

November 11, 2006

Office of Regulations and Interpretations
Employee Benefits Security Administration, Room N-5669
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

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Attn: Default Investment Regulation

To Whom It May Concern:

On behalf of Zacks IFE, a subsidiary of Zacks Independent Research, I would like to offer two suggestions on how the Department can improve the fiduciary safety and effectiveness of CFR Part 2550:

1. Lifecycle mutual fund allocations should be controlled by, or at a minimum certified as unbiased and audited by, independent fiduciaries.
2. Managed accounts should be defined as the business method described in Department of Labor Advisory Opinion 2001-09A.

By way of background, Zacks IFE was founded in anticipation of the Pension Protection Act's clarification of "autopilot" investing in defined contribution plans. Zacks IFE is an independent allocator for the proposed default investment vehicles: lifecycle strategies, demographic-adjusted balanced accounts, and managed accounts. The firm also provides audit services for computer-generated proprietary advice programs, as required in Section 601 of the Pension Protection Act ("PPA"). Our comments are as follows:

Lifecycle Funds and Fiduciary Allocation

A number of academics, ERISA specialists, and public policy officials have identified the conflicts that arise when parties in interest are given discretion over the allocation of funds from which they receive variable fees - the very business model of lifecycle mutual funds. Transferring the fund selection and reallocation responsibilities of lifecycle mutual funds to an independent fiduciary will increase the safety and effectiveness of these investments.

Why this issue should be addressed: ERISA fiduciaries are required to remove real or potential conflicts of interest. Many large plans recognize that lifecycle mutual funds self-deal. As a result, a trend in the marketplace is quickly developing in which large plans retain an independent allocator to design and implement a customized lifecycle program using the plan's core investment options. This approach is more prudent because the use of an independent allocator removes the ability of parties in interest to self-deal. This approach is safer because assigning control of participant assets to an independent financial expert (or "IFE" as described in the TCW Prohibited Transaction Exemption and SunAmerica Advisory Opinion) turns the lifecycle strategy into an ERISA 402 investment option. This is possible when the IFE is a 3[38] investment manager and acknowledges its fiduciary responsibilities in writing.

The problem is that small businesses, even if they understand the conflicts of interest inherent in lifecycle mutual funds, do not have the resources to implement a customized approach. Therefore, to protect the small businesses and their employees, we suggest that the trend towards independent fiduciaries in customized lifecycle strategies and SunAmerica Advisory-compliant managed accounts be extended to lifecycle mutual funds. Specifically, we recommend that control of lifecycle mutual fund allocations be transferred to qualified independent financial experts who are willing to acknowledge their fiduciary status and responsibilities.

What will happen if this is not addressed: As Secretary of Labor in 1998, Alexis Herman warned in a letter to William F. Goodling, Chairman of the Committee on Education and the Workforce of the U.S. House of Representatives, that a plan sponsor's fiduciary risk increases when allocations are in the hands of fund companies. To quote the Secretary, "However, under a lifecycle fund, there is no investment manager responsible under ERISA for investment management, which is a critical requirement in order to gain the

protections available if one follows the procedures specified under Section 402 of ERISA. In fact, there is no accountability whatsoever under ERISA with respect to an advisor's allocations under a lifecycle fund. Therefore, there is no fiduciary relief for the plan sponsor available under ERISA Section 402 if a lifecycle fund is the default investment option." It is fair to assume that investment companies will never acknowledge their fiduciary responsibilities in writing. Therefore, plan sponsors using their lifecycle mutual funds may be required to disclose these conflicts of interest to participants. This is a problem because such disclosure may lead to the type of distrust and employee procrastination that the Pension Protection Act was designed to eliminate.

Professor Nicolaj Siggelkow of the Wharton School of Business has confirmed the Secretary's concern by proving that mutual fund companies systematically act in their own economic interest, regardless of the impact on shareholders (Siggelkow, Nicolaj, "Caught Between two Principals," Wharton School, 2004). There is no reason to believe that, where possible, they would not skew the management of default options under their control towards higher fee funds.

The Wall Street Journal has noted the risk of self-selection of proprietary funds. They show that fund companies are beginning to insert their highest cost funds into their tiered risk programs, because they can ("A Once Staid Investment Gets Exotic", January 20, 2006). Since there are no examples of an IFE such as Financial Engines, Ibbotson, ProManage, or GuidedChoice requiring timber, oil & gas, gold, or REIT mutual funds to construct prudent portfolios, this seems to be an example of the kind of self-dealing that Secretary Herman and Professor Siggelkow warned against. Further, it is the kind of self-dealing that will be avoided if the Department recommends an independent third party control the selection of funds used to construct a lifecycle program, as well as their allocation.

An example of suggested language: The default guidelines should contain language that states: "When a registered investment company is responsible for the management of a qualified default investment alternative, fund allocation shall be provided by a qualified independent fiduciary."

What will happen with the clarified language: Including independent allocation in lifecycle mutual funds is easy and cost effective. With the suggested language, independent allocators would be paid a small fee, perhaps 5 to 10 basis points to (1) design the reallocation strategies that their lifecycle mutual fund clients will follow over time and (2) select the proprietary funds used in the lifecycle programs. The suggested language will bring new independent allocators to the market and encourage the current firms to drastically reduce their pricing, which will benefit plan participants.

Further, we believe that removing the ability of parties in interest to self-deal will *increase* assets in lifecycle mutual funds. Years of negative publicity have greatly reduced the level of trust plan sponsors and employees have in fund companies. Eliminating the potential to self-deal by including an independent fiduciary in the process will help restore that trust and make proprietary lifecycle funds easier to sell. Some fund vendors understand this and have pro-actively added independent allocators. An example is Pioneer Investment Management, which recently turned over the control of their lifestyle fund allocations to Ibbotson Associates, an independent financial expert.

As the tort bar turns its attention to the retirement savings industry, Pioneer's use of an IFE lowers their litigation risk and, presumably, their fiduciary insurance premiums. In fact, we believe that the costs of the proposed independent allocation services will be offset by reductions in liability insurance premiums - as the risk of litigation is effectively eliminated. More importantly, the premiums paid by plan sponsors who select lifecycle mutual funds that use an IFE should also be lowered.

Clarifying the Definition of Managed Accounts

The undersigned was a consultant to SunAmerica through its bid for discretionary account management in qualified plans (Department of Labor Advisory Opinion 2001-09A or "The SunAmerica Advisory"). Reporters who covered the landmark ruling did not have a name for the business method described, so used the term "managed accounts". Unfortunately the name stuck. As a result, SunAmerica-compliant "managed accounts" have become confused with retail Separately Managed Accounts ("SMA's") and wrap accounts. I characterize the terms as unfortunate because, contrary to ERISA rules, SMA's and wrap accounts allow a brokers and registered reps to charge a very high fee to construct and assign portfolios of funds from which they receive variable income.

To address this confusion, and to ensure wrap accounts do not find their way into qualified plans, Zacks IFE suggests that managed accounts, as default investments, be required to include the safeguards described in the SunAmerica Advisory. There, the Department of Labor confirmed that a discretionary account was not a prohibited transaction so long as its construction and assignment were under the control of a qualified independent financial expert that has no economic interest in the underlying funds.

Why this issue should be addressed: Discretionary accounts controlled by a party in interest are inconsistent with ERISA, the Pension Protection Act, and the Department's default guidelines, which state, "The Department believes that when plan fiduciaries are relieved of liability for underlying investment management/asset allocation decisions, those responsible for the investment management/asset allocation decisions must be investment professionals who acknowledge their fiduciary responsibilities and liability under ERISA." (29 CFR Part 2550).

What will happen if this is not addressed: The Pension Protection Act goes to great lengths to reduce self-dealing by requiring that advisors either receive flat fees or relinquish advice allocations to a computer-generated model. Without a clearer definition of managed accounts, these protections may be sidestepped, as parties in interest can conveniently confuse "advice" and "managed accounts". We worry that initial advice, provided for a flat fee, will quickly transform into a managed account that allows the broker to self-deal and skew the allocations towards funds that provide the most generous compensation. This risk is so clear, that firms such as Dalbar have launched PPA audit services to ensure this does not occur in a phone center environment.

An example of suggested language: The default guidelines should contain language that states: "The definition of managed account was established in Department of Labor Advisory Opinion 2001-09A, wherein an independent financial expert controls the construction and assignment of participant allocations."

What will happen with the clarified language: The suggested language will eliminate the confusion between transactional advice and ongoing managed accounts. Further, it will ensure that high fee SMA's, controlled by parties in interest at high additional fees, have no place in qualified plans. Since managed accounts under the SunAmerica model are based on computer algorithms, allocations are consistent among employees with similar facts and circumstances and simple for plan sponsors to monitor. Over \$30 billion has been invested in SunAmerica-compliant managed accounts to date, meaning the business method is established and administratively feasible. Since enrollment and communication costs are greatly reduced in autopilot programs, we would expect this clarification would force current IFEs to reduce their pricing. This will result in higher levels of retirement income for plan participants and their beneficiaries.

ERISA fiduciaries are required to remove real or potential conflicts of interest. The best way to eliminate conflicts of interest is to eliminate the potential for parties in interest to self-deal. Towards those ends, we hope that the Department will consider expanding and clarifying the role of independent fiduciaries, as suggested in our comments.

Thank you for your consideration.

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