only two standards and principals that ought to be applied. One is diversification, the very standard laid out in ERISA itself but one that I think is the single most valuable and important aspect, are you properly diversified, I'll expand on that in a minute, and then question number two is, what are the expenses, how much am I paying?

Now, there are a number of assumptions in stating that those are the two most important criteria and I don't nearly have the time to go into that, but I'll try to briefly explain what I mean. I envision a model where you first start with tiers and if we were talking about an employer-based plan, a 401(k) plan, well, there you have typically a set of core vehicles. Will they fit tier one? Tier one says there's a cash or cash equivalent. There's a domestic fixed income and there's a domestic equity vehicle. Does that exist in the plan?

If it does, it's a tier one plan. But what if it goes a step further, that there's an international equity component? Well, then it's a tier two plan, et cetera. And then you continue to slice and dice until you've expanded into a wide range of different asset categories. Now, a number of them we throw out as was stated earlier. I don't care if Malaysian Mortgage Back Riser available in a foreign currency are part of the option. This is an IRA account. Remember who we're talking about. I really don't care about the one percent of IRAs that are more than $200,000.00.

Guess what? They're not the problem. They're not the users of a program like this. It's everybody else, it's the other 99 percent. And as such, I'm very comfortable with the notion that the Department takes a stand and says, "We don't care about a lot of the alternative investments or esoteric aspects, that a model can still be certified without that". So again, I recognize that my comments here today do make certain assumptions that you will have to make for them, in fact, to be adopted or true even, but nevertheless, that's where I'm coming from and one of the reasons why I think it can absolutely work.

So with that, everything has been repeated many, many times so I'm going to go ahead and stop. Any questions, comments?

MR. PIACENTINI: Well, of the witnesses, I think you used the most language of economics and I'm the economist on the panel, so I'll ask a couple of questions.

MR. UNGER: Oh-oh.

MR. PIACENTINI: You talked about market failure and then gave an example saying that people who were identical go to the same place, save at the same rate can have different outcomes. What's behind that? Are they investing differently?

MR. UNGER: No, they'll invest identically, literally the same fund, but --

MR. PIACENTINI: Elaborate.

MR. UNGER: -- one example of market failure is that on one plan you were able to get that money manager in their institutional class of share, charges 67 basis points, okay, not bad. And the other plan, guess what, they're getting the most expensive class of share which is 200 basis points.

MR. STRASFELD: And a six percent

load.

MR. UNGER: And a six percent load. I'm not done though. Guess what else is happening? RAP feels are coming into the industry. Who does it apply to? Sometimes it's the TPA. What's also occurring here? We've forgotten about what vehicles are available. Well, now we're talking about the gamesmanship that occurs in getting your fund, if you're an asset manager, onto a particular platform. How much money are you going to pay as a sub-TA or what's called revenue reduction, in any other industry, by the way, called a kickback.

And we're still not done. We've got different service standards. If you look at many of the bundled providers and I'm picking on 401(k) and I think they're less applicable to IRAs, so I'm starting to get far afield, reel me back in when you want me to stop, but here you've got standards where many platforms are SAS-70 compliant and actually meet the Gramm-Leach-Bliley Act requirements for a security and other platforms aren't SAS-70 and don't meet

Gramm-Leach-Bliley. In fact, that participant's data is not secure regardless of whether they're actually posting a privacy statement or not.

Guess which one is cheaper to run? Guess which one offers greater profitability?

MR. PIACENTINI: So all of those differences is really coming down to fees and expenses of one type or another.

MR. UNGER: And in the end, when you look at any of these funds, and you can go back to Professor Rubin's study out of PACE, or any one of a number of other studies, I would guess that they're probably longer than your arm, there's a sound argument to be made that passive investing, passive index investing has a tendency to outperform active management over extended periods of time. There's no doubt that active managers come into vogue and out of vogue based on their philosophies and perspectives on the overall economics of the current economy and as a result, outperform, but now I'm getting onto a slippery slope probably ticking off what I would have hoped would have been a lot of my potential customers, but the reality is exchange traded funds are out there. It is the white elephant in this room that we're not talking about.

If you adopt this notion that, yes, large cap for the S&P 500 index is going to outperform upwards of 70 or 75 percent of any other large cap core say mutual funds or any manager for that fact, managing in that universe or swimming in that pool of stocks, gets wet. You know, you have trouble not investing in an index fund.

Now, the problem there is traditionally, your priority ETFs, you couldn't get a number of -- you couldn't get a small cap value index fund, mutual fund. Well, now ETFs are here and you can. You can't get it yet in 401(k) plans in a way that answers or provides their principal value which is by definition style adherence which in my opinion is probably actually maybe the only thing more important than fees, but you know, now that you can make diversification occur in an IRA, if you actually do this, use discount brokerage, take a $10,000.00 IRA, even that small, it's amazing. You can go to a discount brokerage house, open up your IRA with $10,000.00, trade it in ETFs at 20 bucks a shot, take into account the underlying expense ratio of those and then compare it to the alternatives, and you've got real issues, as a financial services firm and institution.

Now, I would argue to those -- and I have, to those clients, those financial services institutions, "Don't run away from this, embrace it. Your value add is not the ability to pick on stock over the other. Your value add is the ability to show proper asset allocation given the risk tolerances of the individual, and ultimately to provide service, hand-holding, when the client gets scared because we just had a real shake-out, you're there to prevent them from making changes that they otherwise would for emotional reasons.

So, I've more than answered your

question. I apologize.

MR. PIACENTINI: No, that's helpful.

MR. STRASFELD: Thank you very much. As -- for the few of you who are left, I indicated at the beginning that we'll hold the record open for 30 days, if you have anything witty that you feel you want to augment your testimony already with and were are we sending it, to you? Yes, the information can be forwarded to Chris Motta, either by e-mail or mail or however you want to do it.

Thank you very much for making it through the day.

(Whereupon, at 2:51 p.m. the above-entitled matter concluded.)