IS IT NOW TIME FOR MANAGED ACCOUNTS?

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§1.01 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 in 401(k) or other defined contribution retirement plans to invest their own account balances with or without investment education or advice. From the point of view of minimizing legal risk, this article will argue[1] that managed accounts are the preferable solution to the asset allocation problem over investment education or advice, or default investment funds, such as balance funds and target-date funds.[2]

In the early 1990's investment education was touted as the solution to plan participants' poor asset allocation decisions.[3] When investment education failed, the Pension Protection Act of 2006 ("PPA") was enacted[4] 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 the reasons this article explains, 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 participant-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.[5]

§1.02 ERISA Section 404(c) Regulations

[1] 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.

[1] Taking into account developments since 2003, particularly the Pension Protection Act of 2006, this article is an updated and enhanced version of the argument first published at Wagner, Marcia S., "Managed Accounts: Are they the Answer?," *Tax Management Compensation Planning Journal*, August 2003.

[2] Managed accounts also can be default investment funds. See 29 C.F.R. § 2550.404c-5(e)(4)(iii).

[3] As in the next section, ERISA § 404(c), 26 U.S.C. § 1104(c), allows a plan sponsor to shift the fiduciary liability for the most important investment decision (i.e., asset allocation) to the plan participants.

[4] H.R. 4, 109th Cong., 2nd Sess., P.L. 109-280, Aug. 17, 2006, 120 Stat. 780.

[5] Before self-directed plans became popular, trustee-directed plans commonly used balanced funds for the plan as a whole. These trustee-directed balanced funds also can be default investment funds. See 29 C.F.R. § 2550.404c-5(e)(4)(ii).

The U.S. Court of Appeals for the Seventh Circuit in *Hecker v. Deere & Co.*[6] significantly expanded upon a plan sponsor's ERISA Section 404(c) protection in two ways. First, the Seventh Circuit ruled that *Deere* complied with ERISA Section 404(c) simply by making available a brokerage window as an investment alternative under its plan.[7] Second, the Seventh Circuit effectively ruled that ERISA Section 404(c) protected Deere from liability for allegedly selecting and maintaining unreasonably expensive funds. The Seventh Circuit also ruled that ERISA did not require Deere to disclose the revenue sharing arrangement among the service providers for its plan.

The Seventh 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. 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.[8]

[2] Regulations. DOL's ERISA Section 404(c) regulations published in 1992 contained three key requirements:[9]

- 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.[10]
- 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.[11]
- Third, employees must have access to sufficient information about each investment option so that they can make informed investment decisions.[12]

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).

[6] *Hecker v. Deere & Co*., 556 F.3d 575 (7th Cir. 2009)
[7] According to the 7th Circuit, the plan participants had "a reasonable opportunity to . . . control the risk of loss from fees" through the brokerage window.
[8] See H.R.1984, 401(k) Fair Disclosure for Retirement Security Act, as introduced by House Education and Labor Committee Chairman George Miller in the 111th Cong., 1st Sess., April 21, 2009; and H.R. 2779, Defined Contribution Plan Fee Transparency Act, as introduced by House Ways and Means Select Revenue Measures Subcommittee Chairman Richard E. Neal in the 111th Cong., 1st Sess., June 9, 2009.
[9] 29 C.F.R. § 2550.404c-1 published at 57 *Fed. Reg.* 46932 (Oct. 13, 1992).
[10] 29 C.F.R. § 2550.404c-1(b)(1)(ii).
[11] 29 C.F.R. § 2550.404c-1(b)(2)(i)(A).
[12] 29 C.F.R. § 2550.404c-1(b)(2)(i)(B).

The Section 404(c) regulations specifically do not require the employer to provide investment advice.[13] 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.

[3] 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 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, this 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[14] to explain how employers could provide investment education without providing investment advice.

§1.03 Investment Education

[1] 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.[15] 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.

[a] 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:

- Employees should consider becoming plan participants as soon as they are eligible;
- Plan participants should consider making the maximum contribution possible to the plan; and

[13] 29 C.F.R. § 2550.404c-1(c)(4).
[14] 29 C.F.R. § 2509.96-1 published at 61 *Fed. Reg.* 29588 (June 11, 1996).
[15] ERISA § 3(21)(A)(ii), 29 U.S.C. § 1002(21)(A)(ii), and the corresponding regulation at 29 C.F.R. § 2510.3-21(c)(1).

- 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").

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

- Risk and return, diversification, dollar cost averaging, impact of compound returns, and tax deferred investing;
- Information describing historical differences in rates of return of different asset classes;
- Information describing the effects of inflation on investment planning;
- Access to and assistance in using tools to estimate future retirement income needs;
- Information and assistance in using tools designed to assist Participants and beneficiaries in understanding the impact of differing investment time horizons; and
- Information about and assistance in the use of tools to assess personal risk tolerance.

[c] 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.

[d] 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 the participant's account among the investment alternatives available under the plan based on the particularized needs of the participant. In addition, if a generic asset class within an asset allocation model matches any specific investment alternative available under the plan, that generic asset class must similarly match all other investment alternatives with similar risk and return characteristics.

[2] **<u>Legal Risks</u>.** As noted earlier, investment education has not been working from a practical point of view.[16] However, most plan sponsors are unaware of the legal risks with investment education. Those legal risks are identified below.

[a] Selection and Monitoring. The plan sponsor must act prudently in selecting and monitoring the investment educator.[17] For most plan sponsors, monitoring the effectiveness of investment education rendered is no less difficult than monitoring investment advice or managed accounts.

[b] 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.[18] Thus, an investment educator would not violate ERISA or 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 investment educator's compliance 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 holding a plan sponsor liable under ERISA.

[c] 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

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[16] 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.") Anonymous, "401(k) Investors Need Help to Choose Wisely," Business Insurance, Feb 2, 2009, page 8 ("What is happening to 401(k) plan participants' account balances is not good news. . . . What the numbers illustrate is the importance of investment education. A troubling number in the Fidelity study is that, in 2000, more than one-third of participants had invested all of their 401(k) assets in equities. Even as recently as 2007, 20% of participants still were invested entirely in equities.")

[17] 29 C.F.R. § 2509.96-1(e).

[18] 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.

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 conflicted investment adviser. In addition, the plan sponsor may also have indirect liability under ERISA's co-fiduciary responsibility provisions.[19] For example, the plan sponsor would be liable under the co-fiduciary responsibility rules if it fails to take reasonable 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,[20] 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[21] 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.

[3] Summary. 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 summary, providing investment education is not necessarily safer in all circumstances than providing investment advice.

[19] ERISA § 405(a), 29 U.S.C. § 1105(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.
[20] 29 C.F.R. § 2510.3-21(c).
[21] *Ellis v. Rycenga Homes, Inc.,* 484 F.Supp.2d 694 (W.D. Mich. 2007).

§1.04 **Investment Advice**

Investment advice suffers from two primary defects. First, plan participants fail to implement the advice, even if it is non-conflicted, high-quality, and reasonably-priced. Second, the controversy surrounding conflicted invested advice is not likely to be resolved soon in light of the lengthy struggle[22] to enact PPA's investment advice provisions in 2006 and the subsequent controversy over DOL's interpretation of those investment advice provisions.

[1] Failure to Implement. Receiving financial advice, though laudable, has not proven to be the panacea to participant inertia regarding asset allocation.[23] 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).[24]

[2] Conflicted Investment Advice.

[a] Background. Essentially, investment advisers cannot provide conflicted investment advice to plan sponsors or plan participants. Conflicted investment advice means that the advice could increase the investment adviser's compensation based on the investments selected by the plan sponsor or plan participants.

Investment advisers have essentially three means for dealing with conflicted investment advice. First, eliminate the conflict of interest. Second, find or obtain an ERISA prohibited transaction exemption that authorizes the conflicted advice with disclosure of the conflict to the plan sponsor or plan participants and satisfaction of the other conditions of the prohibited transaction exemption.[25] Third, obtain a DOL advisory opinion that their investment advice arrangement is not conflicted.

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[22] On November 15, 2001, the House passed H.R. 2269, the "Retirement Security Advice Act of 2001," In 107th Cong., 1st Sess. Although H.R. 2260 subsequently died in that Congress, it was a predecessor of PPA investment advice provisions.

[23] 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.")

[24] 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.")

[25] There are only a few prohibited transaction exemptions ("PTEs") that allow conflicted investment advice to be provided to plan sponsors or plan participants. PTE 84-24 allows a broker-dealer serving as the principal underwriter for a mutual fund to receive commissions on the sale of mutual funds to a plan sponsor. PTE 84-24 requires broker-dealers to disclose the commissions to the plan sponsor before the sale is executed and satisfy certain other conditions. PTE 84-24 also allows insurance agents or brokers or pension consultants to receive commissions on the sale of insurance products to a plan sponsor under the same conditions. PTE 86-128 allows broker-dealers to receive commissions for trading individual securities if the commissions are disclosed and certain other conditions are satisfied. Although PTE 86-128 theoretically applies to broker-dealers receiving commissions for selling mutual fund shares not covered by PTE 84-24, it is not a good fit for mutual fund sales.

[b] Pre-PPA DOL Guidance. Notwithstanding PPA, investment advisers can still rely on the DOL's pre-PPA guidance to eliminate their conflicts of interest, according to DOL Field Advice Bulletin 2007-1 and the DOL's investment advice regulations.[26] Before PPA was enacted, the DOL issued several advisory opinions that describe techniques for eliminating conflicts of interest.

[i] Advisory Opinion 97-15A (May 22, 1997) Frost Bank. In this advisory opinion, the DOL told Frost Bank that it would not have a conflict of interest, even though it received third party payments (i.e., mutual fund 12b-1 fees), if it would offset the third party payments against its trustee and recordkeeping fees that it would have otherwise charged to the plans that it was advising. If the third party payments exceeded the bank's trustee and recordkeeping fees, the bank would credit the excess to the plans.

In the advisory opinion, the DOL noted that the bank would be an ERISA fiduciary to the extent it would:

- advise plan sponsors on which mutual funds to invest in or to make available to participants, or
- reserve the right to add or remove mutual funds that it makes available to the plans.

Ordinarily, receiving third party payments from the mutual funds would make the bank's investment advice conflicted if those payments varied based upon the mutual funds selected by the plan sponsor. However, the DOL opined that the offset arrangement eliminated the bank's conflict of interest because the bank's compensation remained level regardless of which mutual funds were selected.

Although the Advisory Opinion 97-15A involved investment advice to plan sponsors, the DOL cited it in its Field Advice Bulletin 2007-1, its first guidance after PPA on providing investment advice to plan participants. Thus, investment advisers can rely on offset arrangements to eliminate conflicts of interest that might otherwise occur due to receipt of third party payments.

[ii] PTE 97-60 (November 4, 1997) Trust Company of the West. In 1997, The Wagner Law Group obtained PTE 97-60 on behalf of Trust Company of the West ("TCW"). Although this was an individual transaction exemption, it was a groundbreaking development that paved the way for the SunAmerica advisory opinion and the PPA statutory exemptions discussed below.

In PTE 97-60, the DOL opined that TCW could provide asset allocation advice to 401(k) plan participants, even though TCW's affiliates would receive fees that varied based on plan participant's asset allocation decisions. The key to

[26] 29 C.F.R. § 2550.408-1(a)(3) at 74 *Fed. Reg.* 3822 (Jan. 21, 2009)

obtaining the exemption was that TCW hire an independent investment expert to develop and maintain an asset allocation advice program beyond the influence of TCW and its affiliates. For example, the independent investment expert could earn no more than 5% of his gross income in any year from TCW or its affiliates.

In addition, although TCW delivered the advice to the plan participants, TCW had no discretion to vary the advice. Rather, the advice was provided by the independent investment expert based on a questionnaire he developed to determine the participants' risk tolerance and financial situation. Based on the responses to the questionnaire, the expert's computer program recommended an asset allocation.

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

In its request for an advisory opinion, SunAmerica also said it would hire an independent investment expert to develop an asset allocation advice program under an arrangement that insulated the advice from SunAmerica's influence. The SunAmerica program has three parts:

- At a conceptual level, the investment expert develops asset allocation models with different risk/return characteristics using the expert's methodology based on generally accepted principles of modern portfolio theory.

- Next, the investment expert applies the asset allocation models to the investments available to plan participants under a particular 401(k) plan and develops computer programs to facilitate providing advice to plan participants. The investment expert determines whether a particular plan has enough different asset classes to implement the asset allocation models. SunAmerica merely informs the plan sponsor whether this requirement has been satisfied. The investment expert also designs a worksheet to collect participant data on their retirement needs.

- Data is collected and fed into computer programs that generate asset allocation advice that meets the participant's retirement needs.

The investment expert retains independence from SunAmerica under the following arrangements that allow it to develop the asset allocation advice program solely in the interest of the plan participants without being influenced by SunAmerica:

- The fees paid to the investment expert by SunAmerica do not exceed 5% of the investment expert's gross income on an annual basis.

- The investment expert's fees do not depend upon how the participants allocate their investments.

- Neither SunAmerica's choice of the investment expert nor its decision to continue or terminate the relationship with the investment expert will depend upon SunAmerica's investment management fees generated by 401(k) plans that used its asset allocation advice program.

- The investment expert retains sole control over the asset allocation models and computer programs, including the staff programming the computers.

- Other than the asset allocation advice program, there are no other relationships between SunAmerica and the investment expert that would allow SunAmerica to influence the investment expert or affect the investment expert's ability to act independently of SunAmerica.

Initially, SunAmerica had applied for a prohibited transaction exemption for the asset allocation advice program. Because DOL concluded that the SunAmerica program did not create a prohibited conflict of interest, the DOL issued an advisory opinion instead of a prohibited transaction exemption.

[iv] Advisory Opinion 2005-10A (May 11, 2005) Country Trust Bank IRAs. In this advisory opinion, the DOL opined that that Country Trust Bank would not have a conflict of interest if it offset third party payments (e.g., 12b-1 fees) against the management fees that it charged its IRA customers for recordkeeping and investment advisory services. In this case, the bank advised its customers on how to invest IRA assets in a manner consistent with five model investment strategies.

The DOL issued the opinion under the prohibited transaction exemption rules in the Internal Revenue Code because IRS's authority to interpret those rules had been transferred to the DOL. Nevertheless, the advisory opinion is relevant for a couple of reasons. First, the DOL stated that the same analysis and conclusions would apply under ERISA if the IRAs were retirement plans. Second, the DOL extended the offset solution to potential conflicts of interest problems to investment advice provided to individuals, as opposed to plan sponsors.

[v] Advisory Opinion 2005-23A (December 7, 2005) IRA Rollovers. Although this advisory opinion is not mentioned in DOL Field Advice Bulletin 2007-1, it explains when ERISA's conflict of interest rules apply to ERISA plan assets rolled over from a retirement plan to an IRA.

The advisory opinion distinguishes between two groups: (1) "a plan officer or someone who is already a plan fiduciary" and (2) someone who is "neither chosen nor promoted by plan fiduciaries," "not otherwise a plan fiduciary," "not a plan fiduciary on some other basis," or "not connected with the plan." The advisory opinion then states that:

- An adviser in the second group (i.e., someone who is not already a fiduciary) can recommend that a plan participant rollover his or her account balance to an IRA, even if the adviser will earn fees on the IRA assets after the rollover. In this situation, ERISA's conflict of interest rules do not apply to the adviser's rollover recommendation.

- An adviser in the first group (i.e., "someone who is already a fiduciary") who recommends that a plan participant rollover his or her account balance to an IRA (or who "responds to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from the plan") could violate ERISA's conflict of interest rules, if the adviser will earn fees on the IRA assets after a plan participant rolls over his or her account balance to the IRA.

An investment adviser who "is already a plan fiduciary" because he or she is providing investment advice to the plan sponsor or plan participants would need to proceed cautiously in responding to a plan participant's rollover questions. The investment adviser could only provide general information about availability—not advisability—of a rollover and refrain from recommending an IRA that will generate fees or commissions for the investment adviser.

[c] Principal Rollover IRA Lawsuit. A 2008 lawsuit against Principal illustrates how ERISA can apply to assets rolled over from a retirement plan to an IRA.[27] In a preliminary ruling in the case, the federal district court allowed a class action for breach of fiduciary duty to proceed based on allegations that Principal's sales call center encouraged participants in ERISA plans who terminated employment to roll over their accounts to Principal IRAs. Allegedly, the IRA investments were restricted to Principal's mutual funds with higher fees and poorer performance than similar funds available under the ERISA plans. According to the court, the plan participants could force Principal to transfer their IRA assets back to the ERISA plans and to give up any profits made on the rollover assets, if the allegations were true.

[3] Statutory Exemptions for Investment Advice. PPA amended ERISA's prohibited transaction rules[28] to encourage more employers to provide investment advice to 401(k) plan participants. To achieve this objective, the term "fiduciary advisers" is defined and the role of plan sponsors that select and monitor them is clarified. To address potential conflicts of interest, two new prohibited transaction exemptions are created: one based on fee-leveling and another based on computer-modeling.

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[27] *Young v. Principal Financial Group, Inc.,* 547 F. Supp. 2d 965 (S.D. Iowa 2008).
[28] ERISA § 408(b)(14), 29 U.S.C. § 1108(b)(14), contains the exemptions. ERISA § 408(g), 29 U.S.C. § 1108(b)(14), contains the conditions that must be met in order to obtain relief under the exemptions. Similar provisions were also added to Internal Revenue Code § 4975(d)(17), 26 U.S.C. § 4975(d)(17).

[a] Fiduciary Advisers. The two new prohibited transaction exemptions are available only to fiduciary advisers that are insurance companies, banks, registered investment advisers, registered broker-dealers and their affiliates, employees, agents, or registered representatives.[29]

[b] Plan Sponsors' Role. Plan sponsors (or similar fiduciaries) still retain fiduciary responsibility for the prudent selection and monitoring of a fiduciary adviser. In addition, the plan sponsors must ensure that the fiduciary adviser contractually agrees to comply with conditions in the statutory exemptions and that the fiduciary adviser acknowledges in writing it is a fiduciary providing investment advice. However, plan sponsors need not monitor the specific investment advice given by a fiduciary adviser to a particular plan participant.

[c] Fee-leveling. The fee-leveling exemption says that a fiduciary adviser can accept compensation for investment advice as long as compensation does not vary depending upon the investment option selected by the plan participant. As noted earlier, the offset arrangements described in Advisory Opinion 97-15A (Frost Bank) and Advisory Opinion 2005-10A (Country Trust Bank IRAs) are precursors of this fee-leveling statutory exemption.

[d] Computer-Modeling. Similarly, the statutory computer-modeling exemption is based on Advisory Opinion 2001-09A (SunAmerica). However, the statutory exemption requires the investment expert to meet certain requirements.[30] The exemption requires the investment expert to certify that the computer model is based on generally accepted investment theories, takes into account a plan participant's situation (e.g., age or risk tolerance), uses objective criteria to make asset allocation recommendations among the investment funds available under the plan, and is not biased in favor of the funds offered by the fiduciary adviser.

[e] Other Requirements. The two new exemptions require the plan sponsor (or similar fiduciary) to authorize the investment advice program and to review an annual audit of the program. The fiduciary adviser must also provide certain disclosure to the plan participants, including a model fee disclosure form[31] developed by the DOL.

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[29] DOL's definition of "registered representatives" includes both investment adviser representatives and registered representatives. "A 'registered representative' of another entity means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c(a)(18)) (substituting the entity for the broker or dealer referred to in such section) or a person described in section 202(a)(17) of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-2(a)(17)) (substituting the entity for the investment adviser referred to in such section)." See 29 C.F.R. § 2550.408g-1(c)(3) at 74 *Fed. Reg.* 3849 (Jan. 21, 2009).

[30] 29 C.F.R. § 2550.408g-1(b)(4)(iii) defines an "eligible investment expert" as a person who "has the appropriate technical training or experience and proficiency to analyze, determine and certify . . . whether a computer model meets the requirements" of the statutory exemption but excludes any person that has any "material affiliation" or "material contractual relationship" with the fiduciary adviser or others with certain relationships with the fiduciary adviser.

[31] The model disclosure form is an Appendix to 29 C.F.R. § 2550.408g-1 and is published at 74 *Fed. Reg.* 3852 (Jan. 21, 2009).

[f] Effective Date. The new statutory exemptions apply to investment advice provided after 2006.

[4] DOL Investment Advice Regulations. This section of the article focuses on why the DOL investment advice regulations have become controversial. Instead of using the term "Chinese Wall," this article uses the term "ethical wall" to describe a means of eliminating conflicted investment advice.

[a] Background. Traditionally, an ethical wall has referred to policies and procedures that financial organizations have put into place to solve problems under federal securities laws. The classic example is the ethical wall established between a bank's lending department and its trust department. With the ethical wall in place, the trust department is kept in the dark about transactions between the lending department and outside firms. This enables the trust department to invest in these outside firms without violating rules on using inside information or on engaging in conflicts of interest.

Only fairly recently has DOL recognized ethical walls might be a means of solving conflicts of interest problems. In a 2004 field advice bulletin,[32] the DOL explained that a directed trustee's possession of non-public information in one part of its organization would not be imputed to those providing trust services if the directed trustee maintained procedures designed to prevent the illegal disclosure under securities, banking or other laws. Although the DOL acknowledged the value of the ethical wall to solve problems, it did not appear ready to describe how they would work under ERISA. In a footnote, the DOL states: "The [DOL] expresses no view as to whether, or under what circumstances, other procedures established by an organization to limit the disclosure of information will serve to avoid the imputation of information to a directed trustee."

After PPA's enactment, however, DOL embraced disclosure rather than an ethical wall as a solution for conflicted investment advice. The Obama administration and Congress appear ready to abandon the disclosure solution.

[b] Field Advice Bulletin 2007-1. In Field Advice Bulletin 2007-1, the DOL stated that the fee-leveling requirement does not apply to an affiliate of an investment advice fiduciary, unless the affiliate is also providing investment advice to the plan participants. In other words, a fiduciary adviser would not be considered conflicted as long as it complied with the fee-leveling requirement, even though the fiduciary adviser's parent company is receiving fees that varied based on the investments selected by the plan participant.

For ERISA practitioners familiar with ERISA's controlled group rules, the implication of DOL's interpretation of the statutory exemptions was noteworthy. An organization could comply with the fee-leveling requirement simply by separately incorporating the part of the organization that would be providing the investment advice to the plan participants. The DOL did not impose limitations other than requiring the fiduciary adviser alone to comply with the fee-leveling requirement. To understand why

[32] Field Advice Bulletin 2004-3 (Dec. 17, 2004).

DOL's approach to the fee-leveling requirement is noteworthy, a quick review of ERISA's controlled group rules is useful.

[c] Controlled Group Concept. Before ERISA, employers sponsoring tax-qualified retirement plans attempted to circumvent the nondiscrimination and similar qualification requirements by subdividing their businesses. For example, one corporation would provide a generous plan for its highly compensated employees. Another corporation would either not sponsor a plan or, if did, would provide a significantly less generous plan for non-highly compensated employees. To avoid this circumvention, ERISA amended the Internal Revenue Code to require employers to take into account the controlled group rules in applying the qualification requirements. The controlled group rules require each plan within a controlled group to be treated as if a single corporation employed all employees of the controlled group.

On the other hand, some employers have legitimate business reasons for providing varying levels of benefits for different businesses. However, the controlled rules would have forced these employers to provide more uniform levels of benefits. To address the problem, the Internal Revenue Code also recognizes so-called "qualified separate lines of business" ("QSLOB"). With QSLOBs, an employer may apply the nondiscrimination and similar rules on a QSLOB basis rather than on an employer-wide basis under the controlled group rules. This enables the employer to vary benefits among its different QSLOBs without failing the qualification requirements. However, the requirements to establish QSLOBs are rather stiff.

In light of the controlled group concept, the DOL might have imposed some limitations on the use of separate incorporation to circumvent the fee-leveling requirement. For example, the DOL might have required the affiliate to establish an ethical wall (i.e., policies and procedures) to prevent the affiliate from using the "stick" to influence the fiduciary adviser's investment advice.[33] With this brief review of the controlled group concept, let's take a closer look at the approach to conflicted investment advice taken in the DOL regulations.

[d] Proposed Regulations. In its proposed regulations,[34] the DOL reiterated its position in Field Advice Bulletin 2007-1 that the statutory fee-leveling requirement applies only to the fiduciary adviser entity, not affiliated entities. In addition, however, the DOL proposed a class exemption that would extend the ethical wall concept to employee, agents, or registered representatives of a fiduciary adviser.[35] In other words, if

[33] The DOL regulations address only the carrot (i.e., fees or compensation). It does not address an affiliate's threat of imposing adverse conditions to influence the financial adviser's investment advice.

[34] "[I]n interpreting the scope of the fee-leveling requirement . . . [DOL] explained, [the conditions for the statutory exemption] references only the fiduciary adviser, not the fiduciary adviser or an affiliate. Inasmuch as a person . . . can be a fiduciary adviser only if that person is a fiduciary of the plan by virtue of providing investment advice, an affiliate of a registered investment adviser, a bank or similar financial institution, an insurance company, or a registered broker dealer will be subject to the varying fee limitation only if that affiliate is providing investment advice to plan participants and beneficiaries." Preamble to the proposed regulations at 73 *Fed. Reg.* 49898 (Aug. 22, 2008).

[35] "In an effort to accommodate a wider variety of business structures and practices, making investment advice more available while protecting participants and beneficiaries, the Department is proposing a class exemption addressing

the employees, agents, or registered representatives advising plan participants satisfied the fee-leveling requirement, the fiduciary adviser could receive fees that varied based on the investment choices of plan participants.

[e] Final Regulations. The final regulations incorporate the statutory fee-leveling and computer-model exemptions and incorporate the class exemption into one document. Again, the focus of this article is on conflicted investment advice that DOL authorized with its regulations on the statutory fee-leveling exemption and class exemption.

[i] Fee-Leveling Regulation. Despite criticism[36] of its controversial interpretation of the statutory fee-leveling requirement that allowed conflicted investment advice, the DOL adopted it as proposed in the final regulations. DOL's principal argument[37] in support of its interpretation is as follows:

> ". . . if the fees . . . received by an affiliate of a fiduciary that provides investment advice do not vary or are offset against those received by the fiduciary for the provision of investment advice, no prohibited transaction would result solely by reason of providing investment advice and thus there would be no need for a prohibited transaction exemption . . ."

One of the conditions in the fee-leveling regulations is critical. It requires that the compensation of the employees, agents, or registered representatives of the fiduciary adviser not vary based on the investments selected by the plan participants. For this purpose, compensation means[38] salary, awards, commissions, or other things of value. In the preamble to the final regulations, the DOL clarified that "things of value" would include trips, gifts and other things that while having a value, are not given in the form of cash.[39]

In response to a question about bonus programs for employees, agents, or registered representatives[40] based on the fiduciary adviser's overall profitability, the DOL explained almost every form of compensation that varies based on the investments selected by plan participants would likely violate the fee-leveling requirement. Nevertheless, the DOL stated that it is conceivable that a bonus program based on the fiduciary adviser's overall profitability would not violate the fee-leveling requirement if plan participants' investments are excluded from,

fee leveling requirements for employees, agents and registered representatives, also appearing in today's Federal Register." Preamble to proposed regulations at 73 *Fed. Reg.* 49898 (Aug. 22, 2008).

[36] "[S]ome commenters objected to the Department's implementation of the statutory [fee-leveling] provision, arguing that Congress, in an effort to eliminate the potential for conflicts of interest, intended the fee-leveling requirement to encompass not only the fiduciary adviser but also affiliates of the fiduciary adviser." Preamble to the final regulations at 74 *Fed. Reg.* 3825 (Jan. 21, 2009).

[37] Preamble to the final regulations at 74 *Fed. Reg.* 3825 (Jan. 21, 2009).

[38] 29 C.F.R. § 2550.408g-1(b)(3)(D) at 74 *Fed. Reg.* 3847 (Jan 21, 2009).

[39] Preamble to the final regulations at 74 *Fed. Reg.* 3825 (Jan 21, 2009).

[40] As noted above, DOL's definition of "registered representatives" includes both investment adviser representatives and registered representatives.

or constituted a negligible portion of, the calculation of the fiduciary adviser's overall profitability.

[ii] Fee-Leveling Class Exemption. Despite even stronger criticisms[41] against the class exemption, the DOL adopted the class exemption that authorizes more conflicted investment advice by applying the fee-leveling requirement only to employees, agents, or register representatives, and not to the fiduciary adviser they represent. The conditions in the class exemption are similar to those imposed on the statutory exemptions. Of course, the fee-leveling class exemption requires that the compensation of the employees, agents, or registered representatives not vary based on the investments selected by the plan participants.[42] Similarly, the class exemption permits the use of the model disclosure form.[43]

However, class exemption imposes more disclosure conditions that are not in the fee-leveling regulation. For example, the employees, agents, or register representatives must explain:

- how their advice is prudent and in the best interests of the participant;[44]
- how and why their advice deviates from computer recommendations or equivalent investment materials,[45] and
- why their advice includes investments with higher fees than other investments available under the plan in the same asset class.[46]

The class exemption also requires the fiduciary adviser to document the advice and deliver the documentation to the participants within thirty days after the advice was provided.[47] Also, the fiduciary adviser must adopt and follow written policies and procedures that are designed to assure compliance with the conditions of the class exemption.[48]

[f] Effective Date. The DOL regulations implementing the statutory exemptions were initially scheduled to be effective on March 23, 2009. At the request of the Obama Administration, however, the DOL reopened the comment period for the

[41] "A number of commenters questioned the Department's authority to grant the proposed class exemption arguing, in effect, that the proposed class exemption is inconsistent with Congressional intent, suggesting that enactment of the statutory exemption for investment advice precluded or otherwise limited the Department's authority to grant an administrative exemption . . . ." Preamble to final regulations at 74 *Fed. Reg.* 3833 (Jan 21, 2009).
[42] 29 C.F.R. § 2550.408g-1(d)(4) at 74 *Fed. Reg.* 3850 (Jan 21, 2009).
[43] 29 C.F.R. § 2550.408g-1(d)(8)(ii)(B).
[44] 29 C.F.R. § 2550.408g-1(d)(6)(ii)(A).
[45] 29 C.F.R. § 2550.408g-1(d)(6)(ii)(A)(3).
[46] 29 C.F.R. § 2550.408g-1(d)(6)(ii)(A)(2).
[47] 29 CFR 2550.408g-1(d)(6)(ii)(B) at 74 *Fed. Reg.* 3851 (Jan 21, 2009).
[48] 29 CFR 2550.408g-1(d)(7) at 74 *Fed. Reg.* 3851 (Jan 21, 2009). See also preamble at 74 *Fed. Reg.* 3835 (Jan. 21, 2009).

regulations and postponed their effective date initially until May 22, 2009,[49] and subsequently until November 18, 2009.[50]

[g] Durability. It is unlikely that the investment advice regulations will survive in their current form, particularly:

- the regulation allowing an affiliate of a fiduciary adviser to receive variable fees based on the investments of plan participants as long as the fiduciary adviser's fees are level; and

- the class exemption allowing a fiduciary adviser to receive variable fees based on the investment of plan participants so long as the fiduciary adviser's employees, agents, and registered representatives receive level compensation.

It is likely that Obama administration will eliminate the class exemption and reinterpret the statutory exemption to require a fiduciary adviser or its affiliate to erect to erect an ethical wall between them if the affiliate receives variable fees.

In the meantime, the Conflicted Investment Advice Prohibition Act of 2009 (H.R. 1988) was introduced in Congress on April 21, 2009. In addition to barring conflicted investment advice, it would also bar money managers or other investment providers from providing advice to plan participants, even if their fiduciary advisers operate in a conflict-free environment.

H.R. 1988 would also effectively overturn the SunAmerica advisory opinion. Unlike the SunAmerica advisory opinion, H.R. 1988 would require the independent third party that develops the computer model to accept fiduciary responsibility for the advice provided to the participants. In addition, existing computer model advice programs based would have to be amended to comply with all of the existing requirements for PPA computer model requirements.

The financial industry and plan sponsor community is likely to lobby effectively to prevent H.R. 1988 from become law. If so, DOL reinterpretation of the PPA statutory exemption is likely to prevail. As noted above, the reinterpretation is likely to a fiduciary adviser or its affiliate to erect to erect an ethical wall between them if the affiliate receives variable fees.

§1.05 Managed Accounts

The prior sections have focused on the disadvantages of investment education and investment advice. In this section, the article focuses on the advantages of managed accounts from various points of view. The significant disadvantage is that managed accounts could be more expensive than investment education or advice or other investment management

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[49] 74 *Fed. Reg.* 6007 (Feb. 4, 2009).
[50] 74 *Fed. Reg.* 23951 (May 22, 2009).

approaches. With competition among managed account providers, the cost disadvantage is likely to diminish over time.

[1] <u>Plan Participants</u>. In general, participants want an easy, hassle-free way of having their money managed.[51] 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.[52]

Once a plan participant describes his or her financial profile (<u>e.g.</u>, age, time horizon, risk tolerance, investment preferences, current investments under the plan, and other assets or sources of income), managed accounts are self-sustaining from the participant's perspective. The participants' accounts are professionally managed and periodically rebalanced in accordance with the participant's financial profile using modern portfolio theory and investment practices and procedures employer by traditional defined benefit pension plans. Simply put, managed accounts constitute an effective mechanism to overcome participants' inertia to implement advice that would benefit them.

[2] <u>Plan Sponsors</u>.

[a] <u>Business Rationale</u>. 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.

[b] <u>Minimizes Fiduciary Risk</u>. 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.

If the managed account is automatic (<u>e.g</u>., 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

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[51] 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.")

[52] 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.")

monitoring the investment manager. ERISA Section 404(c) protection may be available if the participant elects to have his money managed in a managed account.

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.[53]

[c] 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.

[3] 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[54] or advisory opinion. Moreover, once plan participants become accustomed to 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[55] 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

[53] 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.

[54] The DOL regulations, and related class exemption, implementing the statutory investment advice exemptions in the Pension Protection Act of 2006 do not apply to managed accounts. See 29 C.F.R. § 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 *Fed. Reg.* 3833 (Jan. 21, 2009) ("With respect to a recommendation involving a different asset allocation structure, the Department believes that the participant or beneficiary must make an affirmative direction for its implementation.")

[55] 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.

> 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."

[4] **Public Policy.** The effectiveness of the managed account concept, particularly if combined with managed savings, if widely implemented, will result in dramatically increased retirement income.[56] 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.

[5] **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.[57] The balance fund approach is essentially the way that defined contribution plans were invested before participant-directed funds became popular.[58]

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 financial profile (e.g., age, time horizon, risk tolerance, investment preferences, current investments under the plan, and other assets or sources of income). Although the glide path for a target-date fund is based on a participant's age (or length of time to retirement), it does not take into account the participant's tolerance for risk or other elements of the participant's financial profile. The glide path for a balance fund is based solely on the average age of the plan population and, thus, less individualized than a target-date fund.

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[56] 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.")

[57] 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.

[58] 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.

§1.06 Fund of Funds

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 target-date and lifestyle funds.[59] With these funds, the higher-tiered mutual fund invests in lower tiered mutual funds within the same mutual family based on the asset allocation for the plan participant. With a target-date fund, the asset allocation among the lower-tiered mutual funds is automatically determined for a participant based on the participant's age on a glide path that invest less in equity mutual funds and more in fixed income funds as the participant ages or approaches the retirement target date. With a lifestyle fund, a plan participant typically chooses the asset allocation after reviewing asset allocation models based on lifestyle that is typically a function of age. Fund of funds may be provided on a managed or discretionary basis, or in the alternative, advice may be rendered in connection with such funds.

[1] Conflict of Interest Issues. If the investment adviser (e.g., Fidelity Research) that services the mutual fund family (e.g., Fidelity funds) sponsoring the fund of funds determines the asset allocations for plan participants, then conflict of interest issues may arise, as the investment adviser may have a financial incentive to skew the asset allocations to those funds where the investment adviser's profits, fees or margins are the greatest. Although this conflict of interest does not currently create a prohibited transaction[60] because mutual funds themselves are not plan assets,[61] this puts pressure and significant fiduciary responsibility for monitoring[62] on the plan sponsor for hiring someone who could have an incentive to render conflicted advice or management.

By contrast, the managed account programs typically do not have conflict of interest issues, and thus, do not created a heightened fiduciary responsibility for the plan sponsor.

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[59] A lifestyle fund differs from a target-date fund in that equity/fixed income mix does not change automatically as the participants in the fund become older. For this reason, a lifestyle fund by itself could not qualify as QDIA. See Preamble to QDIA regulations at 72 *Fed. Reg.* 60451, 60461 (Oct. 24, 2007).

[60] Mutual fund shares purchased with plan assets constitute plan assets. However, the underlying assets of the mutual funds do not constitute plan assets. See ERISA § 3(21)(B), 29 U.S.C. § 1002(21)(B). Therefore, the fiduciary rules, including the prohibited transaction rules, do not apply to conflicted transactions (e.g., asset allocations) that occur within the mutual fund, unless arranged pursuant to a scheme to circumvent ERISA. Support for this point may be found in the legislative history of ERISA which states:

> "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).

[61] Note, the lead author of this Article has a request before the DOL for clarification, arguing that a fund of funds may constitute plan assets.

[62] 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.

[2] <u>Quality of Process</u>. Since asset allocation is so critical to investment returns, the asset allocation should be as particularized to the individual as possible. Managed accounts are clearly tailored to most salient aspects of the participant's circumstances (<u>e.g.</u>, age, time horizon, risk tolerance, investment preferences, current investments under the plan, and other assets or sources of income), whereas an investment adviser for a fund 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.

[3] <u>Quality of Algorithms</u>. Managed account providers seeking to comply with the SunAmerica advisory opinion,[63] or the PPA statutory exemption[64] based on it, must hire independent investment experts to create the algorithms or "black box" for asset allocation purposes. However, an investment adviser 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. An investment adviser who creates the algorithms for a fund of funds would not be liable as an ERISA fiduciary for the prudence of the algorithms and would not be subject to the prohibited transaction rules. This could result in skewing of algorithms because of a financial conflict of interest but with no ERISA cause of action against the investment adviser.[65] However, the plan sponsor could be liable under ERISA for investing, or allowing plan participants to invest in, mutual funds whose asset allocation is decided by a conflicted investment adviser. As explained above, the plan sponsor's exposure would be increased because ERISA does not apply to the mutual fund investment adviser's conflict of interest.

[4] <u>Disclosure Issues</u>. As a general fiduciary principle, plan sponsors should disclose 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 risk tolerance, outside savings or any circumstance which is particular to the individual and is unusual for the fund of funds target group, the plan sponsor may have a duty to disclose this information. Again, a fund of funds places a burden on plan sponsors that managed accounts simply do not.

[5] <u>Target-Date Funds</u>. Because of the growing importance of target-date funds,[66] the discussion of target-date funds needs to broaden to include those not structured as funds of funds. As 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

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[63] Advisory Opinion 2001-09A (Dec. 14, 2001).

[64] PPA § 601 adding ERISA §§ 408(b)(1) and 408(g).

[65] There could be applicable federal and state securities law causes of action.

[66] 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.

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[67]

	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%

It is unlikely that participants with a 2010 target retirement date would have suffered from this much volatility if they were in a managed account. In any event, the magnitude of the target-date fund losses in 2008 has triggered a Congressional hearing:[68]

> "U.S. Senate Special Committee on Aging Chairman Herb Kohl (D-WI) held a hearing . . . . The panel took a particularly close look 401(k) target date funds, which are designed to gradually shift to more conservative investments as workers approach retirement. Kohl also unveiled findings from a Committee investigation of 401(k) funds designed for people planning to retire in 2010, which revealed a wide variety of objectives, portfolio composition and risk within same-year target date funds. The results of excessive risk can be devastating for those on the brink of retirement: one 2010 target date fund lost 41 percent in 2008. In conjunction with the hearing, Kohl is sending letters today to U.S. Secretary of Labor Hilda Solis and U.S. Securities and Exchange Commission Chairwoman Mary Schapiro, urging them to immediately commence a review of target date funds and begin work on regulations to protect plan participants."

On May 18, 2009, DOL unofficially announced joint hearings with SEC on target-date funds scheduled for June 18, 2009.[69] The official hearing notice[70] asks potential witnesses to testify on:

- How target date fund managers determine asset allocations and changes to asset allocations (including glide paths) over the course of a target date fund's operation;
- How they select and monitor underlying investments;
- How the foregoing, and related risks, are disclosed to investors; and
- The approaches or factors for comparing and evaluating target date funds.

§1.07 Conclusion

To summarize, ERISA Section 404(c) encourages employers to design participant-directed defined contribution plans. DOL has effectively acknowledged that the investment information disclosures required by its 1992 ERISA Section 404(c) regulations are inadequate.

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[67] 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.
[68] February 25, 2009, press release posted at http://aging.senate.gov/record.cfm?id=308665.
[69] Unofficial announcement posted at http://www.dol.gov/ebsa/TDFRelease050809.html.
[70] Official announcement published at 74 *Fed. Reg.* 24052 (May 22, 2009).

In 1994, the DOL made its acknowledgment when it published Interpretive Bulletin 96-1 to distinguish between investment education and investment advice.

However, 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.

While investment advice is better than investment education, investment advice suffers in comparison with managed accounts because it is embroiled in controversy over conflicted investment advice and, it is almost as ineffective as investment education. Managed accounts are also superior to the other QDIA alternatives —balance funds and target-date funds—because the asset allocations can be much more personalized to the individual needs of plan participants.

In addition, managed accounts do not burden plan sponsors with the additional fiduciary responsibilities that the conflict of interest issues associated with funds of funds impose on plan sponsors.

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