RAMIFICATIONS OF THE CURRENT ECONOMIC AND MARKET TURMOIL ON ASSET ALLOCATION: IS IT NOW TIME FOR MANAGED ACCOUNTS?

fi360 NATIONAL CONFERENCE

May 2009

by: Marcia S. Wagner, Esq.
The Wagner Law Group
A Professional Corporation
99 Summer Street, 13th Floor
Boston, MA 02110
Tel: (617) 357-5200
Fax: (617) 357-5250
www.erisa-lawyers.com

TABLE OF CONTENTS

Page

I. INTRODUCTION **1**

II. ERISA SECTION 404(C) REGULATIONS **1**

A. Statute 1

B. Regulations 2

C. Disclosing Information Inadequate 2

III. INVESTMENT EDUCATION **3**

A. Interpretive Bulletin 96-1 3

1. Plan Information *3*

2. General Financial and Investment Information *3*

3. Asset Allocation Models *4*

4. Interactive Investment Materials *4*

B. Legal Risks 4

1. Selection and Monitoring *5*

2. Conflicted Investment Education *5*

3. Investment Education Becomes Investment Advice *5*

III. INVESTMENT ADVICE V. MANAGED ACCOUNTS **6**

A. Plan Participants 7

B. Plan Sponsors 7

1. Business Rationale *7*

2. Minimizes Fiduciary Risk *8*

3. Monitoring Effectiveness *8*

C. Financial Institutions 8

D. Public Policy 9

E. Managed Accounts as QDIAs 10

IV. FUND OF FUNDS V. MANAGED ACCOUNTS **10**

A. Self dealing Issues 10

B. Quality of Process 11

C. Quality of Algorithms 11

D. Disclosure Issues 12

E. Target-Date Funds 12

D. Disclosure Issues.....12
V. CONCLUSION.....12

THE WAGNER LAW GROUP
A PROFESSIONAL CORPORATION

RAMIFICATIONS OF THE CURRENT ECONOMIC AND MARKET TURMOIL ON ASSET ALLOCATION: IS IT NOW TIME FOR MANAGED ACCOUNTS?

I. Introduction

The plunging stock market, severe market volatility, and utter devastation of many plan participants' account balances argue forcibly that it is no longer prudent, if ever it was, to leave the vast majority of plan participants to invest their own account balances with or without investment education or advice. From the point of view of minimizing legal risk, I will argue today that managed accounts are the preferable solution to the asset allocation problem over investment advice, default investment funds, and target-date funds.

In the early 1990's investment education was touted as the solution to plan participants' poor asset allocation decisions. When investment education failed, the Pension Protection Act of 2006 ("PPA") was enacted with provisions to facilitate investment advice and default investment funds, including target-date funds, as solutions to the asset allocation problem. These PPA provisions will also fail, although perhaps not as badly as investment education.

For reasons I will explain today, I believe managed accounts will ultimately prevail as the solution in a "back to the future" development that will bring professional investment management to defined contribution plans that currently exist for defined benefit plans and that used to exist for defined contribution plans before self-directed plans became so popular. The critical difference is that professional investment management will apply separately to each account rather than to the defined contribution plan as a whole.

II. ERISA Section 404(c) Regulations

A. Statute. The argument begins with ERISA Section 404(c). It states that plan sponsors are not liable for any losses caused by a plan participant's own investment decision if the plan complies with certain plan design and disclosure requirements specified in U.S. Department of Labor ("DOL") regulations. This relief from liability is one of the principal reasons that plan sponsors:

- design their 401(k) and other defined contribution plans to allow participants to direct the investment of their accounts;
- comply with DOL's ERISA Section 404(c) regulations.

Last month, the U.S. Court of Appeals for the 7th Circuit in *Hecker v. Deere & Co.* significantly expanded upon a plan sponsor's ERISA Section 404(c) protection in two ways. First, the 7th Circuit ruled that *Deere* complied with ERISA section 404(c) simply by making available a brokerage window as an investment alternative under its plan.[1] Second, the 7th Circuit effectively ruled that ERISA Section 404(c) protected Deere from liability for allegedly selecting and maintaining unreasonably expensive funds.

[1] According to the 7th Circuit, the plan participants had "a reasonable opportunity to . . . control the risk of loss from fees" through the brokerage window.

The 7th Circuit's *Deere* decision will be valuable to other plan sponsors and their investment vendors defending against similar class actions alleging that the plan sponsors allowed the investment vendors to charge excessive fees to 401(k) plan participants. I believe, however, the *Deere* decision may be a Pyrrhic victory because it may provoke Congress—in pending 401(k) fee legislation—to overturn parts of the decision.

B. Regulations. In the interim, let's review the three key requirements in DOL's regulations published in 1992:[2]

- First, the plan must offer a broad range of investment alternatives, including at least three diversified "core" options with each of those having different risk and return characteristics.[3]
- Second, employees must be allowed to transfer among these options with a frequency commensurate with the investments' market volatility, but at least as often as quarterly in the case of the core options.[4]
- Third, employees must have access to sufficient information about each investment option so that they can make informed investment decisions.[5]

To meet the information disclosure requirement, these 1992 DOL regulations require plan sponsors to provide specific information, such as:

- for each investment option, its investment objectives and risk and return characteristics, including type and diversification of assets; and
- for mutual funds or other investment options registered with the SEC, a copy of the most recent prospectus or profile (i.e., a summary of key information contained in a mutual fund prospectus).

The Section 404(c) regulations specifically do not require the employer to provide investment advice.[6] They also do not require an employer to provide investment education, except to the extent that the regulations require the disclosure of the information on DOL's laundry list.

C. Disclosing Information Inadequate. Many employers were concerned that simply disclosing the information on DOL's laundry list was inadequate. These employers wanted their plan participants to understand investment principles that they could apply to their own financial situation, including their accounts under the employer's participant-directed defined contribution plan. By intelligently applying these investment principles, plan participants could make asset allocation decisions that would increase the rate of return

[2] 29 CFR 2550.404c-1 published at 57 *Federal Register* 46932 (10/13/1992).
[3] 29 CFR 2550.404c-1(b)(1)(ii).
[4] 29 CFR 2550.404c-1(b)(2)(i)(A).
[5] 29 CFR 2550.404c-1(b)(2)(i)(B).
[6] 29 CFR 2550.404c-1(c)(4).

consistent with their tolerance for risk. Earning higher rates of return would enhance the ability of plan participants to accumulate more adequate retirement income.

The issue for these employers was whether they could educate plan participants about investment principles without providing investment advice. By not providing investment advice, these employer could still take advantage of the liability relief under ERISA Section 404(c) and not assume fiduciary responsibility for providing investment advice. In 1996, the DOL published guidance[7] to explain how employers could provide investment education without providing investment advice.

III. Investment Education

A. Interpretive Bulletin 96-1. The Interpretive Bulletin describes four categories of information and materials that constitute investment education, not "investment advice" under the definition of "fiduciary" in ERISA.[8] The goal of investment education is to provide plan participants with the investment principles and other tools they need to make their own decisions regarding asset allocation or other investment issues. Investment education does not recommend an asset allocation to plan participants based on the participant's financial situation, such as age, time horizon, risk tolerance, investment preferences, current investments under the plan, and other assets or sources of income.

1. Plan Information. This category included the information required to be disclosed under ERISA Section 404(c). It can also explain the advantages of participating in the plan and suggest that:

   (a) Employees should consider becoming plan participants as soon as they are eligible;
   (b) Plan participants should consider making the maximum contribution possible to the plan; and
   (c) If plan participants change employment, they should consider (a) refraining from receiving taxable distributions from the plan, and (b) making tax-free rollovers into another employer-sponsored retirement plan or an individual retirement account ("IRA").

2. General Financial and Investment Information. The category describes general financial and investment concepts such as:

   (a) Risk and return, diversification, dollar cost averaging, impact of compound returns, and tax deferred investing;
   (b) Information describing historical differences in rates of return of different asset classes;

[7] 29 CFR 2509.96-1 published at 61 *Federal Register* 29588 (6/11/1996).
[8] ERISA Section 3(21)(A)(ii) and the corresponding regulation at 29 CFR 2510.3-21(c)(1).

(c) Information describing the effects of inflation on investment planning;

(d) Access to and assistance in using tools to estimate future retirement income needs;

(e) Information and assistance in using tools designed to assist Participants and beneficiaries in understanding the impact of differing investment time horizons; and

(f) Information about and assistance in the use of tools to assess personal risk tolerance.

3. Asset Allocation Models. This category includes information and materials (e.g., pie charts, graphs, case studies, etc.) illustrating asset allocation models, including target-date funds, for hypothetical individuals with different time horizons and risk profiles.

4. Interactive Investment Materials. The category includes questionnaires, worksheets, computer software, web-based calculators and similar materials to enable plan participants to estimate future retirement income needs and to assess the impact of different asset allocations on retirement income estimates.

Providing these four categories of information and materials to plan participants would **not** constitute "investment advice" - irrespective of who provides the information (e.g., plan sponsor, fiduciary or service provider), the form in which the information or material is provided (e.g., on an individual or group basis, in writing or orally, via video or computer software), or whether an identified category is furnished alone or in combination with other identified categories.

The asset allocation models and interactive material categories come close to providing investment advice but not close enough. Those categories cannot provide individualized recommendations to a plan participant regarding how the plan participant should allocate the assets in participant's account among the investment alternatives available under the plan based on the particularized needs of the participant. For example, if the asset allocation model matches a generic asset class with any specific investment alternative available under the plan, the asset allocation model must also match the generic asset class with all other investment alternatives with similar risk and return characteristics.

B. Legal Risks. As I mentioned earlier, investment education has not been working from a practical point of view.[9] However, most plan sponsors are unaware of the legal risks with investment education. I'll will briefly review those legal risks now.

[9] Arleen Jacobius, "401(k) Education Fails as Participants Time Market," *Pensions & Investments*, March 17, 2003, page 3. ("Statistics may vary on how much 401(k) plan participants have invested in the stock market, but one thing is certain: Investment education doesn't seem to be working. Although employers try to educate their employees to avoid market timing and to invest for the long term, research shows participants' equity exposure increases when the market is up, and decreases when the market is down.")

1. Selection and Monitoring. The plan sponsor must act prudently in selecting and monitoring the investment educator.[10] For most plan sponsors, monitoring the effectiveness of investment education rendered is no less difficult than monitoring investment advice or managed accounts.

2. Conflicted Investment Education. An investment educator is not a fiduciary subject to ERISA's conflict-of-interest rules. Although possible, it is also unlikely that an investment educator would be subject to state laws barring conflicts of interest.[11] Thus, an investment educator would not violate ERISA and state law in providing conflicted investment education. Thus, an investment educator, such as a mutual fund distributor, could skew the "education" to lead plan participants to select funds that could result in higher compensation for investment educator without violating ERISA or, in most cases, state law. However, the plan sponsor responsible for selecting and monitoring the investment educator would be at risk for the damages caused by investment educator's conflicted education.

No plan sponsor will want to monitor the laws of various states. However, if the investment educator is held liable under state law for providing conflicted investment education, the state-law holding will be strong evidence in a federal court that a plan sponsor breached its fiduciary duty in selecting and monitoring a conflicted investment educator. Even if state law does not prohibit conflicted investment education, the plan sponsor may still be liable for the imprudent selection or monitoring of the investment educator. The absence of a state-law violation would not prevent a federal court from a plan sponsor liable under ERISA.

3. Investment Education Becomes Investment Advice. A plan sponsor would have to monitor the investment educator to prevent it from slipping over the line to become an investment advice fiduciary. If the "education" turns out to be "investment advice," and the investment advice fiduciary provides conflicted investment advice, the investment advice fiduciary will violate ERISA's conflict of interest rules. The plan sponsor will have direct liability again for imprudently selecting and monitoring a conflict investment adviser. In addition, the plan sponsor may also have indirect liability under ERISA's co-fiduciary responsibility provisions.[12] For example, the plan sponsor would be liable under the co-fiduciary responsibility rules if it fails to take reasonable

[10] 29 CFR 2509.96-1(e).

[11] ERISA Section generally preempts all state laws, except for those which relate to banking, insurance, securities, and generally applicable criminal law. However, several courts have applied state laws to ERISA service-providers. See *Coyne v. Selman*, 98 F.3d 1457 (4th Cir. 1996), *Curtis v. Nevada Bonding,* 53 F.3d 1023, 1027 (9th Cir. 1995) and *Dukes v. U.S. Healthcare, Inc.*, 57 F.3d 350, 355 (3rd Cir. 1995), cert. denied 116 S.Ct. 564 (U.S. 1995). In contrast, most state laws would not be applicable to investment advice fiduciaries or managed account providers.

[12] ERISA Section 405(a) provides that a plan sponsor, acting in its capacity as fiduciary, is liable for an investment advice fiduciary's breach of fiduciary duty if (1) the plan sponsor participates knowingly in a breach, (2) the plan sponsor's imprudence enables the investment advice fiduciary to commit a breach, or (3) fails to take reasonable steps to remedy a known breach.

steps to remedy a known breach (e.g., providing conflicted investment advice) by the investment advice fiduciary.

The definition of investment advice fiduciary is broad enough to capture financial professionals who think that they are providing investment education, not investment advice. Under the DOL's regulations,[13] a person will be viewed as an investment advice fiduciary if he provides advice regarding the advisability of investing in securities (e.g., mutual fund shares) and renders the advice:

> "on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, . . . that such [advice] will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as . . . overall portfolio composition . . . ." (Emphasis added)

Relying on these DOL regulations, a federal district court[14] concluded that a securities broker was an investment advice fiduciary under ERISA, citing the following factors:

- the broker and his client (i.e., the plan trustee and president of the plan sponsor) met regularly over the course of a number of years to review the plan's investments;
- the broker was the trustee's only source of investment advice; and
- the trustee never failed to accept his recommendations.

These factors apply equally to a financial professional purportedly providing investment education to plan participants.

III. Investment Advice v. Managed Accounts

I have just explained why investment education is not only ineffective, it also exposes plan sponsors to legal risks for monitoring and selecting the investment educator, particularly those who provide conflicted investment education, whether or not its slips into investment advice. In short, I do not think providing investment education is necessarily safer in all circumstances than providing investment advice or managed accounts. I will now compare investment advice against managed accounts. The comparison will demonstrate that managed accounts are superior to investment advice from several points of view.

[13] 29 CFR 2510.3-21(c).
[14] *Ellis v. Rycenga Homes, Inc.,* 484 F.Supp.2d 694 (W.D. Mich. 2007).

A. Plan Participants. The majority of participants want a professional to manage their retirement accounts, especially after so many have seen their account balances devastated by the stock market decline.[15]

In general, participants want an easy, hassle-free way of having their money managed.[16] Receiving financial advice, though laudable, has not proven to be the panacea to participant inertia regarding asset allocation. Experts surmise that the reason is that too much is expected of participants in the typical investment advice product (e.g., significant amounts of financial information, implementing the advice, periodic rebalancing, periodic supervision).[17]

In sharp contrast, managed accounts, once certain financial information is received, are self-sustaining from the participant's perspective; little is thereafter required as managed accounts by their very design require the absolute minimum input from plan participants. The participants' accounts are professionally managed and periodically rebalanced in accordance with the modern portfolio theory and investment practices and procedures used by traditional defined benefit pension plans.

Simply put, managed accounts constitute an effective mechanism to get participants' inertia to benefit the participants themselves.

B. Plan Sponsors.

1. Business Rationale. Managed accounts support the underlying business rationale for plan sponsors adopting retirement plans: to wit, the attraction and retention of valued employees. To the extent that employees value the managed account approach to retirement savings, they will be more satisfied with their employers, likely increasing retention rates; similarly, attractive retirement programs serve to attract desirable employees.

---

[15] John D'Antona Jr., "A Future Full of Change," *Pensions & Investments*, Feb 9, 2009, page 12. ("The devastation defined contribution plans suffered in last year's market mayhem is expected to lead to major changes in plan design and asset allocation . . . . Bottom line: The focus on equities in an investment portfolio and the traditional equity and fixed-income split revealed a basic flaw in plan design.")

[16] Joanne Sammer, Matthew G Lamoreaux, "Managed Accounts," *Journal of Accountancy*, August 2007, page 32. ([H]istorically even when companies provide investment advice, a large number of employees do not implement the advisers' recommendations. As a result, employees continue to invest too conservatively or take on too much risk. Or they don't assess their investment strategy or rebalance portfolios over time.") Sheldon M Geller, "Participant-Level Money Management Account Option," *The CPA Journal*, November 2006, page 58. ("Although some 401(k) service providers offer asset-allocation guidance and education, many plan participants desire money-management investment advice and monitoring services for their retirement plan accounts.")

[17] Phyllis Feinberg, "401(k) Participants Sniff at Internet Advice Tools," *Pensions & Investments,* March 8, 2004, page 12. ("The Internet hasn't lived up to its promise to 401(k) plan sponsors looking to provide investment education and advice . . . . [O]nly 35% of plan participants actually use Internet advice tools, mainly because only a relatively small percentage of 401(k) plan participants have the financial knowledge to work their way through an Internet questionnaire.")

2. Minimizes Fiduciary Risk. A prime concern of plan sponsors is the desire to eliminate as much as possible any fiduciary liability they might face. Managed accounts are particularly effective in this regard. In implementing a managed account program, the employer must select and monitor the investment manager. ERISA Section 402 enables a named fiduciary to appoint an investment manager, who must on a timely basis acknowledge its fiduciary status. Thereafter, the named fiduciary, typically the employer, is only responsible for prudently retaining and monitoring the investment manager. This is routine for defined benefit plan sponsors. Most defined contribution plan sponsors would quickly learn the routine.

Even though ERISA Section 404(c) protection should not be needed if the plan sponsor complies with ERISA Section 402 for hiring and retaining investment managers, it may be available if the participant elects to have his money managed in a managed account. If the managed account is automatic (e.g., negative election), there is no Section 404(c) protection. However, it should not be needed because ERISA Section 402 should provide the same protection, limiting fiduciary responsibility to prudently selecting and monitoring the investment manager.

Finally, the employer's fiduciary exposure is significantly ameliorated by providing a high quality, effective program (measured by increased likelihood of reaching retirement income objectives) to plan participants.[18]

3. Monitoring Effectiveness. As noted above, the plan sponsor has a fiduciary obligation to monitor the effectiveness of its retirement programs. With respect to asset allocation, a managed account program will be 100% effective (i.e., asset allocation will be actively managed, including rebalanced). By contrast, once advice is provided, the plan participant still must implement the advice and periodically rebalance his portfolio. The extent to which each participant's actions are consistent with the advice or recommendations will be difficult and costly for the plan sponsor to monitor, and advice will, in any event, likely not achieve 100% effectiveness, because plan participant inertia would inhibit such result.

C. Financial Institutions. By implementing non-conflicted managed account programs, financial institutions will likely reap significant benefits for several reasons. There will be no need to pursue the difficult, expensive and time-consuming process of applying for a prohibited transaction exemption.[19] Moreover, once plan participants become accustomed to

---

[18] See February 19, 1998 DOL Information Letter to Diane Orantes Ceresi of the SEIU. In the letter, the DOL states that, if a plan sponsor determines to offer a product or service to a benefit plan, that decision is a fiduciary function and the quality of the offering must be taken into consideration.

[19] The DOL regulations, and related class exemption, implementing the statutory exemptions in the Pension Protection Act of 2006 provide limited relief from conflicts of interest. However, this relief does not apply to managed accounts. See 29 CFR 2550.2550.408g-1(d)(8)(any investment under the exemptions must occurs "solely at the direction" of the plan participant). See also preamble to regulation at 74 Federal Register 3833 (1/21/2009) ("With respect to a recommendation involving a different asset allocation structure, the Department believes that the

managed accounts, it is likely that they will want non-plan assets so managed, as well as rollovers from qualified plans. Thus, those financial institutions offering managed accounts should experience significantly increased rates of asset gathering and retention. Finally, the interests of the financial institutions and the plan sponsors are perfectly aligned under a managed account program. The managed account program is an uncontroversial way of providing participants with what they want and need, while reducing plan sponsor's fiduciary liability. This is in stark contrast to the provision of conflicted investment advice which, even if it does not rise to the level of a prohibited transaction, puts severe fiduciary pressure on the plan sponsor. In discussing conflicted investment advice, DOL explained to Congress[20] that:

> "This would shift responsibility from persons who are in the business of offering such products and services and are most knowledgeable about the market to persons who hire and monitor such persons, usually plan sponsors, who typically know far less. . . . This would also increase the responsibility of plan sponsors because they would now be dealing with persons who are subject to a less protective regulatory framework. The increased responsibility could discourage plan sponsors, who are sensitive to increased potential liability and regulatory burdens, from establishing and continuing to maintain employee benefit plans."

D. <u>Public Policy</u>. The effectiveness of the managed account concept, particularly if combined with managed savings, if widely implemented, will result in dramatically increased retirement income.[21] This can only be viewed positively given the gross inadequacy of the retirement approaches of most people, particularly baby-boomers, and the uncertainty regarding the funding of the Social Security system.

Managed accounts might also assist in ameliorating governmental budgetary issues as baby-boomers retire; by increasing rates of savings in tax-deferred retirement vehicles, managed accounts providers thereby increase the amount of money that will be distributed from such vehicles and therefore subjected to ordinary income tax. This expected phenomenon will increase governmental revenue just when the retirement of the baby-boomers will be challenging the solvency of the social security system.

---

participant or beneficiary must make an affirmative direction for its implementation.")

[20] Secretary of Labor Alexis M. Herman's July 19, 2000, letter to the Honorable William F. Goodling, Chairman of the Committee on Education and the Workforce of the U.S. House of Representatives, strongly opposing H.R. 4747, the Retirement Security Advice Act of 2000, H.R. 4749, the ERISA Modernization Act, and H.R. 4748, the Comprehensive ERISA Modernization Act of 2000, which substantially included the provisions of both H.R. 4747 and H.R. 4749.

[21] M Barton Waring, Laurence B Siegel, "Wake Up and Smell the Coffee! DC Plans Aren't Working: Here's How to Fix Them," *Journal of Investing*, Winter 2007, page 81. ("DC plans are not working, if they're meant to provide security in retirement for the workers that contribute to them. . . . They were originally designed to supplement DB plans, not to replace them. DC plans are not now doing the job even remotely adequately.")

E. Managed Accounts as QDIAs. The DOL has recognized the value of managed accounts for plan participants by including them as one of the three classes of qualified default investment alternatives (QDIAs). The other two classes are target-date funds (a.k.a. life-cycle funds) and balanced funds. With target-date funds, a plan participant would be placed in a particular fund based on his or her age (or length of time to retirement) along with similar situated plan participants.[22] The balance fund approach is essentially the way that defined contribution plans were invested before participant-directed funds became popular.[23]

Each class of QDIAs includes a glide path that changes the equity/fixed income asset mix to become more conservative by investing less in equity and more in fixed income over time. However, managed accounts are more effective in implementing an appropriate glide path for a plan participant because the glide path is individualized based on the participant's time horizon, risk tolerance, and financial situation. Although the glide path for a target-date fund is based on age of the plan participant, it does not take into account the participant's tolerance for risk or financial situation. The glide path for a balance fund is based solely on the average age of the plan population.

IV. Fund of Funds v. Managed Accounts.

Fund of funds raise fiduciary issues that are not present with respect to managed accounts. The two most common examples of the use of fund of funds are life cycle funds and target-date funds. These are a combination of mutual funds contained within another mutual fund in which participants are advised to invest depending primarily on their life stage (i.e., age). Such funds may be provided on a managed or discretionary basis, or in the alternative, advice may be rendered in connection with such funds.

A. Self dealing Issues. If the financial service provider, which is affiliated with the fund of funds mutual fund family, creates the algorithm for asset allocation applicable to individual plan participants, then the issue of self dealing arises, as the financial service provider may have an incentive to skew the advice to those funds where the group's profits, fees or margins are the greatest. Although this conflict of interest does not give rise to a prohibited transaction because mutual funds themselves are not plan assets,[24] this puts pressure and

---

[22] The number of target-date funds within the QDIA would depend how the participants are grouped by age (or length of time to retirement). Thus, a QDIA that groups participants in five-year bands would require more target-date funds than a QDIA that groups participants in ten-year bands.

[23] A QDIA balanced fund would operate similar to a target-date fund except the QDIA would have only one fund. The investment manager would change the equity/fixed income mix as the population in the fund as a whole becomes older.

[24] Mutual fund shares purchased with plan assets constitute plan assets. Therefore, the fiduciary rules, including the prohibited transaction rules, are applicable to transactions involving the purchase of mutual fund shares. However, the underlying assets of the mutual funds do not constitute plan assets. Thus, transactions that occur within the mutual fund, which would otherwise constitute prohibited self dealing, do not constitute prohibited transactions, absent a plan or arrangement to circumvent ERISA's protections. Support for this point may be found in the legislative history of ERISA which states:

significant fiduciary responsibility for monitoring[25] on the plan sponsor for hiring someone who could have an incentive to render conflicted advice or management.

By contrast, the managed account programs have no self dealing element, and thus, no heightened fiduciary responsibility for the plan sponsor.

B. Quality of Process. Since asset allocation is so critical to returns, the advice rendered should be as particularized to the individual as possible. Managed accounts are clearly tailored to most salient aspects of the participant's circumstances (e.g., age, risk tolerance, retirement goals, savings rate, assets/liabilities outside of the plan), whereas advisers for funds of funds generally place most if not all emphasis on one factor: age. Hence, arguably, the fund of funds alternative is a lesser quality choice than managed funds. In accordance with the Department's information letter on quality discussed above, the plan sponsor, as fiduciary, should document and explain why it would choose a service of lesser quality or effectiveness. All other things being equal, this documentation element clearly places a high burden on a plan sponsor who chooses a fund of funds option over a managed account program.

C. Quality of Algorithms. Managed account providers seeking to comply with the SunAmerica Advisory Opinion,[26] or the PPA statutory exemption[27] based on it, must hire independent investment experts to create the algorithms or "black box" for asset allocation purposes. However, investment advisers for funds of funds cannot fall within the ambit of the SunAmerica Advisory Opinion and, therefore, usually do not hire such independent investment experts. This places heightened burdens on the plan sponsors. The financial service providers for funds of funds who create the algorithms would not be liable as ERISA fiduciaries for the appropriateness of the algorithms and would not be subject to the prohibited transaction protections. This could result in skewing of algorithms, in a manner which would be prohibited by ERISA, but with no ERISA cause of action against the investment adviser for the mutual fund.[28] However, the plan sponsor could be liable under ERISA for investing, or allowing plan participants to invest in, mutual funds whose asset allocation is based on potentially conflicted advice. The plan sponsor's exposure would be increased since the conflict is not regulated under ERISA.

> "Since [ERISA] prohibits both direct and indirect transactions, it is expected that where a mutual fund, e.g., acquires property from a party-in-interest as part of the arrangement under which the plan invests or retains its investment in the mutual fund, this is to be a prohibited transaction." (3 U.S. Cong. & Adm. News 1974, p. 5089).

[25] In a March 15, 1998, letter from Deputy Assistant Secretary of the Labor Ann L. Combs to Secretary of the SEC Jonathon Katz, the DOL opined that if plan sponsors invested in certain mutual funds being registered with SEC by College Retirement Equities Fund ("CREF"), they could not fulfill their ongoing fiduciary responsibilities to effectively monitor plan investments. The legal proposition the "Combs Letter" stands for is that plan sponsors have significant ERISA liability with respect to the decision to invest in financial products if critical protections are lacking.

[26] Advisory Opinion 2001-09A (December 14, 2001).

[27] PPA Section 601 adding ERISA Sections 408(b)(1) and 408(g).

[28] There could be applicable state law causes of action.

D. Disclosure Issues. As a general fiduciary principle, plan sponsors should disclose to participants issues that participants should take into consideration regarding investment advice. Thus, for example, if the investment adviser with respect to a fund of funds does not take into account individual circumstances that could be relevant to appropriate asset allocation for that individual, such as outside savings or any circumstance which is particular to the individual unusual for the fund of funds target group, the plan sponsor may have a duty to disclose this information. Again, funds of funds place a burden on plan sponsors that managed accounts simply do not.

E. Target-Date Funds. Because of the growing importance of target-date funds,[29] I would now like to broaden the discussion of target-date funds, to include those not structured as funds of funds. As I noted earlier, target-date funds like the other QDIAs must have a glide path to reduce plan participants' equity exposure as they grow older. However, participants in target-date funds have recently suffered significant losses, including participants with a 2010 target retirement date. The following table illustrates the magnitude of the losses:

2010 Target-Date Funds[30]

	2008 Equity Allocation	2008 Loss	Jan 31, 2009 Equity Allocation
T. Rowe Price	63%	-27.7%	58%
Fidelity	50%	-26.6%	41%
Vanguard	52%	-20.7%	54%

One of the questions that I would like to ask my fellow panelists is whether participants with a 2010 target retirement date would have suffered from this much volatility if they were in a managed account.

V. Conclusion.

To summarize, we know that ERISA Section 404(c) encourages employers to design participant-directed defined contribution plans.

We also learned that the DOL has effectively acknowledged that the investment information disclosures required by its 1992 ERISA Section 404(c) regulations are inadequate.

In 1994, the DOL acknowledged its ERISA Section 404(c) regulations were ineffective when it published Interpretive Bulletin 96-1 to distinguish between investment education and

[29] Target-date funds grew from $2 billion in assets in 1007 to $18 million in 2007, according to Vanguard Center for Retirement Research, "Target-Date Funds: Plan and Participant Adoption in 2007," November 24, 2008. The report is posted at https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article?File=RetResPPA.

[30] The source for the table is Target Date Analytics Inc. LLC using Morningstar Data as reported at John D'Antona Jr., "A Future Full of Change," *Pensions & Investments*, Feb 9, 2009, page 12.

investment advice. However, I then argued that investment education is not only ineffective but exposes plan sponsors to legal risks for monitoring and selecting the investment educator. These legal risks are greater than those associated with investment advice or managed accounts.

Finally, I presented a series of comparisons to demonstrate that managed accounts are superior to investment advice and the alternative QDIAs. In conclusion, I think managed accounts are the solution to asset allocation problem.