Managed Accounts: Still the Best, Least Risky Solution Yet Developed

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After reading Mr. Matta's critique (the "Critique") of the article, "Managed Accounts: Are They the Answer?" (the "Article"), I am more convinced than ever that the points made in the Article are valid. The following attempts to eliminate any confusion occasioned by the Critique.

PTE 77-4: Interpretation of Class Exemptions

The Article notes that certain practitioners take the position that exemptions should be interpreted as statutes. However, the Article states that such position does not appear to take into account the express terms of Section 408(a) of ERISA.

As stated in the Article, Section 408(a) requires express findings with respect to and therefore contemplation of the specific transactions in question. This is necessary for the Department of Labor (the "Department") to arrive at appropriate conditions that address the potential for overreaching. The Department's sensitivity in this regard is illustrated by its discussion of one of the comments in the preamble to PTE 77-4. There, the Department stated that it would not provide relief for an investment adviser charging the higher of the investment advisory fee or the fee paid for management of the investment company. The suggestion was not accepted because it would have involved a "potential for abuse involving economic gain for the fiduciary which could not be easily monitored."

Consider this is the context of comprehensive asset allocation, using similar methodologies to those used in the context of defined benefit plans. Such allocation necessarily involves a number of calculations and assumptions any one of which can be modified slightly to provide substantial changes in allocation and correspondingly higher fees and profits to an investment manager. Given the subtlety of the potential abuse, the importance of asset allocation, and the fact that the enabling software was not available in 1977[1] or in 1984 (Class Exemption 84-24), it seems clear that no relief was intended at those times with respect to the ability to develop or modify the formulae upon which asset allocation is based.[2]

We also know how the Department did address these potential abuses when it specifically considered them in applications for exemptions. In such cases, the Department conditioned relief on flattening the fee structure (except with respect to money market-type vehicles), or where variable fees were charged, on the use of independently developed algorithms. Therefore,

[1] Although it is not necessary to the conclusion that it is unclear whether relief for investment advice relating to asset allocation is provided by PTE 77-4, I note that by its terms, PTE 77-4 does not address investment advice under ERISA, but addresses investment advisors under the Investment Company Act of 1940.

[2] Also, even if one takes the position that class exemptions are to be read as statutes, then later issued class exemptions or Departmental interpretations of such exemptions cannot be taken into account in interpreting previously issued class exemptions under the well-established principle that the intent of later Congress' cannot be used to interpret laws earlier enacted.

despite the Critique's arguments, there is a substantial risk on relying on either PTE 77-4 or PTE 84-24 to provide relief for comprehensive asset allocation.

Relative Safety of the SunAmerica Approach

The Critique attempts to reason that alternative approaches under which persons with conflicts of interest are retained to provide asset allocation services, present similar risks to the SunAmerica approach. For the following reasons, there is not even a reasonable argument that supports such position.

The Critique states that the Investment Company Act provides similar protections as ERISA. On this basis, it reasons that investments in a life cycle fund where the mutual fund adviser receives variable fees and profits depending upon its own asset allocation would not entail significant risk to a plan sponsor who reviews only the fees charged by the mutual fund. Under ERISA, it is clearly prohibited for a fiduciary to allocate assets between different investment vehicles that contain plan assets, if the vehicles pay the same fiduciary variable fees and profits. To the extent that applicable law (e.g., the Investment Company Act of 1940) permits a mutual fund adviser to do this, the regulatory schemes of such laws and ERISA are very different in this regard. It has been argued that mutual fund advisers would never abuse their shareholders by inappropriately skewing asset allocations. However, given the recent reports of abuses by mutual fund advisers that are easily detected and difficult to defend, it would not be rational to assume that at least some would not engage in skewing asset allocations since such skewing is much harder to detect and much easier to defend. Any plan sponsor that bases an investment in a life cycle fund, even in part on such an assumption, depending on the facts and circumstances, could be at material risk, unless additional protections are employed, such as those discussed in the Article.

The Critique posits there is a risk to a financial service provider, such as SunAmerica, that the independent financial expert it hires could furnish imprudent algorithms. Prudence under ERISA is largely determined by the process which is utilized. Independent financial experts are chosen by financial service providers who, in this connection, can and do review the basis for the financial experts' asset allocation on an initial and ongoing basis. The relative prudence of this process, compared with that suggested in the Critique of a financial service provider with a conflict of interest formulating the basis for asset allocation, should be obvious.

Conclusion

As posited in the Article, I believe that the approach enunciated in the SunAmerica opinion letter is currently the best, least risky from the plan sponsor's perspective for the hardest to reach participants – i.e., those that want to minimize their involvement. To the extent such persons exist in virtually every plan, then the SunAmerica approach is a "one size fits all" approach for all plans – not necessarily for all individuals in such plans, but for individuals in plans that want unbiased professionals to make asset allocation decisions for them. Announcements by Fidelity, Merrill Lynch and Wachovia, among others, that they will provide

managed account asset allocation services in accordance with the SunAmerica model underscore the attractiveness and significance of this model.[3]

[3] The author does not represent any of these institutions or any financial institution currently considering implementing a managed account program.