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Via Electronic Filing

Elaine L. Chao  
Secretary of Labor  
Office of Regulations and Interpretations, Employee Benefits Security Administration  
Attn: Investment Advice Regulation, Room N-5655  
U.S. Department of Labor  
200 Constitution Avenue, NW  
Washington, DC 20210

RE: Proposed Rules on Investment Advice Exemption for 401(k) Plans and IRAs

Dear Secretary Chao:

Thank you for the opportunity to comment on the above referenced rule proposal regarding the proposed regulations § 2550.408g-1 and 2550.408g-2 of the Employee Retirement Income Security Act of 1974 (“ERISA”) (the “proposed regulations”) and the proposed class exemption from the Department of Labor (the “Department”) Notice in the Federal Register, volume 73, number 164, dated August 22, 2008, (the “proposed class exemption”) which provide exceptions to the prohibition under ERISA against many financial advisors providing investment advice. The Cornell Law Securities Clinic (the “Clinic”) is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the largely rural “Southern Tier” region of upstate New York.<sup>1</sup>

**Introduction**

The proposed regulations would provide exemptions to the strict prohibition under ERISA against investment advice provided by investment advisors who could benefit from an investor acting upon that advice (i.e. self-dealing). Although ERISA prohibits such advice, it and the Internal Revenue Code were amended by the Pension

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<sup>1</sup> For more information, please see <http://securities.lawschool.cornell.edu>.

Protection Act of 2006 (the “PPA”) to permit investment advisors to provide expertise to investors in certain situations. The above-mentioned Federal Register contains proposed regulations that implement the changes proposed by the PPA and also contains a class exemption proposal which further extends the exemption.

The Clinic supports the effort of the Department in the proposed regulations, but recommends the Department not proceed with the proposed class exemption without first waiting to determine the impact of the proposed regulations. Alternatively, if the Department proceeds with the proposed class exemption in its current condition, the Clinic encourages the Department to consider significant penalties to deter manipulation by investment advisors. The Clinic feels that due to the malleable standards promulgated under this proposed class exemption, investment advisers have significant room to justify misleading information, and thus, to preserve the integrity of the system and encourage confidence of investors, the Department should counteract that tendency by providing for severe penalties for noncompliance.

**A. The Proposed Regulations Permit Better Advice**

The Clinic understands the Department’s concern, as explained in the notice of proposed regulations, of the lack of qualified advice available to many investors due to advisors’ fear of self-dealing.<sup>2</sup> These proposed regulations would help to reduce the roughly \$100 billion dollars lost every year through inaccurate or unavailable information.<sup>3</sup>

The Clinic views the two conditions—either fee-leveled advice or independent computer program information—as essential to maintaining the benefit of this proposal. The fee-leveling provision removes the principal incentive for the advisor to sell particular products that may not be as suitable for the investor, yet provides higher commissions. By removing that incentive, the proposed regulation helps to align the interests of the advisor and advising company with those of the investor because the only increase in revenue that the advisor or fiduciary company will see is repeat business and referral business, which will only occur if the investor is pleased with the initial recommendation.

The independence of the computer program recommendations poses some concern for the Clinic because it would permit an advisor to contradict the independent evaluation and encourage a bad investment. Although the computer evaluation will provide a benchmark with which the investor may evaluate the advisor’s recommendation, the advisor still has some ability to self-deal and convince the investor that the computer system is incorrect for some reason. Because elderly investors are frequently the target of such scams and elderly people often have less understanding of computers and computer systems, they will naturally be more likely to trust the advisor than the computer, providing a better opportunity for the investor to take advantage of the

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<sup>2</sup> See Investment Advice—Participants and Beneficiaries, 73 Fed. Reg. 49,896, 49,903 (Aug. 22, 2008).

<sup>3</sup> See *id.*

investor. Despite this concern, the Clinic feels that between the safeguard of the independent evaluation of the computer recommendations and the legal obligations of the advisor to provide a suitable product, the benefit of permitting more advisors to help investors overcomes the potential detriment.

**B. The Proposed Class Exemption Grants Excessive Latitude**

*1. The Department Should Not Pursue the Proposed Class Exemption*

*i. The Standard is Too Easily Manipulated*

The Clinic opposes the current proposed class exemption because it removes too many of the procedural safeguards necessary to prevent rogue advisors from abusing investors. Under the proposed class exemption, an advisor who determines a computer evaluation is not feasible then must provide certain disclosures and—in order to obtain greater compensation opportunities—graphs, charts, documentation and other educational material to be used as a metric against which the investor can measure the advisor's recommendation.<sup>4</sup> While the proposed class exemption would further the Department's goal of making financial advice more readily available,<sup>5</sup> this particular proposed class exemption relies on a subjective determination by the advisor to determine the amount of safeguards to utilize, which poses a great potential for damage. Providing to the investor published materials against which the investor can compare the advice from the individual advisor puts investors in the same situation they were in before they sought advice from a financial advisor, eliminating almost all benefit of having a financial advisor.

As argued previously, an independent computer evaluation that is regularly reviewed by an independent auditor is roughly the limit of when the benefits of the availability of additional financial advisors outweigh the potential for detriment. Thus any proposal that provides fewer safeguards fails to sufficiently protect the investor. The proposed class exemption provides fewer safeguards than the independent computer evaluation and thus is an insufficient protection.

The Clinic's main concern about the proposed class exemption is the ability of the advisor to determine that the evaluation of the proposed investments is too complex for a computer analysis and thus avoid providing that independent analysis. In order to avoid providing an independent computer evaluation, the advisor must merely reasonably determine it would not be feasible.<sup>6</sup> Such a subjective standard will be easily manipulated by advisors seeking to avoid providing computer evaluations that contradict their own recommendations.

In addition, the safeguard of providing education or other benchmarking information is much too easy to manipulate by either providing too little or incorrect

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<sup>4</sup> See *id.* at 49,926.

<sup>5</sup> See *id.* at 49,925.

<sup>6</sup> See *id.* at 49,926.

information or by overloading the investor with information. In either situation, the investors are unlikely to understand the independent material sufficiently to act in a manner contradictory to the insistence of the financial advisor. Further, the advisor could easily provide reasons why the independent material is incorrect or inapplicable, thus encouraging the investor to follow the advisor's recommendation. To reiterate, putting investors in situations in which they must use published material to evaluate their advisors' recommendations is effectively putting them back in the position they started before they hired a financial advisor to consider investments—that of reading information and listening to self-interested advisors describe their self-serving investments.

ii. The Fee-Leveling Provision Still Benefits Individual Advisors from Small Broker-Entities

Another reason the Clinic advises not adopting the proposed class exemption is the lack of a fee-leveling provision for the fiduciary broker-entity and particularly the lack of a fee-leveling provision for the advisor if the advisor includes "additional conditions."<sup>7</sup> Due to the inclusion of fee-leveling provisions in the above-discussed proposed regulations, a fee-leveling provision in an exemption that provides fewer safeguards for the investor would be necessary. The Clinic recognizes that, formally, no compensation of any sort should be provided to the advisor based upon sales under this proposed class exemption, but the Clinic remains skeptical of a complete lack of special benefits or recognition that would be provided to an advisor who regularly provides the entity with greater revenues. Further, in small broker-entities, the distinctions between the individual advisor and the broker-entity become very blurred and a benefit accruing to the broker-entity quickly becomes a benefit to the individual advisor.

2. *The Department Should Enhance the Penalty Under The Proposed Class Exemption*

If the Department determines, considering the interests of investors, to pass the proposed class exemption, the Clinic requests the Department consider imposing an enhanced penalty for violations of this exemption. An enhanced penalty would counteract an increased incentive created by the proposed class exemption for an advisor to mislead an investor.

In criminal law theory, deterrence must be measured by comparing the probability of getting caught and punished, the severity of the punishment, and the benefit to be had by completing the crime and escaping without punishment.<sup>8</sup> The proposed class exemption reduces the probability of advisers being caught and punished because the decision regarding whether a computer analysis would be unfeasible is based upon the

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<sup>7</sup> See *id.* at 49,906.

<sup>8</sup> See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 221 (6th ed. 2003) (providing an example of the relation between the allotted punishment, the probability of being punished and the deterrence level using a fine as a punishment for a crime); see also Peter T. Wendel, *A Law and Economics Analysis of the Right to Face-to-Face Confrontation Post-Maryland v. Craig: Distinguishing the Forest from the Trees*, 22 *HOFSTRA L. REV.* 405, 476 & n.247 (1993).



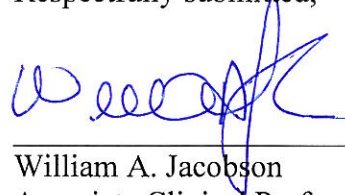
subjective determination of the advisor. Further, in order to prevent a decrease in productivity, broker-entities are likely to oversee individual advisors' "reasonableness" determinations with significant deference, thus making it easier for the individual advisor to take advantage of investors. Thus, assuming the benefit to be had by the advisor and/or broker-entity remains the same (which would not be a valid assumption if the advisor can receive higher commissions based upon the product sold), the penalty for violation must be increased to maintain the current level of deterrence.

### **Conclusion**

The Clinic feels the Department has correctly weighed the potential benefits available through the proposed regulations as being greater than the potential detriments through abuse by advisors, and thus supports the enactment of the proposed regulations. The Clinic, however, discourages the Department from approving the proposed class exemption. The proposed exemption removes too many safeguards against deception by financial advisors. Alternatively, if the Department approves the proposed class exemption, the Clinic proposes an increased penalty for noncompliance with the advisors' duties to their investors. The Clinic suggests the Department approve the proposed regulations and then wait to see the impact of those exemptions and at a later time reevaluate the need for the additional proposed class exemption.

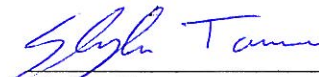
The Clinic appreciates the Department's consideration of its comment letter.

Respectfully submitted,



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