

# CALLAN ASSOCIATES<sup>INC.</sup>

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Office of Regulations and Interpretations  
Employee Benefits Security Administration (EBSA)  
E-ORI@DOL.GOV  
Department of Labor  
Washington, DC 20210  
Attn: 29 CFR Part 2550. Default Investment Alternatives Under Participant Directed Individual Account Plans; Proposed Rule

Ladies and Gentlemen:

Callan Associates is pleased to submit the following comments regarding the proposed rule regarding Default Investment Alternatives for Participant Directed Individual Accounts. Callan Associates is a diversified investment consulting firm with 275 fund sponsor clients, responsible for over \$898 billion in assets, including defined benefit and defined contribution plans, as well as foundations and endowments, with asset levels ranging from \$100 million to \$100 billion. Callan has, therefore, a strong interest in proposals affecting our clients' ability to effectively manage their defined contribution plans, the cost and effectiveness of defined contribution plans, as well as the role of defined contribution plans in the American economy.

The proposed guidelines were published in notice form in the Federal Register on September 27, 2006 (the "Notice"). See Fed. Reg. Doc 06-8282. The Notice states that comments must be received by November 13, 2006.

Callan commends the Department's efforts to provide guidance in regards to the type of investment strategies into which Defined Contribution plan participants can be defaulted. We also agree that any default investment be diversified and managed to a level of risk commensurate with the participant's demographic characteristics.

We are concerned, however, that requiring the default investment alternative to be either managed by an investment manager, as defined in ERISA §3(38) of the Act, or by an investment company registered under the Investment Company Act of 1940, will greatly limit the ability of plan sponsors to offer cost effective, well-diversified investment alternatives tailored to their particular plan participants.

## Background

Asset allocation investment products of the type referred to (target-date or target-risk funds) may be managed by investment managers as defined in ERISA §3(38), by investment companies registered under the Investment Company Act of 1940, as well as on an individual basis in the form of managed accounts. However, many plan sponsors have found that their participants are best served when the plan sponsor constructs the target-date or target-risk funds using the existing investment options within the plan (the “core funds”) approach.

The core funds approach benefits plan participants by allowing plan sponsors to:

- (1) *Tailor the asset allocations of the target-date or target-risk funds to the characteristics of their participant population.* Despite having the same objective (e.g., aggressive risk, or a 2030 target date), the underlying asset allocations of these funds can differ substantially, depending upon an investment firm’s investment philosophy or market outlook. Moreover, as the investment outlook of a firm changes, the asset allocation of these funds can shift substantially. Allowing plan sponsors to develop their own asset allocations ameliorates this issue by allowing the plan sponsor to control the asset allocation or glide path (series of asset allocations), and keep it tailored to the plan.
- (2) *Provide the “best-of-class” options within the asset allocation portfolios comprised of the best funds available in each asset category, as well as diversify investment manager risk (e.g., business risk, investment philosophy risk).* Target-date or target-risk mutual funds usually limit the underlying funds within the asset allocation to the mutual funds offered by a given mutual fund family. In some cases, the mutual funds within a family of mutual funds have overlapping style. This can result in target-date or target-risk mutual funds that have reduced diversification benefits. In addition, different mutual funds managed by the same fund family can vary significantly in terms of quality. For example, a fund family may have an excellent large-cap fund, but very poor small-cap funds. Despite this, the target-date or target-risk mutual fund which requires small-cap exposure for diversification purposes, would still include the fund family’s small-cap funds.
- (3) *Leverage the economies of scale within the defined contribution plan to reduce the cost of the target-date or target-risk funds.* Many large plan sponsors use collective trusts and/or separate accounts as opposed to mutual funds as their core funds, as these collective trusts and separate accounts tend to have expenses that are much lower than those of even institutionally priced mutual funds due to economies of scale. By basing the target-date or target-risk portfolios on collective trusts and separate accounts, the average weighted expense ratio of the core funds approach may be significantly lower than that of a target mutual fund. In one study, a large plan sponsor found that it could save between 24% and 45% on fees by blending the core funds within its plan rather than using a typical set of target-date mutual funds.

As worded, for a core funds approach to be a qualified default investment alternative (QDIA), the manager of the core funds approach would be required to be an investment manager as defined by ERISA §3(38). This means that the manager of the core funds approach would be required to: A) have the power to manage, acquire, or dispose of any asset of a plan; B) be registered as an investment adviser under the Investment Advisers Act of 1940 or under the laws of the state, or be a bank or insurance company; and C) acknowledge in writing as to being a fiduciary with respect to the plan. As proposed, the regulations generally eliminate the ability of plan sponsors to independently create target-date and target-risk funds based on the core funds approach, and potentially greatly increase the cost of such funds—when managed externally—to plan participants.

### **Plan Sponsor as Manager of Target-Date and Target-Risk Portfolios**

When a plan sponsor is prepared to assume fiduciary responsibility with respect to the target-risk asset allocation or the target-date glide path, typically that plan sponsor will not pass through the modest additional costs of creating the asset allocation or glide paths to plan participants. This is typically true even if the plan sponsor has engaged the help of an outside investment consultant in creating the asset allocations or glide paths. However, if the outside investment consultant is required to assume fiduciary responsibility for the asset allocation or glide path—on top of the fiduciary responsibility of the plan sponsor—the cost would go from being nominal to far more material. All but the largest plans would likely find it necessary to pass part or all of such costs along to plan participants.

### **Outside Investment Managers' Additional Fiduciary Responsibility**

Further, if the outside investment manager is required to assume fiduciary responsibility not only for the asset allocation or glide path, but for fund selection and potentially even individual security selection (when the underlying core fund is not registered under the Investment Company Act of 1940), the result will be even greater unnecessary cost to plan participants. This cost will arise out of the increased scope of potential fiduciary liability resulting from the additional, unnecessary layers of fiduciary responsibility.

Note that the plan sponsor already has fiduciary responsibility with respect to the underlying fund selection within the target funds, and the investment manager (even if the fund is not registered under the Investment Company Act of 1940) has fiduciary responsibility for the management of the underlying funds within the plan. Thus the policy goals served by this additional fiduciary requirement are redundant.

The Department's requirement, as worded, would force most plans to use potentially more costly and less well-diversified mutual funds as their QDIA instead of the core funds approach.

### **Alternative Approach I**

We propose that the Department create an environment that allows for more cost-competitive and higher quality QDIAs by eliminating the requirement that the target-date and target-risk QDIAs should be either managed by an investment manager (as defined in ERISA §3(38) of the Act), or by an investment company registered under the Investment Company Act of 1940.

Instead, we propose that the final rule should allow plan sponsors to directly manage a QDIA. In this way, unnecessary and redundant costs would be eliminated, making well-diversified core funds approach target-date and target-risk funds available as QDIAs for a broad range of participants in DC plans.

### **Alternative Approach II**

As another alternative, at a minimum, it would provide significant relief if the Department were to clarify that fiduciary responsibility by the manager of the core funds approach is limited to the asset allocation or glide path.

The Department's requirement that the target-date or target-risk portfolios should be managed by an investment professional would still be maintained, as the manager would still be required to be a registered investment advisor. But, by requiring that the manager acknowledge in writing that they are a fiduciary with respect to the asset allocation or the glide path *only*, rather than the entire plan, the inefficiencies and redundancies of many layers of fiduciary responsibility would be avoided. In this way, the professionals responsible for each level of management would be held accountable for their specific management level, without the costly and inefficient duplication of fiduciary responsibility. The plan sponsor would be responsible for fund selection, fund managers would be responsible for management of the underlying funds, and the core funds approach target-date or target-risk manager would be responsible for the glide path or asset allocation.

This approach would greatly aid in keeping costs reasonable, making it feasible for participants in plans beyond mega plans to benefit from the core funds approach to target-date and target-risk QDIAs.

### **Conclusion**

Again, we commend the Department's efforts with respect to the development of the QDIA guidelines. We believe that by modifying the guidelines as we describe above, the Department will achieve its goals of creating cost-effective ways for plan participants to achieve better diversification within their defined contribution plans.

We appreciate the opportunity to make this submission. Please feel free to contact us if you have any questions.

Sincerely,



Ron Peyton  
President and Chief Executive Officer



Lori Lucas  
Senior Vice President