THE WAGNER LAW GROUP
A PROFESSIONAL CORPORATION
99 SUMMER STREET, 13TH FLOOR • BOSTON, MA 02110 • (617) 357-5200

FACSIMILE
(617) 357-5250

E-MAIL
marcia@wagnerlawgroup.com

WEBSITES
www.erisa-lawyers.com
www.wagnerlawgroup.com

November 10, 2006

By Federal Express

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

ATTN: Default Investment Regulation

To Whom It May Concern:

We appreciate the hard work of the professionals at the Department of Labor (the "Department") in proposing this regulation in so short a timeframe. We hope that these comments will assist the Department in improving the regulation, so that even more plan sponsors benefit from making default investments safer and more protective of participants and beneficiaries.

Risks for Plan Sponsors

The regulations state that persons who make the decisions with respect to the default alternatives are responsible under ERISA for the selection and monitoring of the selected alternatives thereafter. The person so responsible is typically the plan sponsor. We are concerned that the current structure of the regulation leaves many questions unanswered for plan sponsors and may place them unnecessarily at risk, and that this is particularly the case for small plan sponsors.

We are also concerned that by specifically naming and describing certain types of asset allocation funds, the Department is implicitly indicating that there is not any issue with respect to the manner in which plan providers have chosen to structure their funds. We believe that this may be a disservice to plan sponsors, particularly small plan sponsors, who tend to be less aware and sensitive to the fact that the regulation does not address the legality of the structures and does not provide any relief for the operation of the investment structure created by the person who performs the asset allocation.

Risk Posed by a Particular Type of Vehicle

This risk may be most acute because one of the types of vehicles specified under the regulation, in most cases, involves undisclosed and unregulated self dealing or self dealing that is prohibited by ERISA. Such vehicle places plan sponsors at added risk by enhancing and increasing their responsibility for such a selection, and for monitoring thereafter. Selection of such vehicles also may require additional disclosures which note actual and potential self dealing and the effect thereof on investment returns and risk.[1]

Small plan sponsors are at added risk since they tend to be less aware of the risks and are least able to determine whether such vehicles are appropriate, and may be required to hire persons to assist them, which is complicated by the fact that many of the persons who are qualified to assist them are also conflicted with respect to their monitoring and review, which is another fact that most small plan sponsors will not know. An investigation by the SEC confirmed that a high percentage of pension consultants surveyed have conflicts of interest.[2] Finally, even where potential and actual conflicts of providers and consultants are understood, small plan sponsors do not typically have the economic clout to negotiate protections when vendors choose to structure these vehicles in a manner which facilitates and enables self dealing.

The vehicles in question are tiered asset allocation mutual funds, which are mutual funds consisting of shares of other mutual funds, otherwise known as a "fund of funds", in which the assets are allocated amongst the underlying mutual funds by the fund's investment advisor, for example, life cycle funds. The underlying mutual funds almost always charge different fees; thus, the allocations result in higher or lower fees and/or profits to the investment advisor. Such allocation would constitute prohibited self dealing if the allocations were subject to ERISA's prohibited transaction protections. This places plan sponsors who are evaluating such vehicles in the difficult position of not fully understanding or, if understanding, then ignoring the inherent conflicts.

It may not be prudent to ignore the conflicts, because a number of mutual fund advisors have recently demonstrated that they did not hesitate to act to increase their own fees, even where such actions are inconsistent with their prospectuses and applicable law (e.g., market timing and insider trading). In point of fact, Professor Nicolaj Siggelkow of the Wharton School has demonstrated a systemic and pervasive tendency for mutual fund advisors to maximize their own fee income or profits.[3] It follows that there is the potentiality and indeed a likelihood for at

---

[1] A growing body of case law deals with the fiduciary duty to disclose relevant information to plan participants and beneficiaries. A preeminent text regarding Title I issues, ERISA Fiduciary Law (Serota, Susan P., ERISA Fiduciary Law, Bureau of National Affairs (1995)), has added a chapter in its supplement (Chapter 16) which addresses this topic, in recognition of its growing importance. A number of cases cited in this Chapter take the position that fiduciaries are required to disclose facts that are material to a participant's decision that are typically not known to participants. In this connection, plan fiduciaries who select certain investment vehicles may be required under ERISA to disclose conflicts of interests inherent in such vehicles.

[2] See, SEC Staff Report Concerning Examinations of Pension Consultants, May 16, 2005.

[3] Siggelkow, Nicolaj, "Caught Between Two Principals," Wharton School, 2004.

least some asset allocation mutual fund advisors to maximize their fees and profits by modifying the underlying asset allocations. Professor Siggelkow's research indicates that mutual fund advisors will generally seek to maximize their profits; there is no reason to believe that tendency could not or might not affect asset allocation in an asset allocation mutual fund, which could corrupt the asset allocation process. Here, the conflict of interest is not regulated, or even required to be disclosed by federal securities law, and the amounts to be gained by skewing asset allocation are potentially enormous. Therefore, it would require quite a leap of faith to assume that no mutual fund advisor would skew asset allocation in tiered asset allocation funds to increase its fees.

This means that plan sponsors who do not examine the asset allocation to determine whether it is skewed may be at some fiduciary risk. This type of risk was recognized by the Department of Labor when Secretary Alexis M. Herman in her letter of July 19, 2000 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. These bills would have effectively removed investment advice from the application of the prohibited transaction protections, enabling the provision of conflicted advice with little safeguard from abuse.

The Secretary opined:

> "The 'Retirement Security Advice Act' would effectively leave retirement plan participants and beneficiaries vulnerable to bad and, in some cases, conflicted investment advice with little or no meaningful recourse if they rely on it. The bill would create a statutory exemption from the prohibited transaction rules for 'fiduciary advisers' who provide investment advice to a plan, or to its participants or beneficiaries. Such advisers would be required to disclose their fee arrangements and interest in any assets they recommend for purchase or sale (along with other required disclosures); in return, they could not be held liable under ERISA's per se prohibitions for the advice they render. Participants harmed by the advice would have to show that the advice was imprudent, a much more difficult task than showing a conflict of interest. This alteration of the rights and remedies that currently govern the provision of investment advice would place the risk of bad investment advice squarely on the participant. . . ."

and, in the undersigned's opinion, the plan sponsor that arguably imprudently hired such adviser.

With respect to the ERISA Modernization Act, the Secretary opined:

> "The changes would weaken or eliminate rules designed to prevent the abuse of benefit plans by persons who profit from their dealing with plan funds. 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 and monitor

services and are most knowledgeable about the market to persons who hire and monitor such persons, usually plan sponsors, who typically know far less. We believe that such a shift would lead to abusive arrangements. 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."

Arguably, the only way a plan sponsor could fulfill its fiduciary obligations with respect to selecting and monitoring a conflicted investment adviser would be to have an independent expert review and approve the adviser's algorithms or "black box" used to create the recommended investment allocations. This would likely be cost prohibitive and practicably unworkable to all but the largest and most sophisticated plan sponsors. If enacted, the Secretary was effectively arguing that these or similar bills would have placed extremely significant burdens not only on plan sponsors with increased and significant fiduciary exposure, but on plan participants, as well. The inappropriate incentives inherent in conflicted advice may lead to inappropriate investment allocations, resulting in increased risk to plan participants and/or lower investment returns. The author respectfully submits the same issues Secretary Herman was concerned about very much exist with respect to tiered asset allocation mutual funds.

Are Tiered Asset Allocation Mutual Funds Consistent with ERISA?

Mutual fund advisors take the position that because asset allocation occurs within a mutual fund that owns shares of other mutual funds, ERISA is not applicable because it provides that mutual fund shares do not constitute plan assets. They rely on two provisions in ERISA: Sections 3(21) and 401(b).

Section 3(21)(B) provides:

> "If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940, such investment shall not **by itself** cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in this title, except insofar as such investment company or its investment advisor or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter."

Section 401(b)(1) provides:

> "In the case of a plan which invests in any security issued by an investment company registered under the Investment Company Act of 1940, the assets of

> such plan shall be deemed to include such security but shall not, **solely by reason of such investment**, be deemed to include any assets of such investment company."
>
> (Emphasis supplied in each case.)

The wording of these sections indicates that, under some circumstances, the assets in a mutual fund could be considered to constitute plan assets. The legislative history of ERISA provides guidance with respect to the factors a court may apply in determining whether mutual funds shares in tiered arrangements should be considered plan assets and whether the mutual fund advisor should be considered a fiduciary under ERISA.

The Conference Report accompanying ERISA provides at page 296 that "[s]ince mutual funds are regulated under the Investment Company Act of 1940 ...it is not considered necessary to apply the fiduciary rules to mutual funds merely because plans invest in their shares. Therefore, the substitute provides that the mere investment by a plan in the shares of a mutual fund is not to be sufficient to cause the assets of the fund to be considered assets of the plan. However, a plan's assets will include the shares of a mutual fund held by the plan."

A report by Senator Long of the Committee on Finance provides guidance on the protections in the Investment Company Act that the Congress that passed ERISA may have found to be sufficiently protective.[4] That Report provided as one reason, at page 103, that "[m]utual funds are currently subject to substantial restrictions on transactions with affiliated persons under the Investment Company Act of 1940...." (emphasis supplied).

This indicates that the exception, by which mutual fund shares do not constitute plan assets, may have been premised on or predicated upon protections against transactions that are analogous to the prohibited transaction protections in ERISA. This would argue against the application of the exception to tiered asset allocation mutual funds where the investment advisor performs the asset allocation for the following reasons:

1) By normal statutory construction, the entity (e.g., a mutual fund advisor) asserting the exception from remedial scheme has the burden of proof to show it is excepted therefrom. This could be a significant hurdle to overcome given the inherent conflicts of interest and the above-cited legislative history.

2) An exception from the remedial scheme could not have contemplated tiered asset allocation mutual funds where the advisor does the allocation, as such investment structure did not exist at that time.

[4] The Report accompanied the Comprehensive Private Pension Security Act of 1973, S. 1179.

3) Available legislative history indicates that the underpinning for the mutual fund exception was premised on protections against self interested transactions that are part of the Investment Company Act. Given that the tiered asset allocation mutual fund structure has no protection whatsoever against self dealing and does not even require disclosure of the self dealing, this supports the conclusion that no relief is provided from the self dealing inherent in tiered asset allocation mutual funds.

4) It is required under well established rules of statutory construction to give the limitations contained in ERISA Sections 3(21)(B) and 401(b)(1) meaning. Therefore, persons who argue for the application of the exception to tiered asset allocation mutual funds must presumably, at a minimum, postulate other more abusive structures to which these limitations apply other than those that imbed the necessity of continued and repeated acts of classic self dealing, as in tiered asset allocation mutual funds.

5) Litigation that may determine this issue would likely arise in a context involving abusive arrangements that would not be favorable for persons asserting the application of the exception.

Some may argue that given the widespread use of tiered asset allocation mutual funds and their acceptance in the marketplace, courts would be loathe to disturb their operation. This line of argument would be more persuasive if many of the same people who may make such arguments had not made similar arguments with respect to insurance company general accounts. These arguments did not persuade the Supreme Court when it rejected an interpretative bulletin issued by the DOL and held that insurance company accounts did, in fact, hold plan assets.[5]

Impact on Plan Sponsors/Fiduciaries

If it is ultimately determined that mutual fund shares in a tiered asset allocation fund constitute plan assets, it would likely affect fiduciaries who invest in these funds, as a court could more easily find an investment in tiered funds, with imbedded conflicts of interest, constitutes a fiduciary breach. In such a case, the fund advisor itself would be more clearly liable under ERISA and would probably be the main target of lawsuits. The amount of the potential liability on some fund company advisors could affect their very viability and ability to honor indemnification agreements with plan sponsors/fiduciaries. This effect would be more severe the more successful an advisor is in marketing asset allocation funds where it performs the allocations.

[5] See, John Hancock Mutual Life Ins. v. Harris Trust & Sav. Bank, 510 U.S. 86 (1993).

Conclusion Concerning Tiered Asset Allocation Mutual Funds

The selection and monitoring of tiered asset allocation mutual funds raise a number of issues for plan sponsors under ERISA. These issues are more acute for small plan sponsors. Consequently, the undersigned believes that the Employee Benefits Security Administration ("EBSA") has failed to comply with certain procedural requirements generally applicable to rulemaking. Specifically, this proposal is insufficient as to requirements of the Regulatory Flexibility Act (5 U.S.C 601, *et seq.*) Although EBSA has certified that this proposal will not have a significant impact on a substantial number of small entities pursuant to 5 U.S.C. 605(b), and accordingly has not performed the initial regulatory flexibility analysis otherwise required under 5 U.S.C. 603, the undersigned does not agree that the factual basis for the certification supports its conclusion. Among other things, because EBSA's certification did not address the impact on small businesses facing the Hobson's choice of expending assets and resources (in a manner that is disproportionate as compared with larger businesses, many of whom have the capability to perform the analysis in house) in either (i) determining whether the asset allocation of tiered asset allocation mutual funds is skewed, or (ii) facing potential liability by reason of the failure to do so, EBSA's certification did not comply with the Small Business Regulatory Enforcement Fairness Act. Therefore, this deficiency requires EBSA to conduct a supplemental Initial Regulatory Flexibility Analysis ("IRFA") before publishing the final regulations which take concrete steps to ameliorate the risk posed by self dealing.

In this connection, the undersigned notes that two of the three categories of investment that may be used as defaults may consist of tiered asset allocation mutual funds, and that such funds may, in fact, be the most appropriate for a small business, if their structure did not potentially involve self dealing. The same Congress that passed the Pension Protection Act of 2006 and directed that the Department issue regulations to provide a safe harbor for default investments that are addressed in this regulation also addressed conflicts of interest in connection with asset allocation advice. This Congress provided that advice that could involve a conflict of interest could not be provided absent specific protections and disclosures by the conflicted person, designed to address and reduce the impact of the conflict of interest. It appears to be contrary to the intent of this Congress to specify as permissible investment alternatives those which are designed to provide for unregulated and undisclosed conflicts of interest in connection with active asset allocation.

The undersigned believes that it would be more consistent with the intent of Congress for the Department to require that investment vehicles, that have imbedded conflicts of interest, to adopt the protections in the exemption for investment advice in the Pension Protection Act of 2006 to reduce and disclose conflicts of interest. For example, a mutual fund advisor of a tiered asset allocation mutual fund could be required to either use algorithms of an independent third party for asset allocation or to at least have its own algorithms certified by an independent person as not biased, and then have the actual asset allocation audited to ensure that allocations are made consistently with the independent or certified algorithms. This is not impractical as evidenced by the fact that at least two major money managers currently utilize algorithms from

an independent person to allocate assets in tiered asset allocation mutual funds. This approach could make it possible to have a single certification and audit rather than numerous certifications and audits of the asset allocation methodology that may otherwise be required. Even if additional review by the plan sponsor were appropriate, an existing certification and audit could reduce the costs as an additional examination could start with the existing work as a base certification, rather than starting from scratch. This would reduce the costs for all plans, and should increase the use of the safe harbor in a manner that is clearly consistent with the intent of the same Congress that passed legislation containing the safe harbor that is addressed by this rule.

Also, the Department should consider requiring that any investment adviser of a tiered mutual fund not provide indemnification to larger plan sponsors unless it also provides the same indemnification to smaller plan sponsors. This will help to level the playing field for smaller plan sponsors who do not have the economic clout to negotiate protections for issues which arise due to the aggressive structures (tiered allocation mutual funds) chosen by some investment advisers.

If protective changes are not included, plan sponsors will incur additional expense and/or additional risks, which will fall most heavily on small plan sponsors. In this regard, existing case law requires preparation and distribution of disclosure concerning the conflict of interest inherent in most tiered mutual fund arrangements. It would be useful if the Department could suggest model language plan sponsors could use to disclose the conflict of interest inherent in most tiered mutual fund arrangements if the final rule does not eliminate the conflict of interest and therefore the requirement for such disclosure. Also, the Department should consider that fiduciary insurers who are aware of the risks will likely increase insurance premiums.

Therefore, the Department should remove tiered asset allocation mutual funds where the conflicts of interest are not eliminated or minimized as acceptable investments in the safe harbor. The Department should also conduct an IRFA before publishing the final regulations. The Department could finalize the regulation without tiered asset allocation mutual funds and then consider adding them back with appropriate protections after conducting an IRFA. Even if the final regulations are delayed, as noted in the preamble, plan sponsors can obtain similar relief, with fewer conditions, by simply appointing an investment manager who acknowledges its fiduciary status in writing.

Further Refine Demographics

The Department should provide additional guidance with respect to the selection of investment alternatives based on factors that are particular to a plan. For example, a plan sponsored by a fast food organization could have one group of employees whose average tenure is one year (working in restaurants) and another (managers) whose tenure is an average of seven years, and who also accrue valuable benefits under a defined benefit plan. While the first group would likely outnumber the second, the second would probably have the great majority of

current and expected assets in the plan. Under these circumstances, should the choice of a default alternative be based on the anticipated return to the plan as a whole, which would argue for more consideration of alternatives based on the factors of the second group, or should it be based on the majority of participants?

Also, the Department should address how the presence of a defined benefit plan might affect the analysis of which alternative a fiduciary should select for a plan. Academic studies demonstrate the importance of being on, or close to, the efficient frontier. An investment alternative that selects a mixture that does not take account of significant benefits earned or to be earned under a defined benefit plan is, by its very design, likely to miss the optimal range on or close to the efficient frontier by a large margin. This is because the benefit provided under a defined benefit plan is very similar to a bond fund, and will generally cause a participant's account to be over-weighted in bonds unless the defined benefit is taken into account. It would be useful to know whether this has to be considered when selecting an investment alternative, and the weight that should be given to this factor. Should a fiduciary make its investment alternative decision based on the risk/reward to most of the assets in the plan or to the majority of participants? Should a fiduciary take into account the fact that the longer-term employees with the largest account balances in the plan will also tend to have the greatest accrued benefit in the defined benefit plan, and take into account the "signaling effect" (i.e., the sponsor has picked this fund which encourages others to invest in it) the default investment choice will have even with respect to participants who are placed in the default alternative?

Fiduciary Consideration of Two Default Alternatives

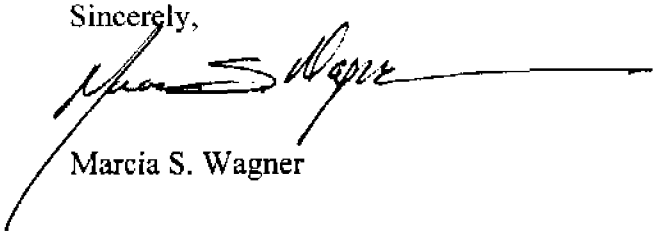
In some plans, such as the examples above, different alternatives may better serve the needs of different groups. To what extent should consideration be given to having two or more default funds when the demographics of two or more groups in the plan are very distinct and different? Should the cost of having two or more default investment funds in a plan be weighed against placing participants on or close to the efficient frontier; if so, should it be based on the anticipated amount of assets in each account over time? Would it be prudent to do such a comparison and document that a fiduciary has done so?

Issues may arise under the non-discrimination rules with respect to providing different alternatives to different groups. The Internal Revenue Service (the "Service") has stated that amounts contributed to plans in settlement of bona fide allegations of fiduciary breaches do not affect the non-discrimination rules concerning annual additions. It would be useful if the Department could coordinate with the Service to similarly address the provision of investment allocation assistance. In this connection, the Department might explore whether the Service would be willing to state that providing differing alternatives to different groups of employees in order to act consistently with fiduciary duty would not run afoul of the non-discrimination rules.

* * * * *

Thank you for your attention to and consideration of this comment.

Sincerely,



Marcia S. Wagner