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Submitted electronically

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, DC 20210

Attn: Investment Advice Class Exemption
Investment Advice Regulations

Ladies and Gentlemen:

The Investment Company Institute strongly supports the Department of Labor's proposed regulations and proposed class exemption for the provision of investment advice to participants and beneficiaries of self-directed individual account plans and IRAs.[1] The proposal will significantly encourage plans and providers to offer individualized investment advice programs to assist participants and beneficiaries of ERISA plans and IRA investors in managing their accounts.

The Department's proposal includes both a proposed regulation implementing the statutory exemption Congress added under the Pension Protection Act of 2006 and a proposed prohibited transaction class exemption providing relief for investment advice transactions similar to those covered by the statutory exemption, but subject to different conditions.[2] The class exemption is designed to complement the Regulation by furthering the availability of individualized investment advice under circumstances not encompassed in the Statutory Exemption or Regulation.

The Institute supports both the Regulation and the PTE. The PTE offers a "level fees" alternative (section III(f)) available to both ERISA plans and IRAs that applies the level fees condition

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors and advisers. Members of ICI manage total assets of $12.11 trillion and serve almost 90 million shareholders.

[2] In this letter we refer to statutory exemption, proposed regulation, and proposed prohibited transaction class exemption as the "Statutory Exemption," "Regulation," and the "PTE," respectively.

to the individual, rather than his or her employer, where that individual is providing advice on behalf of the fiduciary adviser. We also support the more flexible PTE computer model option (section III(e)), which allows individual advisers to make recommendations that supplement the ones generated by the model, subject to additional protections for participants.

The Institute believes that the overall workability and utility of the proposals can be enhanced with the modifications and clarifications discussed below. Our comments cover both the PTE and the Regulation.

1) Overall Scope and General Conditions

a) The Department should clarify that a fiduciary adviser need not take into account under its advice program each and every factor listed in the Regulation and section III(c) of the PTE.

Section (c)(1)(ii) of the Regulation and Section III(c) of the PTE provide as a condition of the PTE that the investment advice "take[] into account information furnished by a participant or beneficiary relating to age, life expectancy, retirement age, risk tolerance, other assets or sources of income and investment preferences." While some highly customized (and, therefore, more expensive) programs do take into account all of these factors, many advice programs, for good reasons, do not ask for information about and take into account every one of these factors. It can be difficult to obtain information on all of the enumerated items (such as regarding other assets or sources of income), and some participants are reluctant to provide this information. Some factors overlap or may be inferred from others (*e.g.*, age and life expectancy, retirement age and risk tolerance). The Department should clarify that a fiduciary adviser need not take into account each enumerated factor, provided that the fiduciary adviser discloses to the hiring ERISA plan fiduciary or IRA beneficiary which types of information it uses in formulating its investment recommendations to participants.

This clarification is consistent with other comparable provisions. In the case of a computer model program under the statutory exemption, ERISA section 408(g)(3)(B)(ii) specifically provides that the model "may" include the factors which are referenced in section (c)(1)(ii) of the Regulation and section III(c) of the PTE. This suggests that, in a similar context, advisers need not consider every single potential factor relevant to assessing a participant's risk profile and investment preferences. The Department also adopted a flexible approach in the case of IRAs using educational materials (section III(e)(2)(C)), which makes clear that such factors are *examples* of the types of information that asset allocation models must take into account. Finally, granting the advice provider some flexibility on the types of participant information considered is not inconsistent with the interests of participants and

beneficiaries because the advice provider remains subject to the overall condition (section III(b)) that the advice is based on generally accepted investment theories.[3]

b) The Department should clarify that a financial adviser can provide advice to employees who participate in the financial adviser's in-house ERISA covered plan.

Under both the Regulation and the PTE, the arrangement under which investment advice is provided to participants and beneficiaries must be expressly authorized in advance by a plan fiduciary (or IRA beneficiary) who is not affiliated with the advice provider. In the case of an IRA, the IRA beneficiary will not be treated as an affiliate of the advice provider solely by reason of being an employee of such person. It appears therefore that the exemption is available where employees of a financial institution establish their IRAs with the financial institution and obtain advisory services from that institution. We recommend that the Department make a clear statement to that effect in the final Regulation and PTE and that the Department take the same position with respect to in-house ERISA covered plans.

Specifically, the Department should exclude from "affiliate" status participants and beneficiaries of ERISA-governed plans who may be employees of the advice provider. There would appear to be no reason to preclude employees of a financial institution from accessing the same services that are afforded to clients of the institution. A myriad of exemptions recognize that, subject to ERISA's general fiduciary protections, it is appropriate to allow a financial institution to use its own products and services for its in-house plans. *See, e.g.,* PTE 77-3 (allowing the use of affiliated mutual funds); ERISA § 408(b)(5) (allowing the use of affiliated insurance contracts); PTE 79-41 (expanding the application of § 408(b)(5)). This additional relief could be subject to a requirement that the advice provider also provides the same investment advice program to participants of unaffiliated plans in the ordinary course of its business.

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[3] We are also concerned with the statement on page 49897 of the preamble to the Regulation, which says that "the principles [that an advice program take into account information furnished by a participant relating to age, life expectancy, etc.] are so fundamental to the provisions of informed, individualized investment advice that a failure on the part of a plan fiduciary to insist on such conditions in the selection of an investment adviser for plan participants would, in the Department's view, raise serious questions as to the fiduciary's exercise of prudence." Without further clarification, this statement could alarm plan sponsors and serve to disqualify from consideration many prudent and appropriate investment advice programs that for very sound reasons do not take every one of these factors into account. This statement suggests that a plan sponsor has only two choices – offer no advice program *at all*, or offer a more costly advice program that is highly individualized to every participant no matter the size of the participant's portfolio or sophistication of the participant.

c) The Department should clarify that a participant need not separately consent to automatic rebalancing.

The Statutory Exemption and Section III(k) of the PTE provide that the sale, acquisition or holding of a security or other property must occur solely at the direction of the recipient of investment advice. Investment advice programs often allow the participant to authorize in advance that the fiduciary adviser perform automatic rebalancing of the participant's portfolio at regular intervals (*e.g.*, quarterly or annually) pursuant to a non-discretionary formula, without further specific direction by the participant. It is our view that such non-discretionary rebalancing is a non-fiduciary act that does not require relief under the exemption. The Department should clarify that such rebalancing does not violate the Statutory Exemption or section III(k) of the PTE.[4]

2) <u>Computer Modeling Option</u>

a) The Department should clarify that a fiduciary adviser may limit its advice program to a subset of the plan's available investment options, where disclosed to the plan's independent fiduciary,[5] provided that the number and types of investment options remaining are sufficient to permit a participant or beneficiary to construct a prudently diversified portfolio pursuant to the fiduciary adviser's recommendations.

Section 408(g)(3)(B)(v) of the statutory exemption provides that any computer model must take into account "all investment options under the plan." These requirements are incorporated into the PTE by cross-reference in the computer model alternative set out in section III(e)(1). Although the Department has clarified that only "designated investment options" must be taken into account, we believe a requirement to take into account all investment options may be unworkable in some circumstances and may inhibit the provision of advice in certain plans. For example:

- Many plans offer a wide range of investment options that may not be relevant or appropriate for use in an advice program. A plan may contain legacy options offered (continued from a predecessor plan), managed accounts, or target date funds. Managed accounts and target date funds are better viewed as alternatives to a customized asset allocation recommended by a computer model.

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[4] Alternatively, the Department could provide for this non-discretionary rebalancing solely in the PTE based on similar negative consent provisions in prior exemptions.

[5] Or, in the case of an in-house plan, if in the ordinary course of its business the fiduciary adviser excludes such factors from computer models used with its outside client plans.

- Some options may not be suitable for an advice program because of various restrictions (*e.g.*, minimum investment size, restrictions on withdrawal frequency).

Requiring that models take into account all investment options available under the plan would not necessarily increase participant choices. In fact, such a requirement will likely decrease choices by making it more difficult to find advice providers willing to offer their services to plans with large numbers of investment choices. Accordingly, we believe that this decision should be left to the hiring fiduciary based on full disclosure by the adviser as to the extent to which its model will or will not take into account all designated plan investment options and provided that the number and types of investment options remaining are sufficient to permit a participant or beneficiary to construct a prudently diversified portfolio pursuant to the fiduciary adviser's recommendations.

Alternatively, the Department should consider providing additional flexibility to exclude certain investment options such as those described above, similar to the exceptions the Department provided for self-directed brokerage accounts and employer securities.

In addition, to the extent that a plan offers employer securities as an investment option, we ask that the Department clarify that advisers have flexibility in how they take the employer securities into account. Though the Regulation clarifies that an adviser may disregard options that include employer securities, some models do consider employer securities even if they do not offer any recommendations as to whether a participant should buy or sell employer securities. When a model takes employer securities into account, it is typical that those securities affect the adviser's recommendations as to the remainder of the participant's account that is not invested in employer securities (*e.g.*, the recommendations relating to the balance of the account take into account the higher risks associated with the portion invested in employer securities). This should be permissible under the Regulation and PTE.

b) The Department should provide examples of circumstances that "reasonably preclude" the use of computer modeling for purposes of section III(e)(2) of the PTE.

The PTE provides a special rule for IRAs "with respect to which the types or number of investment choices reasonably precludes the use of a computer model." We recommend the Department provide additional guidance to help providers know when an IRA meets this test. At a minimum, the Department should clarify that the following would always be deemed to qualify under section III(e)(2):

- Where the IRA can invest in most any individual security available through a brokerage account (subject to normal account restrictions based on suitability, etc., and subject to any

IRA-specific limitation such as avoiding prohibited transactions, no investment that may generate UBTI, etc.).

- Where the IRA can (subject to the above types of restrictions) invest in any mutual fund or a "supermarket" or similar wide range of mutual funds from multiple fund sponsors/families.

3) <u>Level Fees Option</u>

The Department should provide examples of the types of compensation arrangements that do not violate the "level fees" condition.

The Department should clarify that a bonus program that is based primarily on the overall profitability of the fiduciary adviser, or an affiliate of the adviser (*e.g.*, the adviser's parent), or a designated business unit within the adviser's business, or a controlled group that includes the adviser, or a designated business unit within such controlled group, over a specified period of time (typically one year), does not violate the level fees requirement.

In addition, we recommend that the Department acknowledge that bonus compensation measured by assets under management, or increases in assets under management over a specified period, without regard to the specific investment option in which those assets are invested or the profitability of any specific investment option is permissible.[6]

4) <u>Non-compliance with the terms of the PTE</u>

Section V of the PTE provides that in the case of a "pattern or practice" of noncompliance with any of the conditions of the exemption, relief is unavailable with respect to *any* advice by the fiduciary adviser during the period of noncompliance. The scope of this penalty is unclear, and the potential penalties so draconian and without precedent,[7] that it may discourage advice providers from relying on the exemption.

The proposed PTE includes myriad provisions that we believe make a "pattern or practice" rule unnecessary. For example, as a condition of the regulation, the adviser must adopt policies and

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[6] For example, some 401(k) service providers reward employees for successfully increasing enrollment and/or contribution rates for participants. These bonus programs are based on increasing retirement savings, not on the particular investment options that a participant selects. One member described an overall reward program that provides for an all-expense paid trip to a resort for a conference that provides both advanced education and training and social and recreational activities. Eligibility is based on total gross compensation, and none of the compensation to recipients varies based on any investment option selected by a retirement plan or IRA client.

[7] Our outside counsel looked for previous class exemptions with a similar "pattern or practice" rule and did not find any.

procedures to ensure compliance (section III(i)). In addition, the adviser must hire an auditor to review compliance with the exemption, as well as report instances of noncompliance to the Department (section III(j)). Finally, since the excise tax in section 4975 of the Internal Revenue Code applies to each transaction that is a prohibited, and generally "pyramids" in subsequent tax years until corrected, a fiduciary adviser has a strong interest in limiting any instances of noncompliance.

We recommend that in finalizing the PTE the Department follow the same standard that applies for any other exemption – each transaction for which all the conditions are satisfied should be covered. Transactions for which the conditions are not satisfied should not be covered.

5) <u>Audit</u>

Our members question the need for the requirement to send to the Department a copy of the audit report if the auditor determines *any* instances of noncompliance with the conditions of the exemption. An audit is most effective when the auditor and audited party work together to identify areas to improve compliance controls and correct nonmaterial errors. For example, an audit may discover isolated instances where the annual notice required by section III(g)(1) is provided a few days late, or the documentation described in section III(e)(4) required to be created within 30 days is created a few days late. These nonmaterial compliance issues are best addressed by the auditor working with the fiduciary adviser to revisit the fiduciary adviser's policies and procedures and improve controls. This process may be hampered if the consequence of the auditor's requirement to notify the Department places the auditor and fiduciary adviser in an adversarial relationship or obligates the authorizing plan fiduciary to view any compliance weakness reported by the auditor as a prohibited transaction.

Requiring that *any* instance of noncompliance be reported to the Department by the auditor and treated as a prohibited transaction would seem to be unnecessary. First, the authorizing plan fiduciary will receive the auditor's report describing any such nonmaterial compliance deficiencies and the steps to be taken to address them. Second, deficiencies that are material that actually involve prohibited transactions will be reported. The fiduciary adviser must self-report by filing a Form 5330 and paying the excise tax. In addition, the plan administrator must report any prohibited transactions during a plan year on Form 5500.

Accordingly, we recommend that the Department either remove the requirement of the auditor to notify the Department or provide that notification is required only when the auditor determines that compliance failures are material under the auditor's standards.

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We believe that the proposed clarifications and modifications will enhance the overall proposal and provide more meaningful advice options for participants and beneficiaries. If you have any questions, please contact the undersigned at 202.326.5810 or Mary Podesta at 202.326.5826.

Sincerely,

/s/ Michael L. Hadley

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